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# The Economic Crisis and Governance in the European Union

## A critical assessment

Edited by
Javier Bilbao-Ubillos

ROUTLEDGE

# The Economic Crisis and Governance in the European Union

This book explores the way in which the financial crisis that began in the US spread to the economy of the European Union. It takes a critical look at the measures adopted by EU institutions in response to that crisis, seeking to explain the rationale behind them, their context, their development and why different exit strategies were not adopted. In doing this, the book makes comparisons with the measures adopted by institutions in the US and the UK.

As the crisis has shown that the financial supervision frameworks prevailing in 2007 were not fully able to deal with the largest financial crisis in history, this volume also reviews the proposals that have been designed to reform the supervisory architecture of financial services in the EU.

The book concludes that the EU member states under most pressure from financial markets do suffer from intrinsic problems, but that the economic effects of the crisis have been exacerbated by shortcomings in economic governance within the EU.

This work will be highly relevant to policy makers and scholars looking at EU integration, finance and market regulation.

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## A critical assessment

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# 1 Introduction

*Javier Bilbao-Ubillos*

The governance of the economic crisis in Europe has become a topic of undoubted current interest. There are two main reasons for this:

- On one hand, the economies of Europe are facing a crisis of a magnitude and complexity not seen for decades: most European Union (EU) Member States have slipped back into recession in the first quarter of 2013 without having recovered from the major shrinkage that they suffered in 2009. The effects of the credit crunch can still be felt in matters such as access to funding[1] and problems in the balance-sheets of banks; and what looked like the certain break-up of the euro has barely been avoided, with some countries suffering a sovereign debt crisis and Cyprus hovering on the brink of abandoning the common currency in March 2013.
- On the other hand, Member States have been unable on this occasion to make fully autonomous use (at national level) of a number of conventional economic policy instruments that would have helped them to tackle the recession. These constraints have affected members of the Eurozone in particular (countries which not only have no individual monetary and exchange policies but have also lost part of their freedom to manage their own fiscal policies).

Thus, progress towards European integration has meant that the Member States of the EU as a whole are having to face up to the economic and financial crisis with no possibility of resorting to trade policies and with fiscal policies subject to a number of constraints that have recently been exacerbated in the formulation of the new Stability and Growth Pact (SGP) and the entry into force of the Treaty on Stability, Coordination and Governance (TSCG) for all countries in the EU-27 except the United Kingdom and the Czech Republic. But Eurozone members no longer have the option of resorting to changing their exchange rates and interest rates (methods that have traditionally proved useful in economies suffering from asymmetric shocks).

Until now, the consequences of handing over authority for economic policy to supranational EU bodies had never been tested under adverse circumstances. In this sense, the current crisis has posed an enormous challenge to the architecture of economic governance designed in the EU, which seems not to have worked as dynamically or effectively as necessary: hence the topicality and interest of the study undertaken in this book.

With this in mind, the book is divided into two main parts:

- Part I focuses on the roots and structural weaknesses that have proved conducive to the propagation and, above all, duration of the economic crisis in the European Union, where its impact has been felt for longer than in other institutional contexts. Some of the elements that sparked the current situation can be found in the very institutional design and construction of European Monetary Union (EMU). The authors of the Delors Report of 1989 (which provided the basis for the drawing up of the Treaty of European Union in those points concerned with EMU) were aware that the future monetary union could not be provided with a mechanism for the transfer of public resources, and that it would be difficult to achieve enough labour mobility and price/wage flexibility to tackle an asymmetric shock (Garcia-Durán and Millet 2012: 114). As pointed out by Bergsten (2012: 110), Europe embarked on a broad, but incomplete, process of monetary union backed by the euro and the European Central Bank (ECB); but the process included practically no economic union (e.g. no fiscal or banking union), no institutions for sharing economic governance and no effective co-ordination of structural economic policies. But besides this, Part I analyses specifically the model of economic growth of the preceding decades, the different financial supervision architectures, the institutional framework of the Eurozone in terms of attaining short-term macroeconomic policy objectives, and the way in which decision-making processes are regulated.
- Part II examines the praxis of economic governance as actually carried out in the EU during the management of the economic crisis, and takes a critical look at the dysfunctions that have led to its disappointing economic results. To that end it looks at the economic policy guidelines that have prevailed in the strategies drawn up for exiting the crisis, at the effectiveness of the decisions made by the EU and at the way in which the debt and banking crises have been handled. It also examines what some authors have called "conflicts between national interests" (Comín 2012: 37): it is argued that such conflicts may have given rise to asymmetries in the capacity for political influence in joint decision-making and in the possibility of adapting the "rules of play" to the needs of each country.

The chapters that make up the two parts have been put together as follows: Part I, which is clearly focused on the historical development of the process of European integration, looks mainly at institutional points and at matters of context in the formulation of economic policies, including the distribution of authority among Community bodies and national institutions. Accordingly, the four chapters in Part I are set out as follows:

- Chapter 2 analyses the model of economic growth of the preceding decades, paying particular attention to the changes made in the theories of economic policy and the lesser degree of freedom that results from the formidable external restrictions imposed by ever more voluminous and internationalised financial markets, which make it harder for many countries to draw up more autonomous policies.

Some authors argue that, in the context of the economic and social prospects envisioned for the next decade, there are powerful reasons that point towards a certain return to the idea of active, changing macroeconomic policies. That is to say, public and market policies should advance towards a new, more stable balance. This will require greater autonomy for policy and the reintroduction of pragmatic controls on transnational movements of capital. Should this not be done, it is very likely that the international economy will face further, highly serious crises.

- Chapter 3 reviews the different arrangements in place for the supervision of the financial sector and the proposals for reforming this architecture of the supervision put forward from 2007 onwards in some countries; it compares and assesses how well they are suited to the needs identified in the relevant jurisdictions. The European Banking Union (with the initial launch of the Single Supervision Mechanism), the abolition of the single supervisor in the UK and its replacement by a twin peak supervision model and the Dodd-Frank Act (which implements regulatory and supervisory reform in the US) are described and analysed. Progress in the area of financial stability has been generalised as evidenced by the changes introduced in the three jurisdictions, which have provided financial authorities with instruments to develop a macro-prudential policy.
- Chapter 4 analyses the shortcomings in the institutional framework of the Eurozone in terms of attaining short-term macroeconomic policy objectives. Special attention is paid to the distribution of areas of authority between national governments and supranational bodies in matters of monetary policy, control of fiscal policy instruments, supervision of the financial system and management of government debt.
- Finally, Chapter 5 looks at the structural limits of economic governance in the EU, focusing primarily on the way in which decision-making processes are regulated, which hampers the early diagnosis of problems and prevents sufficiently fast and flexible responses from being made. It is argued that the seriousness of the crisis, combined with the economic and demographic prospects, will force a rethinking of the conditions for the pursuit of profit and lead to progress towards a new, sustainable concept of development and a reorganisation of the welfare state.

Part II takes a critical look at the response strategy implemented by the EU in managing the economic crisis, and seeks to expose the shortcomings in terms of governance and the dysfunctions inherent in the measures taken (and in the failure to take others), which have exacerbated the problems and furthered a lack of confidence among financial operators. The chapters look first at general aspects (the drawing up of exit strategies in the governance of the crisis in

Europe, the economic policy benchmarks that have guided decision-making and the consequences of the actions taken in terms of economic policy) and then at more specific points, i.e. points which are highly important but which affect specific aspects of economic intervention (such as the way in which sovereign debt crises have been treated).

These chapters are structured as follows:

- Chapter 6 starts from the premise that there were structural shortcomings in the design of the Eurozone (comprising as it did countries with widely differing fabrics of production and levels of competitiveness that did not constitute an *optimum monetary area*) and then sets out a reasoned argument asserting that the architecture of economic governance in the EU has serious failings in its ideological aspects (design of a coherent exit strategy) and in its institutional aspects (procedures, irreversibility and implementation periods of the decisions made).

  As a result, the EU's response to the crisis has been late in coming, hesitant and sometimes lacking in sufficient force. There have also been contradictory measures taken over the course of the management of the crisis, as evidenced in the brusque changes of exit strategy and the low level of observance of some of the decisions made by the EU (e.g. the first bail-out agreement for Cyprus deliberately contravened Directive 2009/14/CE of the European Parliament and the Council of 11 March 2009, which guaranteed deposits up to €100,000 and was transposed into the legislation of the various Member States; moreover, it envisaged the enforcement of controls on movement of capital, a move which was highly exceptional in terms of EU regulations).

  Thus, the intrinsic problems of some Member States (strong budgetary or external trade imbalances, vulnerable financial systems, economic stagnation and poor labour market operation) have been exacerbated by the lack of confidence shown by the markets in the operation of the euro and in EU institutions as a whole.
- Chapter 7 gives an interpretation of the successive measures adopted from the viewpoint of the economic policy paradigms that have served as benchmarks for them. At the start of the economic crisis in 2008, most EU governments (and the European Commission) embraced what could be considered as the standard Keynesian economic response, albeit with different levels of enthusiasm. Two years later there was a general, radical U-turn, which placed fiscal consolidation at the forefront of economic policy.

  Although this change can be partly explained by the increasing pressure exerted by the financial markets on the weakest countries, there was a general belief at the time (that still persists today) that fiscal consolidation could lead, even in the short run, to economic growth. The chapter reviews the likelihood of such an event from theoretical and empirical perspectives, the hypothesis of expansive austerity and the implications of the adoption of such an interpretation of the functioning of markets for the recovery of the EU.

- Chapter 8, written from a political economy viewpoint, warns of the possibility that governments may seek to break the deficit/debt circle by further lowering working conditions, salaries and social welfare conditions, whose detrimental effects on growth can no longer be counteracted by borrowing. Rather than opting for a federalisation of European economic policy, which would take into account the interests of the different states and create mechanisms for solidarity, the exit strategy implemented seems to consist of imposing new rules of governance that tilt the balance of power further towards the market and away from the state. These new rules of governance comprise a "Europisation of conservative German policies".
- Chapter 9 focuses on the management of the sovereign debt crises and seeks to explain the behaviour of the financial markets, based on their assessment of the economic situation of each country and the potential for getting back to the path to growth.

  At the beginning of the crisis, Spain had a much lower level of public debt than most EMU countries; less, indeed, than the UK, the US and Japan. In fact, even today its public debt is below the average for OECD (Organization for Economic Cooperation and Development) countries, yet Spain is one of the countries whose public debt has been penalised most by the markets. The reason is the high level of private debt in Spain, the great majority of which is intermediated through the banking system. As long as doubts remain concerning the health of the Spanish banking system, markets will be increasingly worried that some of that private debt might eventually be converted into public debt.

  This represents a "diabolical loop" that is magnified by the single-minded approach that is currently being imposed to correct the imbalances within the Eurozone. According to this view, all adjustments should rely on austerity measures taken by debtor countries. The present book argues that, far from helping to correct those imbalances, over-reliance on austerity measures deepens the vulnerability of the Spanish banking system and therefore threatens the long-term economic potential and sustainability of public finances.

The critical tone employed here should be seen as an invitation to hold a broad discussion in academic circles and indeed among decision-makers concerning the various options for finding an exit from the crisis, and the consequences of each one in terms of growth, employment, financial stability, social and territorial cohesion and support for the European project. Some theoretical benchmarks orienting exit strategies from the crisis in Europe that have prevailed in the face of all the empirical evidence need to be called into question, not just because of the poor results that they have attained to date but also because of the scant attention that has been paid to other more ambitious, firmer measures taken elsewhere (e.g. in the US, the UK and, more recently, Japan), and because of their negative consequences in terms of the feeling of belonging to the EU in various countries (there has been an alarming upsurge in euro-scepticism in many countries).

The constraints imposed on the ECB by basic Community regulations have forced it to focus on price stability as its sole objective (Art. 127 of the Treaty on the Functioning of the European Union – TFEU) – set and obsessively held at a mystical figure of 2 per cent[2] – and prohibited it from providing direct funding to public sectors (Art. 123–124 TFEU). For a long time this has theoretically deprived the ECB of any significant capability to intervene on a discretional basis in support of the liquidity of financial systems, the solvency of governments or the soundness of the euro (thus discouraging speculation), given that interest rates are now so low that other, less orthodox ways of stimulating growth from monetary policy must be found.

In its *Global Financial Stability Report*, published in April 2013 (IMF 2013a), the IMF (International Monetary Fund) refers to the combination of exceptionally low policy interest rates and unconventional policy measures as "MP-plus" to indicate that these policies go beyond conventional monetary policy in terms of tools and objectives. The IMF classifies these measures – which have been implemented by several major central banks, but especially by the Federal Reserve, the Bank of England and, more recently, the Bank of Japan – into four groups:

1 *prolonged periods of very low interest rates*, sometimes combined with forward guidance on the length of time for which rates are expected to remain low;
2 *quantitative easing* (QE), which involves direct purchases in government bond markets to reduce yield levels or term spreads when the policy rate is at, or close to, the lower bound;
3 *indirect credit easing* (ICE), in which central banks provide long-term liquidity to banks (sometimes with a relaxation in access conditions), with the objective of promoting bank lending; and
4 *direct credit easing* (DCE), when central banks directly intervene in credit markets – such as through purchases of corporate bonds or mortgage-backed securities – to lower interest rates and ease financing conditions (and possibly mitigate dysfunction) in these markets.

Up to the end of 2011 (two waves of euro "quantitative easing" by December 2011 and February 2012), the ECB did not take part in this intensive, proactive use of monetary policy, and indeed it continues to express reservations concerning some measures. This is especially true for the acquisition of sovereign debt (the announcement of *outright monetary transactions* by the ECB – in secondary, sovereign bond markets, under certain conditions,[3] involving bonds issued by Eurozone Member States – was made on 2 August 2012 and concretised by September). Moreover, the ECB is to sterilise all its purchases so that its price stability objective is not affected.

The treaties also sanction the prohibition on any country answering for the debts and financial obligations of another Member State (Art. 125 TFEU), which has formally prevented any mutualisation of sovereign debt and any extraordinary provision of resources to draw up a truly compensatory budget at the European level that might have been able to mitigate at an early stage the economic problems of countries that have subsequently had to be bailed out.

The vested interests of some Member States (e.g. Germany, the Netherlands and Finland) in defending a literal interpretation of the treaties and intergovernmental agreements has prevented the attainment even of the minimal flexibility that would have enabled the aforesaid solutions to be implemented as alternatives to the rigid official position. That official position has begun to change only very gradually since the risk of the break-up of the euro and of insolvency on the part of governments and financial systems has become evident (i.e. as from May 2010).

These constraints and self-imposed limitations have shaped the ideological component of economic governance of the crisis in the EU, with the emphasis being on austerity in the public sector and full confidence in the efficient working of the markets, especially the financial markets. In the terms used by Susan Strange, this block, headed by Germany, could be said to have exerted *structural power* in the EU, in that it has been capable of dominating the world of ideas and imposing a hegemonic interpretation of events that is not open to argument. It thus indirectly determines what economic policy decisions are made and what priorities are discussed (Steinberg 2013).

De Grauwe and Ji (2013: 2) rightly describe the logic behind this dominant approach as follows:

> (. . .) the surging spreads observed from 2010 to the middle of 2012 were the result of deteriorating fundamentals (e.g. domestic government debt, external debt, competitiveness, etc.). Thus, the market was just a messenger of bad news. Its judgement should then be respected. The implication of that theory is that the only way these spreads can go down is by improving the fundamentals, mainly by austerity programs aimed at reducing government budget deficits and debts.

However, as the same authors point out, when in September 2012 the ECB finally found the will to act[4] – following the announcement by Draghi on July 26 that "the ECB will do what's needed to preserve euro" – spreads decreased sharply. It can therefore also be argued that had it acted earlier, much of the panic in the markets may not have occurred and excessive austerity programmes may have been avoided. As stated by Begg, "where individual Member States have no option but to consolidate public finances, there is a danger of a collective deflationary bias" (Begg 2012: 4).

Nor should it be forgotten that the austerity programmes prescribed for the public sectors of Member States with sovereign debt problems coincided with a tendency towards deleveraging among businesses and households in those same states, and with a strong euro on the currency markets (with the EU failing to react to movements by the bigger countries in pursuit of more favourable exchange rates that would lead to an upturn in demand through exports). It is