The Financial Crisis: Strengthening or Weakening the EU?[1)]

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This article comments on some recent answers given to the old question 'Do we need a European economic government?' (gouvernement économique) which at the same time could also give an answer to the question of whether the EU will be strengthened or weakened by the current financial crisis. These questions were raised in the context of the preparation of the Washington Financial World Summit (G-20 summit, in public opinion also called 'emergency summit') by the EU Heads of State or Government in the run-up to their informal meeting on 7 November 2008. Angela Merkel gave her answer to the first question in her press briefing on the meeting's main results. The second question relating to the strengthening or weakening of the EU may be answered twofold: (1) from the point of view of the relation between decentralized and centralized institutions and competences, and (2) as far as the EU's role in relation to the USA and the rest of the world within a globalized economy is concerned.

The following comments are mainly focussed on the first aspect, namely concerning two reasons for interventions by any centralized authorities and competences like those of the EU, in particular dealing with the consequences of the Monetary Union (MU). Both of them are provided by well established concepts of economic theory, namely (1) the theory of Optimum Currency Areas (OCA) and (2) dealing with transnational (cross-border) aspects and externalities. Thus, the answer to the old question mentioned above under these circumstances is at a first glance a 'YES'. Under these conditions this would also mean strengthening the EU. For further and more detailed discussion see the respective articles in EUWatch, Issue 3 (October/ November 2006), on 'The Future of the Euro' and Issue 5 (February 2007), on 'Subsidiarity – A Limit to EU Competence?'.

Looking at the 'soft headline proposals' of the summit meetings' outcome, however, the correct answer would be 'weakening' rather than 'strengthening'. This can of course be seen definitely only when concrete results are visible in the spring of 2009 having put the headline proposals into action as intended by the summit proposals. Thus the main conclusion to be drawn at the moment is that any new institutional structure like an economic government is not sufficient. It only makes sense if we have substantial policy concepts which (as a necessary condition) should be realized by this new structure. These concepts are - despite all summit efforts - still missing or at least not yet visible.

The former Austrian Chancellor Alfred Gusenbauer (in office until the new federal government was appointed on 2 December 2008) recently stated in relation to the financial crisis: 'I do not want to imagine where we would stand today, if we did not have the Euro. … The Euro is the only currency which was not attacked by speculation, it has established itself on the market as the strongest currency and it functions as a stability anchor.'

Yes, he may be right, but it applies only within the context of the financial markets' view [Finanzwirtschaft]. In terms of the 'real' economy [Realwirtschaft] there is no reason to forget all the economic and social disparities between Euro-countries putting the Monetary Union (MU) at risk – even of its collapse, in particular if compensation mechanisms (for some examples see below) are not sufficient in the absence of the well known criteria of an 'Optimum Currency Area' (OCA). These criteria are in particular wage flexibility, labour mobility and freedom of capital. Only a political union could ultimately guarantee all the functioning of these compensation mechanisms. This was pointed out clearly by the OCA economists, among them Robert A. Mundell (Nobel Prize winner in 1999) and Paul De Grauwe (distinguished financial economist at the University of Leuven and adviser to EC President Barroso) – see the interviews with De Grauwe reprinted in EUWatch, Issue 3 (Oct./ Nov. 2006). One essential element of a political union and at the same time necessary (even if not sufficient by itself) condition for its functioning is an economic government.

So, undoubtedly, the Euro protects itself against irrational speculative currency attacks, but neither does it prevent slopping over of the crisis to the real economy nor does it remove real economy [realwirtschaftliche] disparities.

On the contrary, as the present automobile industries crisis and dramatically increasing unemployment show, the real economy crisis will even intensify. Irrespective of this, the Euro depends on the removal of these disparities by those mechanisms developed by the OCA theorists to minimize the risk of any MU collapse. Otherwise the consequence of the MU's breakdown is risked. Those who are sceptical towards more centralization in the fields of substantial policies that would create compensation mechanisms will have to shoulder the responsibility for having deliberately or negligently exposed the MU to the risk of failure or breakdown. These centralized compensation mechanisms consist either in providing more funds for the Union budget by additional financial contributions of the Member States or in introducing EU taxation – both in order to establish an efficient financial equalization system. This would become necessary in order to create some kind of insurance system (including also financing unemployment relief) against external economic shocks. Furthermore, it would imply more Union competences in economic policy matters which would no longer remain under the main responsibility of the Member States as it is under the present legal status of the Treaty.

So, given that the OCA criteria are not fulfilled, MU postulates as a 'first best' solution more centralization in the fields of economic policy matters including additional budgetary funding, but it does not mean centralization in all kinds of matter. We are faced with a rather complex structure of competences: some having to be centralized and others which have to remain decentralized, i.e. in the hands of Member States. In this sense, the OCA theory implications are twofold and even partly contradictory because they try to integrate two different and even conflicting economic paradigms. If Member States refuse to provide additional funding of the Union budget to counteract economic disparities among them, or if the introduction of a Union tax is not accepted, the 'second best' solution could only consist in maintaining sufficient budgetary autonomy at national level – even by allowing increasing national budget deficits to enable Member States to manage their economic problems at home by themselves. This, however, would conflict with the Stability Pact criteria leading to contradictions and inconsistencies between the supply-side oriented OCA conditions (flexibility of wages, labour mobility, freedom of capital movement within the MU) and the demand-side oriented national fiscal policy instruments. Whereas the former are being influenced by monetarist and so-called 'neo-liberal' ideas (focussing on cut-back management of public budgets), the latter is experiencing a Keynesian 'revival' of anti-cyclical budget policies. The main economic policy instruments, which - in this sense of 'second best' conditions - have to be kept in the hands of Member States (i.e. under primary responsibility of Member States according to the present legal status), concern employment policy and social policy matters.

To sum it up preliminarily: If the Union will not succeed in minimizing the risks pointed out by the OCA theory, the MU could collapse. Thus, the postulated political union should not only guarantee the functioning of compensation mechanisms, but also overcome deficits of political legitimacy of purely monetary economic integration. This has to be provided by changing the character of economic policy from a mere matter of 'common concern' which has to be coordinated (leaving the primary responsibility of Member States untouched) to a matter of primary Union responsibility, in addition to specialized economic policy sectors which are already part of the exclusive or shared Union competences. Employment and social matters, however, should stay under the primary responsibility of the Member States. This means that the existing coordination mechanisms in these areas should remain untouched, although parts of these areas may also get under pressure for more centralization, e.g. the harmonization of social insurance systems as a consequence of the common market freedoms. But in principal, keeping these areas decentralized can be well justified by the subsidiarity principle (cf. the Treaty formula 'better achieved' by the Union not being fulfilled). These aspects have been widely ignored by the OCA theory.

This leads to the second case in which centralized interventions are needed.

For this purpose let us consider the individual Member States as individual actors, and the Community/ Union as a whole as a collective actor. External effects (externalities, spillovers) mean that any individual rational activity which affects others for the better (in the case of external economies or positive external effects) or for the worse (in the case of external diseconomies or negative external effects) cannot be taken into account by these others paying for external economies or being compensated in the case of diseconomies. If these effects cannot be 'internalized', e.g. by direct negotiations on compensation payments between those causing and those being affected by these externalities, a 'higher authority', usually the State, will have to intervene.

This is especially so in cases where the external effect cannot be attributed to a particular group of individuals, or where market prices do not exist as a measure for compensation payments. The analogous model applies to the relation between the EU Member States as individual actors and the Community/ Union as a higher authority and collective entity that is capable of internalizing external effects between Member States (e.g. transnational environmental pollution). It can apply even in the case of transnational issues originating from outside the Community/Union and whose effects are unequally distributed between its Member States, e.g. the refugee problem.

In this situation too, considerations based on the subsidiarity principle come to the fore. Looking at the present financial crisis, EU and national interventions can also be justified by the subsidiarity principle in the case of cross-border effects of the crisis whose causes and consequences also have cross-border phenomena and therefore have to be dealt with in this context. Undoubtedly, we will need interventions both at national level and supranational (Union or even global) level. But at the same time interventions which occur exclusively on the national level are not sufficient (not efficient enough). Thus the main question is whether the problem can be 'better', i.e. more efficiently, solved at Union or national level (cf. the Treaty's subsidiarity formula 'not sufficiently achieved' by Member States, but 'better' achieved by the Union). Needless to say, in the age of globalization it is obvious that a centralized intervention – in this case by a central regulatory authority – is absolutely necessary. This argument becomes even clearer when we consider that deregulation of transnational capital flows following the freedom of capital ideology of the 'neo-liberal' economic mainstream paradigm has intensified globalization and, vice versa, globalization has evoked even more deregulation. In this spiral, the fateful and disastrous financial market innovations could prosper.

Under these subsidiarity aspects, should the OCA conditions not be fulfilled, a European tax on speculative financial transactions could be considered, not least to get additional funds for financing compensation payments. And, as such European tax may not be sufficient, a world-wide tax should be introduced. Yet even such kind of taxation would not suffice to counter speculative international financial transactions. Thus an EU-wide or even worldwide financial regulatory authority should be envisaged. Considering all these aspects when raising the question 'Do we need a European economic government?' to overcome all these negative phenomena, the answer undoubtedly would be 'Yes'.

Yet it should also be stressed that in the age of globalization a mere European financial regulatory authority, or even any kind of worldwide institutional structures are, by themselves, not sufficient. What seems to be necessary is a substantial concept which is foreseen to be realized by any new institutional structure like the idea of an economic government. There are serious doubts whether such a substantial concept already exists, given that it has not (or at least not yet) been provided by the recent European and world summits. Perhaps clearer results will be seen when concrete action plans based on the G-20 summit's concepts will come into effect next year.

It is pure coincidence that in the event of the financial crisis the question of a European economic government was again raised under the French presidency by Nicolas Sarkozy, as this is in line with an old French postulate based on the typical French tradition of étatism dating back to Colbert, the French minister of finance under King Louis XIV. It conflicts with the anti-statist neo-liberal mainstream, which perhaps will be overcome under the influences of the present crisis. These mainstream ideas were fully unfolded under the dominant ideology of the freedom of capital mobility established on 1 July 1990 and later linked to the first stage of the MU. Now we seem to harvest its rotten fruit.

In the mid-1990s, the Germans (Theo Waigel) advocated the Maastricht Stability criteria, strictly following the neo-liberal monetarist mainstream.

This was answered by the French proposal of a gouvernement économique which was immediately rejected by Germany because it feared that this would threaten the European Central Bank's independence. The outcome was (1) the adoption of the Stability Pact at the Amsterdam summit and (2) the establishment of the Euro-Group composed of the finance ministers of the Euro-countries as a compromise answer to the French demand.

Apparently Sarkozy – perhaps following his specific personal ambitions – is trying to revive the old idea of an economic government by setting up the Euro-Group in the composition of the heads of state or government. Yet this has not found consensus at the informal meeting of heads of state or government on

7 November 2008. Thus, the opportunity to institutionalize undoubtedly necessary re-regulation procedures of deregulated financial markets was wasted because not even the institutional structure to manage this kind of re-regulation has found consensus. Also, when differentiating between supervision and regulation, it is the supervision of deregulated markets that may be given priority, not necessarily more regulations. But even with respect to this more 'modest' approach, the summit did not give satisfactory answers. (The real cause of this may be found in the independence ideology of the ECB.)

Instead, the European leaders agreed on stressing the necessity of the existing coordination procedures among all 27 Member States (and not exclusively among the Euro-countries), whatever this could mean. In Angela Merkel's words: 'The Council in the composition of the heads of state or government… is of course a body dealing with economic questions – just call it economic government. The crucial point is that it covers all 27 Member States.'

When preparing the G-20 summit in Washington, one week after the European summit, the EU heads of state or government only found minimal consensus concerning an effective and efficient strategy to overcome the present crisis and to counteract all future irrational market manoeuvres. According to the German weekly news magazine SPIEGEL (No. 46, 10 November 2008) the European proposals to the Washington summit of 15 November have to be characterized as well-intentioned headlines rather than precise propositions. These proposals did not dare to foil the intentions of the US Treasury Secretary to bail out the banks with taxpayers' money but would not bail out the taxpayers with sufficient regulation or at least supervision of the banking sector.

According to SPIEGEL, it was expected that even these very 'soft' European regulatory proposals would be refused by the Americans in line with their strong neo-liberal anti-statist ideology (although, after all, the US administration is highly statist vis-à-vis citizens but not vis-à-vis the banking cartel). This ideology is still publicly advocated by the President in office (but not yet by the President-elect) who strongly opposes new regulatory state interventions and additional international 'super-authorities' to overcome the crisis. These soft European 'headline proposals' consisted of 'five specific approaches', namely to

- submit rating agencies to registration, surveillance and rules of governance;
- adopt principles of convergence of accounting standards;
- decide that no market segment, no territory, and no financial institution should escape proportionate and adequate regulation and at least oversight;
- establish codes of conduct to avoid excessive risk-taking in the financial sector, including the systems of remuneration;
- strengthen the role of the IMF by giving it initial responsibility, together with the Financial Stability Forum (FSF), of recommending the measures needed to restore confidence and stability.

The two most important proposals were expected to be the most controversial topics of the G-20 Washington summit. These were (1) the 'catch-all line' of complete and overall (global) regulation and oversight of all kinds of 'innovative' high-risk financial operations and products of the financial industries, including their location in 'tax havens' (third indent), and (2) overcoming the IMF's identity crisis by giving it a key role in avoiding future crises (last indent).

Nothing was said, however, on how all these proposals could be achieved and what kind of sanctions should be foreseen to make them effective. The FSF mentioned in the last indent would, according to the proposal, consist of high level officials of the G-7 finance ministries, central banks and financial supervision authorities. Similar recommendations had already been presented one month ago in the Forum-'s follow-up report on 'Enhancing Market and Institutional Resilience' to the G-7 finance ministers (see http://www.fsforum.org/). The same had been suggested by the OECD in its 'two pillar action plan in response to crisis': 'First, align regulations and incentives in the financial sector so that market operators act in a tighter oversight and risk management environment. Second, review and upgrade national policies and improve policy coordination at the international level to restore the conditions for economic growth.'

So what was the outcome of the Washington financial world summit, also publicly known as the 'emergency summit'?

Prior to the summit, expectations had been played down. It was said that the summit would only be the beginning of a longer process (without saying in what direction) and that there would be no Bretton Woods II. It was not officially stated of course, that the real reasons of this modest outcome had to be seen in the light of the fact that national interests, influenced by the financial corporations (mostly located in the City of London and Wall Street), were still too divergent, even across Europe, when it came to the hardly-veiled old conflict concerning the establishment of an economic government. President Bush, who hosted the summit, consequently stated in his opening address 'that the problem did not develop over night, so it will not be solved over night'. Of course he did not say that regulators had 'overslept' the whole problem, as Barry Eichengreen (distinguished financial economist at the University of California in Berkeley) said in an interview with Frankfurter Allgemeine Zeitung (FAZ). Moreover, the President-elect avoided taking part in the summit. Apparently he did not want to be associated with a possible failure of the summit, as commentators said.

In the aftermath of this modest outcome, going back to the initial question ('Financial crisis: strengthening or weakening the EU?') the answer would more likely have to be 'weakening', rather than 'strengthening', and that the casino behaviour of financial market operators will be prolonged (the heart of the beast presumably has to be located in the secretive US Federal Reserve which is controlled by the banking cartels, not by the Treasury or even the Congress). By abstaining from 'clear-cut' interventions into anarchic, boundless and irrational financial market behaviour, political leaders will not succeed in getting back the ghost of unlimited (non-supervised) deregulation into the bottle. They do not recognize that they weaken themselves by it.

This is paradoxical. To escape the paradox, the most efficient risk management that could be adopted would include prohibiting all kinds of so-called financial market innovations which go beyond conventional share trading on the stock exchange. The latter would still comprise enough speculative elements to evoke the traders' and their clients' thrills, and leave the principles of free market economy and 'good old' capitalism untouched. There would be enough range for their deployment. These dubious 'innovations', also showing at first glance impressing new coinage (neologism), are short selling, derivative market operations, hedge fund industries, credit default swaps (CDS), the creation of real estate 'bubbles' by bundling and selling subprime mortgages, asset-backed securities (ABS), collateral debt obligations (CDO). All this has perverted risk sharing. What originally was believed to be a useful instrument now turns out as a virtual attempt of risk abolition by shifting it away. This was managed by creating tradable products labelled as useful 'financial innovations', which in fact were high-risk speculations, perverting stock exchange to betting offices. In short, the banking institutions' created credit out of thin air, i.e. derivatives – multiple credit that does not exist because it has no real collateral, but on which they receive interest. Like a 'pyramid scheme', its survival depends on the creation of more credit for new clients.

Of course, any prohibition hurts purism of market radical neo-liberalism, in particular in its Anglo-Saxon version (not so much however, as far as the German tradition of social market economy, the French tradition of étatism, the Austrian tradition of social partnership and the Scandinavian welfare state tradition are concerned). But it has to be recalled that neo-liberalism only legitimizes the interests of the financial capital, not those of the 'real' capital, as the Austrian economic researcher Stephan Schulmeister pointed out recently.

The SPIEGEL (No. 47, 17 November 2008) bluntly stated that the crash had been caused by capital crime and compared the bankers to sports car drivers supervised by policemen on horsebacks. It is feared that this would not be changed, even by transnational supervisory authorities, because 'money is like gas, it is not possible to get hold of it, it always searches for the fastest way to maximum profit.' Only prohibitions could help in this situation.

Yet this radical solution will not be applied, not even approached, given that the US strictly oppose any kind of 'heavy-handed' intervention. This did, however, not hinder the US to pump such amounts of [fresh] dollars into banks, which only cynics would not regard as a heavy-handed intervention: 700 billion US Dollars were provided by the Treasury Asset Relief Program (TARP) as defined under the Emergency Economic Stabilizing Act, and, according to CNBC, the complete 'Financial Crisis Balance Sheet' (including Federal Reserve operations, Federal Housing Administration operations and others) amounts to the unimaginable sum of 4.2 trillion US Dollars (see http://www.cnbc.com/id/27719011).

European countries did the same providing huge amounts partly for guarantees and partly for increasing the banks' capital resources. Even if the money has to be paid back within a few years after the bank's 'recreation', these measures do not mean granting a loan but in fact nationalization of property shares (at least limited in time) corresponding to the amount granted by the State, although in legal terms no strict conditions securing the State's interests are to be stated. The German 'rescue package' amounts to 500 billion, the Austrian one to 100 billion Euros.

The explicit summit commitment 'that any reforms must be in line with free market principles' has underlined further abstention from 'heavy-handed intervention', of course with the exception of monetary grants. The summit has contented itself with the aim of possibly reaching the most modest success: that (at least) the risks linked with the above mentioned financial market 'innovations' could be made transparent. This could be reached by closer cooperation, common and more effective standards of regulation, supervision and rating. Only for this purpose, broad principles and a detailed action plan were set out. But it was made clear that all this would only be the beginning of a longer process of regulatory reform, the first steps of which are foreseen to be agreed in a follow-up summit meeting in the spring of 2009.

Much of the consensus seemed to be achieved in relation to the overall regulation and oversight of all kinds of financial market operations. According to the Financial Times, European leaders won a partial victory in this regard. No clear consensus was achieved, however, on the future role of the IMF. Major concerns still seem to persevere in Asian and Latin American states, not least because of their negative experience with the Fund's strictly neo-liberal policy reform proposals in the past, and in the US, probably due to its general scepticism towards international organizations. There is no doubt, therefore, that the creation of a world financial supervision authority remains utopian. Agreement was only reached to set up supervisory colleges consisting of national supervisors and regulatory authorities for major cross-border financial institutions. Regulation of the financial sector will thus remain under the primary responsibility of the nation states. In the above-mentioned interview Barry Eichengreen raised doubts with respect to the efficiency of such a college, because there would be 'much discussion but less decision'. He would clearly prefer a 'World Financial Organization (WFO)' analogous to the WTO, enabling each country to follow its own policy but submitting itself to common standard rules. In his view, this could be a compromise between the present status of insufficient national regulation, which undoubtedly is not satisfactory, and the illusion of a global supervision authority.

So the real outcome of the summit effort is: Let us wait and see. It is feared that this does not give rise to optimism. Meanwhile, tax payers' money keeps bailing out the failed financial institutions.

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