The Subordination of European Finance

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Abstract: European political leaderships have responded to the emergence of global finance by a sustained drive to integrate Europe's own financial systems on the basis of a switch from classical bank credit to tradable securities. In itself, this was a rational response. However, financial integration was pursued at breakneck speed and in disregard of important public goods including economic stability and social justice. Reforms were undertaken in a climate of moral panic, in the false belief that the EU faced a serious problem of external competitiveness. In consequence, Europe's banks and institutional investors were badly exposed to the sub-prime crisis, the eurozone has been radically disorganised and the EU has had little influence on the evolution of global financial structures and practices.

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1. Introduction

The last fifteen years have seen the complete subordination of European finance to the globalised US financial system. This shift was supported enthusiastically by both political and corporate leaderships. Its consequences are firstly that European finance was as heavily implicated in credit crisis as was American finance and secondly that the Europeans are at a disadvantage in formulating a response to the crisis.

This does not mean that the Europeans were wrong to integrate and open their financial systems. The development of a global financial system posed a challenge that could not be met by the fragmented, particularist, national and regional systems of the past. However, the integration and liberalisation measures adopted by the Europeans were simplistic and reckless. The aim was simply to reduce financial transactions costs as quickly as possible. In pursuit of this objective virtually every aspect of social control was compromised.

The rest of this article is organised as follows. Section 2 characterises the transformation of finance in the largest EU economy, that of Germany. This is only the most important example of a process which took place in all member states. In section 3 the account moves to the EU level: the background to EU financial policies was the Lisbon strategy which can be seen as resulting from a moral panic and as launching an attempt at breakneck Americanisation – especially in the financial sphere. Section 4 considers the EU's financial integration strategy in more detail and section 5 looks at the efforts of the Commission to introduce a sub-prime mortgage market in Europe – only the outbreak of the US sub-prime crisis put an end to this project. Section 6 recounts one consequence of the European policies – the fact that EU banks are even more exposed to the crisis than were their US counterparts. Section 7 relates financial developments to the persistent macroeconomic malfunctions of the eurozone; real estate bubbles and other speculative inflows into countries with big current account deficits delayed, while exacerbating an open crisis of the monetary union. Section 8 presents some very recent developments and section 9 concludes..

2. The Americanisation of German Finance

In the 1990s virtually every member state government in the EU decided to complete the liberalisation of its financial sector and to promote the development of its security markets. The most significant of these moves was in Germany where it involved the dismantlement of a complex financial system centred on bank credit.

An important step in the abandonment of Germany's stakeholder financial system, with concentrated holdings, inter-firm linkages and the role of the banks as shareholders, was the abolition, by the Schröder government, of capital gains tax on the cross-holdings of equity by German banks and other corporations. This was to prepare the way for the dissolution of *Deutschland AG* (see Streeck and Höpner 2003).

Data on actual ownership structures may overestimate the continuity of German finance: even before shares are disposed of, a bank might start to regard them as

components of a portfolio rather than as supports for a long-term involvement in the enterprise concerned.

The long-standing complaint (for example by the economic liberals of Kiel University – see Klodt, Stehn et al. 1994) that Germany was unable to attract FDI proves to have been completely unfounded. The reality was that German proprietors were unwilling to sell – there was always a big potential market for German industrial assets and the notion that international investors were shunning Germany was simply a moral panic. UNCTAD reports that in 2007, Germany received $50 billion in FDI inflows – still behind the UK, France and Spain, but ahead of the other EU member states. The data on M&As also indicates that Germany now welcomes inward investment into major industrial companies.

The switch in German policy and objectives came late – the change was earlier in France and many other EU member states. However, the transformation in Germany was then extremely rapid. Equity holdings ceased to be the support of long-standing relationships between industrial companies or between companies and banks. The German Monopoly Commission reported that whereas in 1996 the six biggest private sector banks held stakes in 75 of the largest 100 companies by 2004 this had been reduced to 30. Over the same period the total number of cross-holdings among the 100 largest companies fell from 51 to 28 and the number of enterprises (including the banks) possessing such stakes from 39 to 17 (Deutscher Bundestag 2006).

The motives behind the switch may vary, but there was general agreement across business and political leaderships that it was necessary. The big corporations had always found some aspects of their dependence on domestic banks irksome – they had begun to emancipate themselves from this tutelage as early as the 1970s. As they became more multinational and developed their external relations dense financial relations with other German companies may have come to seem more of an encumbrance than an advantage. The big banks themselves were clearly pursuing global strategies, sometimes in a reckless manner. The political class in Germany, as elsewhere, did not perhaps understand the issues completely. They were certainly subject to intense lobbying from institutional investors both for a deregulation of finance and for a transfer of responsibility for pensions and other benefits from the state to the financial corporations (Wehlau 2009). Like the whole European political class, they also became persuaded that they were facing a critical competitive threat from a reborn US economy. These notions are discussed in the next section.

3. Finance and the Lisbon Strategy

At the end of a decade which culminated in an enormous financial crisis, it may be salutary to recall that the strategy ('Lisbon agenda') adopted at its beginning by EU leaderships not only had the integration and liberalisation of European finance as a key theme, but specified its objectives directly in terms *of the reduction of transactions costs*. The Stockholm Council of 2001 repeated its endorsement of the strategy:

> At Lisbon the European Council defined an **ambitious strategy for change**. A strategy to make the European Union by 2010 '*the most competitive and dynamic knowledge-based economy in the world, capable of sustainable economic growth with more and better jobs and greater social cohesion*.'

Insisting on the ‘right regulatory environment’ it spelt out the aims of the strategy in a notorious phrase:

> Business and citizens in the European Union need a regulatory environment which is clear, effective and workable in a rapidly changing, global market place. This is a key element if the European Union is to become the **cheapest and easiest place to do business** in the world.”
>
> (European Commission 2001, emphasis in original)

Subsequent events were to make it clear that cheap business is not always good business.

The Lisbon strategy was adopted at the height of the ‘new economy’ euphoria in the US. The recent performance of the US economy seemed to have put an end to the long catch-up by EU countries. The rapid deployment of new technologies was seen as the basis for this reversal: the role of macroeconomic policies in sustaining US development, on the other hand, was not considered. In the EU, the solution for unemployment is never higher demand but always “structural reforms” of the labour market; the fact that three decades of such reforms have not reduced unemployment only proves that we need a lot more of them.

In retrospect the obsession with US productivity growth seems to have been something of a moral panic. The aggregate data on labour productivity trends concealed two important factors in the comparison of EU and US data.

Firstly, the surge in US productivity was heavily concentrated on a few sectors. The huge productivity lead enjoyed by the US in retail distribution, for example, hardly seems to provide grounds for alarm among the Europeans. Secondly, the deterioration of European performance relative to that in the US is by no means EU-wide. A comprehensive study by O’Mahoney and van Ark (2003) showed that, on the contrary, it could be attributed to two countries, Germany and Italy, ‘with Germany about twice as important as Italy.’

Thus, there was little evidence of a Europe-wide problem. Nevertheless, Europe-wide institutional and policy reform was the solution. For example, the Sapir (2003) report, giving a first assessment of the launch of the Lisbon agenda, prescribed as follows:

> The main reason for disappointing growth in the EU is quite clear. During the past decades, the economy has been confronted by a series of long-lasting shocks – the information technology revolution, German re-unification, the opening up to the new market economies of central and eastern Europe, globalisation – which called for new organisational forms of production. The situation demanded less vertically integrated firms, greater mobility within and across firms, greater flexibility of labour markets, greater reliance on market finance and higher investment in both R&D and higher education. In other words, this required massive change in economic institutions and organisations, which has not yet occurred on a large scale in Europe.
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> (Sapir 2003: 123)

In fact, the ‘disappointing’ growth could also be attributed very plausibly to the long period of restrictive macroeconomic policies leading up to monetary unification, but this is not an acceptable thought in the EU. It remains the case, however, that US macroeconomic policies have been much more committed to growth and much less committed to price stability than have EU policies over the last three decades.

On the perceived gap, Joseph Stiglitz has recently commented:

> Flawed statistics may also lead us to make incorrect inferences. In the years preceding the crisis, many in Europe, focusing on America's higher rates of GDP growth, were drawn to the US model. Had they focused on metrics such as median income – providing a better picture of what is happening to most Americans – or made corrections for the increased indebtedness of households and the country as a whole, their enthusiasm might have been more muted.
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> ('Towards a Better Measure of Well-Being', *Financial Times* 13th September 2009)

On these somewhat flimsy foundations, the Lisbon agenda raised a comprehensive programme of institutional change. Finance was central to the agenda. It was thought that the more fluid and liquid US financial system, with its greater reliance on security markets, was a key factor behind its productivity performance. Europe should respond by integrating its capital markets and by removing administrative and legal obstacles to security trading. These measures would overcome the fragmentation and inadequate capitalisation of European equity markets. At the same time portfolio restrictions on pension funds should be removed: 'if these funds in other member states were to reach the level achieved in the Netherlands, five trillion euro could be placed on EU capital markets' (European Commission 2000).

No argument will be made here against the integration of European financial markets as such. On the one hand, the often-vaunted precision of certain European financial structures and practices (the local banks of the Italian industrial districts, the role of the banks in German industrial investment) was based on specific national or regional affinities and this prevented these systems from either combining their forces or expanding beyond their home bases. On the other hand globalisation trends in the world economy were supporting a massive expansion of the US financial system and it was important to meet this challenge. If the Europeans failed to build big liquid capital markets the consequence would be to drive every issuer and investor on the planet into the North American ones (Grahl 2001). Such an outcome would not necessarily disadvantage the Europeans but it could mean that, as specialised financial functions were outsourced to US markets and corporations, the EU would lose influence over the evolution of the global system. There could also be a loss of income if Europe lost market share in a sector characterised by considerable market power and the associated profitability.

Nevertheless, although the integration objective was very reasonable, the way it was pursued (with D.-G. Internal Market leading the Commission's drive towards unified financial markets) was much less so. The goal of the strategy became the simple reduction of transactions costs to the exclusion of virtually all other considerations and several public goods essential to the effective functioning of the financial sector were completely neglected. The financial integration strategy is explored in the next section.

Figure 1 about here

4. The Financial Services Action Plan (FSAP)

The Financial Services Action Plan (together with the Risk Capital Action Plan which had less far-reaching legislative implications) was adopted before the Lisbon Agenda but became a key components of it. Its goal was to remove regulatory differences which inhibited the free movement of capital. However, unlike previous moves towards more integrated finance, the focus this time was on security markets rather than banking.

Market-led integration, seen as essentially a matter of reducing regulatory restrictions and lowering transactions costs was pursued to the neglect of all the public goods that an effective financial system requires if it is to serve the interests of its users rather than merely those of the financial sector. Three examples of such public goods will be given: consumer protection, social cohesion and financial stability. It is easy to show that the Commission, in its breakneck pursuit of integration at any cost, neglected all three.

As regards the protection of retail users of financial services – whether households or small businesses – the Commission virtually ignored their interests until the legislative programme of the FSAP was nearly completed. Their preferred interlocutors were always the financial corporations and the regulators. When, the users of financial services were finally consulted, they were very critical of the deregulatory tendency of the Commission's drive for integration. They saw little benefit in the more open markets that were promoted but many dangers in the downward levelling of regulatory standards (FIN-USE Forum 2004). They made a common sense defence of rules, such as those, for example, 'to protect the elderly against fraudulent products.' Ironically, the critique extended to terminology: for the Commission and the corporation 'home-country control' meant regulation from the country where the corporation was based. The users wanted to turn this round: home regulation should mean the application of the regulatory regime of the consumer's home country, what the providing corporation might call 'host' country control.

One alarming aspect of the Commission's approach was its attack on what was called 'gold-plating,' that is, the application of regulatory standards higher than those specified in EU laws. Now this has always been possible in the EU. Any member country is entitled to apply more stringent standards than the EU – whether this be in employment law, environmental protection or consumer protection. Obviously such higher standards can be a barrier to trade and thus slow down integration, but they do ensure that when integration does take place it is at a high level. In the realm of finance, it was argued, uniform rules were so important that member states should not aim for higher protection for their own citizens.

(The supposed benefits from financial integration are obscure. From the point of view taken here there may well be an important political-economic benefit in terms of autonomy and the ability to influence the shape of global financial systems. The Commission's lamentable attempts to show big gains in terms of GDP from financial integration depend on a handful of complex economic studies. These did indeed show am impressive boost to growth from integration. The studies deploy state of the art

econometrics and heroic assumptions – the claimed benefits from integration invariably depend on the latter. See Block and Grahl (2009.)

The Commission's objectives, in pushing towards integrated security markets was to replicate certain aspects of the US financial system. There is no doubt that the member state with a financial system most closely resembling the American is the UK, which therefore stands as something of a model for the FSAP. Now there is no doubt that, in terms of the interests of retail users of finance, the British model leaves a great deal to be desired. A series of scandals and malpractices – mis-selling of pensions, excessive bank charges, over-pricing of payment insurance – have undermined public confidence in the sector. For examples of the contemptuous way in which the bureaucracies of the banks and institutional investors treat consumers, one need only glance at the Personal Finance section of any newspaper. More systematic critiques have come from sector insiders in the Myners (2001) Report on institutional investment and the Sandler (2002) Report on Medium-Term Savings, and from a series of investigations carried out by the House of Commons Treasury Select Committee under the chairmanship of John McFall. At no point prior to the outbreak of crisis in 2008 did the Directorate-General for the Internal Market, as the section of the Commission responsible for the FSAP, express any concern about the retail users of the more integrated financial sector – on the contrary, their concern was that too much consumer protection would slow things down.

A second public good potentially affected by the FSAP was the European Social Model itself – although this is always mentioned with the utmost solicitude in Commission documents, it was clearly instrumentalised in the Lisbon strategy; only growth could guarantee the continuation of the Social Model, even though that growth, in reality was pursued by methods which were fundamentally antagonistic to the model. In theory, social protection could expand employment and reinforce external competitiveness (Figure 2).

Figure 2 about here

In practice, the FSAP and the financial transformation at which it aimed posed clear threats to European Social Models. These concerned both social protection and employment relations. The case of pensions can illustrate the first: the withdrawal of pay-as-you-go public pension provision and the resulting substitution of security-based marketed pensions was clearly a goal of the Commission. Such a switch can give a big stimulus to the securities markets even though there is abundant evidence that market-based pensions are more expensive, more risky and much more unequally distributed than public sector ones. The expression, 'modernisation of social security,' in the parlance of the Commission was essentially code for this privatisation. However, after the equity market crash in 2001, this ambition seems to have been modified. The threat posed by population ageing was still stressed but now the appropriate response was seen as the pre-funding of public provision by large fiscal surpluses rather than the exposure of individual households to the vagaries of the financial markets.

The dangers to European employment relations can be illustrated by the Commission's drive to liberalise mergers and takeovers. The increased salience of security markets tended to make shareholders more exiguous, as regards both their

rewards and the organisation of the business enterprises in which they had invested. The Commission, again through D.-G. Internal Market, showed its commitment to the ideology of shareholder value by an attempt to deregulate takeovers. The proposed directive would have made hostile takeovers much easier than they were even in the US, and with no safeguards at all for employees. It was defeated in the European Parliament in a tied vote. This commitment to the power of capital markets is hard to reconcile with the values of the European Social Model.

Another important public good, and one very closely associated with the detailed functioning of financial systems, is of course financial stability itself. We have the testimony of no less a figure than Alexandre Lamfalussy, former head of the Bank for International Settlements, as to the insouciance with which the Commission regarded the question. Lamfalussy was actually called in to rescue the FSAP when it became mired in legislative complexities. His committee recommended a simplified process, where only framework regulations were enacted by the European Council and Parliament with specific regulations devolved to committees of member state regulators and officials. Without this procedural change the programme would have been delayed and its legislation would have been less effective.

The draft report from the Lamfalussy committee stated, '…greater efficiency does not necessarily go hand in hand with enhanced stability….Increased integration of securities markets entails more interconnection between financial intermediaries on a cross-border basis, increasing their exposure to common shocks….there is an urgent need to strengthen cooperation at the European level between financial market regulators and the institutions in charge of micro and macro prudential regulation.' In the Commission's response, 'It was politely but firmly suggested that we drop the subject' (Lamfalussy 2003).

Thus the Lisbon Strategy's focus on lowering transactions costs was no exaggeration; the Commission was ready to sacrifice every significant public good in order to establish integrated securities markets with the lowest possible dealing costs. Only the outbreak of massive crisis in 2008 led to any reconsideration of that position.

5. Mortgages – an embarrassing proposal

The shallow and mechanical approach to financial policy in the Commission is well illustrated by its abortive initiative on mortgages. When the legislative programme of the FSAP, designed primarily to integrate wholesale securities markets, was virtually complete, D.-G. Internal Market began to look for new market integration projects. It published a *Green Paper* to press for integration of the mortgage market (European Commission 2005)

American practice was in the background here. One example was the view that with improved 'risk assessment', the risk capital required in the mortgage sector could be reduced (p11). Another was the belief that a big secondary market in mortgages was the way forward: 'Many….. express the view that the further integration of the EU mortgage markets could be considerably enhanced by the emergence of a pan-European funding market' (p13). There is no hint in this document that a continent-

wide secondary market in mortgages might pose certain informational difficulties and the word, 'stability' does not appear in the *Green Paper*.

The usual tame contract economists were hired to give their blessing to this fatuous proposal. Their report (London Economics 2005) sang the praises of the US system, including its sub-prime component:

> US experience suggests that –
>
> - Legal or other restrictions to banks' geographical expansions will reduce the efficiency of the mortgage-lending industry.
> - Steps to create a single EU mortgage market would increase incentives to develop automated systems to process loan applications, which would reduce origination costs.
> - Removing restrictions on maximum mortgage interest rates would **allow a subprime mortgage market to develop**, thus expanding total mortgage lending. (London Economics:168, emphasis added)

The long processes of development which have adjusted housing markets in different member countries to their specific social conditions and social priorities mean nothing to the officials of D.-G. Internal Market, who would sweep everything aside to build another, quite pointless, pan-European market. As late as February 2007, the mortgage proposal was still being promoted, but by the time of the *White Paper* (European Commission 2007) at the end of the year there were signs of a reappraisal. The *White Paper* made the breath-taking assertion that 'recent events in global mortgage markets have confirmed the pertinence of the approach proposed' (p10). Of course, the opposite is the truth – the whole D.-G. Internal Market argument was based on the supposed desirability of more product diversity, although product diversity was a key factor making US mortgage-backed securities opaque and risky.

In 2008, the theme of mortgage market integration has been quietly dropped – one has to look very hard to find it on the Commission's web-site.

6. Huge Leverage of European Banks

A press release from D.-G. Internal Market and Services (27/2/2008) asserts that European banks are well capitalised: 'The origin of the current financial turmoil came from the US sub-prime mortgage sector and a large portion of the European financial sector is not directly affected by the turmoil at this stage. Where financial institutions have sizeable direct exposures to the US sub-prime market, or indirect exposures through structured products, the affected entities have well diversified portfolios and large capital buffers.'

It seems that this is simply not the case. Daniel Gros and Stefano Micosi report that, 'the dozen largest European banks have now on average an overall leverage ratio (shareholder equity to total assets) of 35, compared to less than 20 for the largest US banks.' These economists recognise that the leverage numbers reported to regulators are much lower, but they explain this by the 'massive in-house investment banking operations of European banks' which 'are not subject to any regulatory capital requirement.' They give the following figures for the leverage ratios of European banks as of 30th June 2008: UBS, 46.9; ING 48.8; Barclays, 61.3; Crédit Agricole, 40.4, Deutsche (2007) 52.5. (Gros & Micossi 2008).

This exceptionally high leverage translates into particularly high exposures to 'toxic' assets. Wolfgang Münchau of the *Financial Times*, reacting to a recent IMF stability report, emphasised both the scale of these exposures and the fact that they had still not been written down by the banks concerned:

> The most shocking news from last week's excellent Global Financial Stability Report from the International Monetary Fund was not the headline estimate of total bad assets. That number stands at $4,100bn (£2,800bn, €3,000bn) and will almost certainly be revised upwards. Much more shocking was that the lion's share of these assets belong to European, not North American, banks. Of the total $4,100bn, the global banking system accounts for $2,800bn. Of that, a little over half – $1,426bn – is sitting in European banks, while US banks account for only $1,050bn.
>
> Even worse, European banks have written down much less than American ones. According to Reuters, the US and European banking and insurance sector has so far written down $740bn. More than 70 per cent of the write-downs come from the US. The eurozone's share has been an appalling 14 per cent.
>
> Another statistic from the IMF report: to recapitalise the banking system to reach capital ratios that prevailed in the mid-1990s, capital injections of $275bn would be required for US banks, and a whopping $500bn for European banks.
>
> You get the picture. All these data tell us that Europe has both the biggest problem and has made the least progress.

Financial Times, 26th April 2009

Of course the financial crisis as such is not directly a European phenomenon – it developed in the US mortgage market and is related to imbalances in the US economy – both in terms of the current account and of the distribution of income. But the Lisbon Strategy, with its breakneck rush to build integrated security markets and its single-minded focus on the lowest possible transactions costs, sowed the wind for the EU financial sector.

7. Tensions in the Eurozone

The present article centres on financial developments and cannot provide an extensive analysis of macroeconomic developments. Nevertheless, it seems useful to establish two connections between the financial crisis and the problems of European, and especially Eurozone macroeconomic policy. On the one hand, there are strong internal and external arguments for a macroeconomic expansion in Europe, but any such project is blocked by the internal tensions of the zone. Secondly, it is now clear that even the limited growth achieved in the decade of the Lisbon strategy was to a great extent illusory: only real estate bubbles and other forms of precarious credit expansion allowed some member states to record relatively rapid output growth. The basic weaknesses of the European Monetary Union, as critical commentators have said all along, do in fact prevent balanced economic progress by making it impossible to either compensate for or correct asymmetric developments in the member countries. Aglietta and Berrebi (2007) even go so far as to characterise EMU as a 'false monetary union.'

When one considers the Eurozone in the aggregate, there are strong arguments for an expansionary response to the financial crisis. Unemployment in the EU has risen from 7.0% in 2008 to 9.8% in 2010 with no improvement forecast for 2011. For the Eurozone the rise over the same period has been from 7.5% to 10.3%. External factors also suggest an expansion: the US has to undertake a considerable correction of its current account which is certain to reduce demand in the global economy; the Eurozone is well placed to run a current account deficit and this would provide the most favourable context for an general reduction of imbalances. There would be no threat to the euro. On the contrary, standard Mundell-Fleming reasoning suggests that such an expansion might even strengthen the euro.

However, the institutional weaknesses of the Eurozone, which has neither a budgetary policy nor an external policy, and the extremely aggressive policy of Germany rule out such an outcome.

Table 1 about here

As Table 1 illustrates, there has hardly been severe wage inflation in the Eurozone over the first decade of the new century. But wage repression in Germany has nevertheless been so severe as to generate severe competitiveness problems for several countries using the euro. The Netherlands and Austria, despite aggregate wage growth more rapid than in Germany, have managed to maintain competitiveness, presumably by keeping a very careful eye on the price of tradable goods and services. In several other countries, however, the current account has deteriorated rapidly.

As can be seen, the consequence is to rule out any general expansion – only a reduction in the existing imbalances would make that possible. In fact there is no other means of correction for the deficit countries except simple deflation – as the Irish, now to be followed by the Greeks, have already shown. (The cumulative decline in GDP in Ireland between 2008 and 2010 was 17%.)

Tables 2 and 3 about here

Twice before in the era since the second world war, the extremism of German macroeconomic policy has led to international economic disruption. In both cases the consequences were eventually adverse not only for Germany's partners but for Germany itself. One of these episodes is well known – the crisis of the EMS in 1992 and 1993. The other European countries were trying to use a hard peg to the D-mark to bring down inflation. The Germans raised interest rates to 12%, making it quite impossible for their partners to continue this strategy even though inflation in Germany – supposedly the justification for the squeeze – was never above 4%.

It is less well known that Germany also had a hand in the Volcker shock – the very costly US credit squeeze in 1979 and the early 1980s which was carried out to stabilise the dollar on the foreign exchanges.

At the start of 2007, Germany raised its VAT rate from 16% to 19%, with a counterbalancing cut in social security contributions. The domestic rationale for this move is clear: to stimulate employment by cutting labour costs. In an international view the two moves, equivalent to a devaluation, might be regarded as very aggressive coming from a country with an enormous and growing export surplus.

By the end of 2009, the European financial crisis had provoked uncontrolled fiscal crises, resulting in sharp contractions, in the deficit countries of the Eurozone. In spite of large-scale credits from the ECB and Germany the Greek situation remained critical because the government appeared to be insolvent. Substantial risk premia were being exacted from the governments with weaker economies, especially Greece. A new round of financial crisis was threatened for the big Northern European banks holding the paper of Southern European governments in the event of a default.

Table 4 about here

Thus, the EU failed to respond to the financial crisis in a coherent way and this failure released dangerous centrifugal forces in the Eurozone. And the crisis revealed in the cruellest way the failure of both the Lisbon strategy and the financial transformation which was its central component. The growth figures for the Lisbon decade, 2000-2010, were in any case disappointing. It now appears that a substantial part of that growth in countries such as Ireland and Spain was illusory – the expression of unsustainable house price bubbles and credit expansions.

8. Since the Crisis

In his account of the sub-prime debacle, Andrew Gamble (2010) argues that 'such crises are above all political events; they arise politically, they are constructed politically and they are resolved politically.' This goes too far – the crash, the recession and the deficits are in the first instance economic phenomena. However, the rapid transformation of a breakdown in private finance into an assault on the public sphere certainly shows why one might adopt Gamble's position.

By the end of 2010, the financial crisis as such had been virtually eclipsed by a general fiscal crisis – or by what was presented as such. Public borrowing and public sector indebtedness had increased in nearly all economies, partly through massive state recapitalisation of troubled banks, partly through expansionary budgetary measures to counteract the recession which, as is nearly always the case, followed the financial collapse.

Political leaderships, especially in the European Union, have exaggerated the problem. On the one hand the deterioration of public sector balance sheets was a logical corollary of a necessary strengthening of balance sheets in the private sector: deleveraging by banks and a reduction in household indebtedness are both preconditions for general recovery. On the other hand, there seemed to be no shortage of investible funds and no serious risk that public spending would crowd out private investment. The governments in the major economies were able to borrow very large sums at historically low interest rates: in November 2010 ten year bond yields were 0.96% in Japan, 2.40% in Germany, 2.56% in the US, 2.86% in France and 3.00% in a Britain supposedly on the verge of insolvency. These low rates testify both to a surplus of savings caused by high profit rates and by a concentration of income growth on the richest in society and to a dearth of promising private sector investment opportunities.

The new European Commission, however, has reacted to growing public debt with a consistency worthy of the Bourbons. The Stability and Growth Pact, in its view, was, still is and will continue to be the only correct and adequate framework for fiscal policy within the eurozone. In '2020,' its agenda for the new decade, it writes:

> The Stability and Growth Pact provides the right framework to implement fiscal exit strategies and Member States are setting down such strategies in their stability and convergence programmes. For most countries, the onset of fiscal consolidation should normally occur in 2011. The process of bringing the deficits to below 3% of GDP should be completed, as a rule, by 2013. (European Commission 2010: 24)

An analysis by economists at the Hans Boeckler Foundation shows that the 'Stability and Convergence Programmes' formulated for eurozone countries with a view to bringing public sector deficits rapidly within the Stability Pact limit of 3% are, in many cases, absurd. Current account surpluses and deficits are assumed to diminish only slowly, while public sector borrowing falls very fast. The implication is a huge wave of borrowing by the private sector – an impossibility while banks are deleveraging and households struggling to reduce indebtedness (Brecht et al. 2010).

This exaggeration of the general fiscal problems of the eurozone goes with a tardy and pusillanimous response to the severe crises in several member states, such as Ireland and Greece. The specific background to these crises differs from country to country but there are common factors at EU level: an uncontrolled widening of current account imbalances since the start of the century; and the finance of these imbalances by speculative capital flows which went into reverse after the financial collapse.

An effective response to these emergencies is blocked by the refusal in Germany and the other surplus countries to accept any responsibility for the correction of imbalances or to contemplate the current and capital transfers which are the only path to a successful resolution.

As it became clear that sovereign debt defaults by Greece and others might reignite financial crisis in Northern Europe and cast suspicion on the euro, some action was taken: the ECB began to purchase Greek government bonds, and a European Financial Stability Facility was established, guaranteed by eurozone members, which can provide up to 700 billion euros of emergency refinance. However, on German insistence, the terms and conditions of access to the Facility were made so restrictive that the countries concerned have not yet made use of it. In any case, even more generous credit would only delay, not remove, the threat of insolvency which hangs over several member states.

In the financial sphere itself, there has been limited change in the EU. A draft agenda for reform was produced by a committee chaired by Jacques de Larosière (2009). It proposed both a substantive tightening of regulatory constraints across the financial sector and structural reforms to supervisory institutions (for a critique, see Frangakis and Grahl 2009). However, rapid action was only taken on the second of these themes – with the construction of a 'European Framework for Safeguarding Financial Stability.' This is to have two main components: to deal with systemic risks, existing consultative bodies are to be incorporated in a European Systemic Risk Board under the aegis of the ECB. Commentators have pointed out that such early warning systems already existed at national, European and global levels before the sub-prime crisis and even sometimes accurately identified the emerging risks without leading to effective measures of prevention. Unlike the new US Systemic Risk Council, the European body, when it identifies systemic risks, will not have binding powers requiring banks to reduce the exposures concerned.

The second component of the new stability framework involves a strengthening of European regulatory structures. The previous, essentially intergovernmental committees in the fields of banking, insurance and securities markets are to be replaced by "authorities" with a more federal character. These are now expected to act in a "collegiate" way, rather than as fora for the negotiation of individual member state interests. However, the actual centralisation of powers is rather limited so that it is not clear whether the new bodies can promulgate clear EU-wide regulations. In view of the record of EU financial policy discussed above this Europeanisation of regulatory responsibilities is a somewhat ironic outcome.

It is always easier to rename and reorganise government agencies than to bring about significant changes in corporate practice. So far, legislation to alter the rules governing banks and institutional investors has made very slow progress in the EU, against strong lobbying from the financial sector itself. The US has already legislated through the Dodd-Frank Act; EU reforms lag behind and tend to be weaker than even the mild measures adopted in the US.

By November 2010, only one substantive reform was nearing enactment, a Directive to regulate Alternative Investment Fund Management which deals with hedge funds and private equity. There has been intense lobbying, by the funds concerned, by the City of London and by off-shore interests to dilute the original proposals. Similar pressures are building up around proposed reforms of derivative trading.

A detailed account of ongoing regulatory reform will not be presented here. But to reinforce the central theme of European subordination, the views of two recent critical

commentators can be cited. Peter Wahl (2010, pp9-10) writes that, having encouraged breakneck liberalisation, the EU in the crisis found itself ‘in the situation of the sorcerer’s apprentice’, marginalised by crisis-management initiatives in the member states: ‘the fragmentation has existed before the crisis. But the crisis has brought to light, that the process of European integration is in a critical situation. The centrifugal trends are very strong at the moment, and the crisis has served as a catalyst making them even stronger.’

Myriam Vander Stichele, meanwhile, considers the failure to play a significant role on the international stage. She writes (Stichele 2010: 25-26):

> In the same way as before the financial crisis, EU decision-making on financial regulation is highly influenced by the political power of the financial sector, which results in regulations with limited impact on the industry. The EU follows the G20 agenda at its own pace, while avoiding putting its financial industry at a disadvantage against the US financial industry and also being under pressure from the US not to disadvantage the latter’s industry!

Thus recent events confirm the general argument made above. The uncritical acceptance by EU leaders of every aspect of the US-based global financial system, mean that, even in the crisis of that system, the EU is unable either to define a coherent strategy for its member states or to influence developments beyond its borders.

9. Conclusion

Although this article has been extremely critical of the financial strategies of the EU, it is not intended as a plea for the financial structures of the past – for German *Hausbanken*, French *encadrement de credit* or the local and regional financial systems in Greece or Italy. These systems often achieved a very precise balance between the interests of borrowers and lenders. But they did so only on a narrow, national or regional basis. Their key strength – the support they derived from specific social affinities – proved to be a fatal weakness in the context of a global economy: they were unable to expand on an international basis. Meanwhile the security-market based financial systems of the US may have been both less precise and less stable, but they were able to mobilise financial resources on a vast scale and transfer them around the globe.

EU financial integration was a rational response to globalisation. However, the way it was pursued was not rational. In a climate of moral panic, European leaderships attempted a slavish imitation of some features of the US model (ignoring the social institutions which constrain financial processes even in the US to a certain extent). Public goods central to the European project – social protection, consumer standards were jettisoned in a blind rush to lower financial transactions costs.

Large liquid security markets in Europe, embedded in a stable economy and subject to effective regulation and social control, could have drawn investors and issuers from around the planet and made the EU a key player in shaping the global economy. Instead, a decade of deregulation and speculation culminated in debacle – with European banks worse affected than their US counterparts and the monetary union itself menaced by multiple crises. A process which should have strengthened the EU’s

political economy has ended with its complete subordination to uncontrolled forces within and without. Although the Lisbon strategy proved to be such a complete failure the new European Commission proudly asserts its complete continuity with the past decade. It is to be hoped, however, that the serious threats to the European project which arise from that failure will help to promote a change of direction.

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Tables

Table 1: Pressure on German Wages

Nominal Unit Labour Costs (euros) 2000=100		
	Germany	Eurozone
1999	99.3	98.8
2000	100.0	100.0
2001	100.9	102.4
2002	101.8	105.0
2003	102.8	107.3
2004	102.6	108.3
2005	101.8	109.7
2006	100.4	110.9
2007	100.5	112.7
2008	102.7	116.5
2009	108.0	121.1
2010	107.1	120.5
2011	106.4	120.6

Table 2: Persistent Surpluses

Current Account Balance (% of GDP): The Surplus Pole			
	Germany	Netherlands	Austria
1999	-1.2	4.2	-1.4
2000	-1.6	6.4	-0.7
2001	0.0	5.2	-0.8
2002	2.2	6.1	2.7
2003	2.1	6.1	1.7
2004	4.8	8.6	2.2
2005	5.2	7.5	2.2
2006	6.6	9.0	3.0
2007	7.9	8.5	3.4
2008	6.6	4.2	3.6
2009	5.0	3.9	2.5
2010	4.8	5.9	3.1
2011	4.8	6.4	4.1

Source: AMECO

Table 3: Deficit Countries

Current Account Balance (% of GDP): The Deficit Pole				
	Ireland	Spain	Greece	Portugal
1999	0.2	-2.7	-5.1	-8.9
2000	-0.4	-4.0	-12.0	-10.7
2001	-0.5	-4.3	-11.4	-10.4
2002	-0.4	-3.8	-12.7	-8.5
2003	0.8	-4.0	-12.3	-6.4
2004	-0.1	-5.9	-10.3	-7.8
2005	-3.3	-7.5	-11.0	-9.8
2006	-4.3	-9.0	-12.8	-10.4
2007	-5.1	-10.0	-14.7	-9.8
2008	-5.2	-9.5	-13.8	-12.1
2009	-2.9	-5.1	-13.1	-10.5
2010	-0.9	-4.6	-10.3	-10.1
2011	-0.6	-4.5	-8.6	-10.0

Source: AMECO

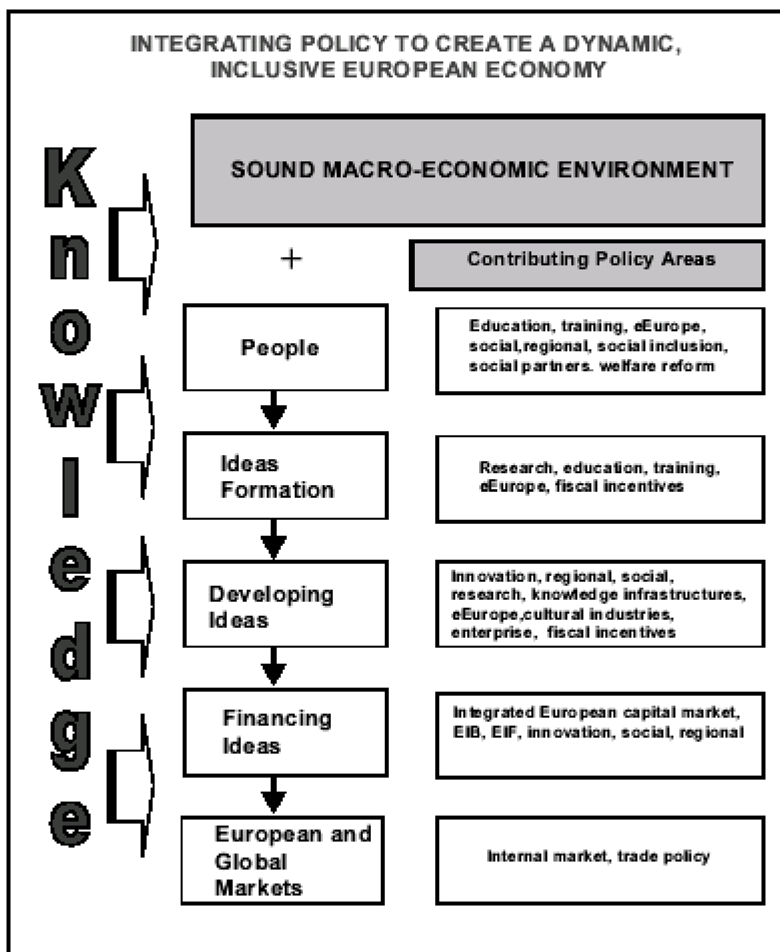
Table 4: Financial Divergence: Ten year bond yields

	London close 1/7/10
Germany	2.57
France	3.02
Netherlands	2.80
Finland	2.83
Austria	3.16
Belgium	3.40
Portugal	5.67
Spain	4.59
Italy	4.08
Ireland	5.54
Greece	10.40

Source: *Financial Times*, 2/7/10, p31

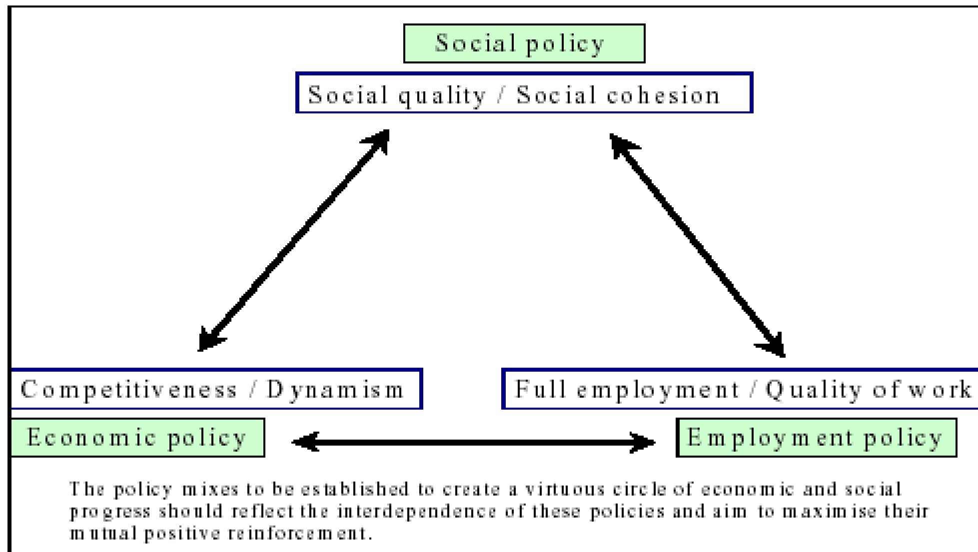
Figures

Figure 1: Finance and the Lisbon Strategy



European Commission (2000: 10)

Figure 2: Social Policy and the Lisbon Strategy



Social Policy Agenda (European Commission 2000a: 6)