paved with good intentions: global financial integration and the eurozone's response

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Abstract
Regional governance systems may resolve the dilemmas of global financial integration, and the Eurozone is the most advanced attempt to do so. The Euroland sovereign debt crisis is a test of this proposition but the outcome finds the EU wanting. The first section places EMU in the broader context of financial liberalisation. The next section shows that we have long known that financial liberalisation is associated with financial instability, demanding robust governance. The subsequent section examines the reaction to the Eurozone crisis, and argues that the lessons available were poorly learned. Although the EU and ECB revealed leadership and crisis management capacity in the financial market phase, the sovereign debt phase of the crisis was less successfully handled, producing conflict among Eurozone members. As a result the Eurozone hangs in the balance.

Keywords debt crisis; economic and monetary union; Eurozone; financial crisis; sovereign debt workout

Two conditions might confirm that regional forms of governance such as the EU can play a positive role in resolving the dilemmas of global integration. First, a successful co-operative resolution of the debt crisis would require that the EU achieved sufficient levels of cross-national legitimacy and shared identity to produce a solution. In turn, that solution would need to demonstrate to member citizens and governments that a common solution was more effective than a national one, thereby strengthening the EU's collective identity and legitimacy. But the outcome tells us that supporters of regional solutions may have been over-optimistic. If so, the financial crisis has landed the EU in greater trouble than we realise.

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GLOBAL FINANCIAL INTEGRATION

Global financial integration became a defining feature of the late twentieth and early twenty-first centuries, along with a somewhat less consistent push for an open trading order. But rapid financial integration was punctuated by severe episodes of financial crisis. For a while, these crises appeared limited to 'emerging markets', which led to reforms in these 'weakest links'. But the ultimate weak link proved to be the US financial system and United States' payments imbalances. The booming market for securitised mortgage-based assets became unstable, and by Summer 2007 an avalanche of misunderstood risks metamorphosed into demon uncertainty, paralysing the interbank market. The entire edifice collapsed, and deflation and depression threatened.

Public authorities re-established a modicum of financial stability by mid-2009 and an internationally coordinated fiscal stimulus launched a fragile recovery. Worries began to shift from the health of the financial sector to rising public debt burdens, exacerbated by the financial sector rescue and the costs of recession. By late 2009, concern was focused on the weaker Eurozone economies, particularly Greece. Governments squabbled, and publicly assigned blame while remaining inactive, worsening an otherwise containable situation, which required another dramatic rescue.

DISTILLING THE LESSONS OF A CRISIS WELL ENOUGH DESERVED (BY SOME)

We have long known that liberal financial markets are potentially unstable. There is historical evidence a-plenty (Kindleberger, 1989; Galbraith, 1993, 1995), and adequate theoretical explanations. The case

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for adequate supervision and regulation is well understood and entrenched in the fabric of post-depression economic systems. At least four lessons can be distiled from the literature (Underhill, Blom and Mügge, 2010):

FINANCIAL INSTABILITY IS PREVALENT

A market-based order of financial integration with a high degree of capital mobility is inherently unstable, as emphasised by political scientists and historians (e.g., Kindleberger and Laffargue, 1982; Strange, 1986), as well as by prominent economists (e.g., Minsky, 1982; Rodrik, 1998; Stiglitz, 2000). In particular, the consequences of financial liberalisation for developing countries were always in serious dispute: net capital flows over time mostly flowed 'uphill' from poor to developed economies, with foreign direct investment a major exception (Prasad, Rajan and Subramanian, 2007). While there were longer-run benefits to financial openness, their realisation depended on successful institutional development and governance (Kose *et al*, 2006).

POLICY SPACE IS CONSTRAINED

This institutional fabric must be consciously developed, and cross-border market integration requires substantial international co-operation if national policy goals are to be achieved. The macroeconomic environment and use of national policy instruments are rendered more difficult by a high degree of capital mobility. The approach at Bretton Woods in 1944 was to make the international monetary and financial order compatible with allowing national governments the policy autonomy to adjust to international imbalances. The financial architects of the 1990s sought instead to adapt and strengthen the 'weakest links' in the global chain – the developing and emerging market economies – to the pressures of the global system. There was no special provision for macroeconomic stability or monetary order.

POLICY INPUTS ARE SKEWED

Financial firms and their associations have historically close and relatively exclusive relationships with state policymakers and key international organisations. G7 governments generally back the preferences of their financial sectors. The institutions of global financial governance, such as the Basel Committee and the International Organization of Securities Commissions, are exclusive policy communities not subject to accountable political processes, a problem exacerbated by frequent recourse to self-regulation. The transnational financial system has been increasingly more responsive to private interests than to providers of collective goods (Cerny, 1996: 96–99) and thus flawed in terms of policy-process legitimacy.

POLICY-RENT SEEKING IS RAMPANT

Narrow, exclusionary policy communities skew the balance between public and private inputs into supervisory/regulatory policy, especially in countries that host the main financial centres, undermining both the legitimacy *and* effectiveness of policy. Liberalisation and a market-based financial architecture did not improve system stability, raised the costs for citizens, and allowed policy-rent seeking by international banks and financial conglomerates. State financial regulatory agencies also had an interest in financial liberalisation. No one denied that better national governance and greater international co-operation were needed. But the result was a crisis-prone system of 'governance light' that delivered advantages to its proponents while constraining the policy space of governments.

EMU: GLOBAL FINANCE, THE 'STABILITY CULTURE' AND INSTITUTIONAL LACUNAE

EU monetary integration was very much part of the global adventure of financial liberalisation, with similar assumptions regarding 'governance light'. The combination of engagement with the liberal financial order plus weak institutions made the EU and the Eurozone highly vulnerable to monetary or financial crisis.

It is useful to review four observations made at the inception of EMU (Underhill, 2002)

- There is a paradox in that, relatively self-sufficient in terms of trade, the EU is deeply integrated into global financial markets and investment flows. Because capital rather than trade flows mediate EMU and the rest of the world, the exchange rate matters less and there is also insulation from short-term current account constraints. But its member states are mainly subject to the asymmetrical market adjustment pressures of capital mobility.
- While there is a clear mandate for managing the Eurozone's monetary policies, it is unclear how international monetary relations or the global financial architecture are to be managed. There is also a dearth of collective EU

machinery for managing internal or externally induced crises. Both of these characteristics induce a reliance on rules and macroeconomic standards, which are easily – and perhaps necessarily – breached under pressure.

- Financial integration and EMU confront members with considerable pressure for convergence in macroeconomic management and corporate governance, as well as intense pressures of political legitimacy in terms of national social policies, identities, and democracy in an increasingly integrated economic order. This is often perceived as a 'sovereignty issue', though it is better characterised as one of identity and policy autonomy.
- EMU enhances the cross-border market forces already at work and was intended to do so. Yet, this integration process juxtaposes distinct political systems with their own internal dynamics. The Eurozone was likely to encounter member-state disagreements as the asymmetrical distributional consequences of integration became clear. As we now know, it did, and the crisis made this worse.

The Maastricht treaty reinforced the logic of global financial integration – the reliance on market forces to provide discipline and stability. The only collective mechanism for dealing with crises was the stability and growth pact (SGP). This was essentially an agreement on sovereign debt burdens, less inflexible than many thought, but implied that governments, not financial markets, were the problem: if the rules were properly applied, stability would prevail. Price stability and the fight against inflation were favoured over growth, employment, and social policies. Monetary policy and day-to-day exchange rate management would be run by a highly independent central bank, not by elected governments or the European Council.

There were also benefits. Eurozone members would gain weight in global financial and monetary affairs. Those formerly subject to German monetary policy would now have a voice at the ECB table. Internal exchange rate crises could not occur, and the most competitive economies would no longer suffer the devaluations of others. The poorer and weaker Eurozone participants would have better access to cheaper capital, and because their trade was largely with other members they would be sheltered from global exchange rate volatility, and relatively free of current account constraints – though with devaluation ruled out they were also subject to new competitive pressures. The national central bank reserves and resources that might be required for adjustment or financial rescue would be pooled: large and stable economies could, and *would* (it was assumed) support the weaker ones. But how well did the Eurozone and EU perform?

CRISIS: THE FINANCIAL PHASE

The ECB compensated for the lack of EU collective machinery by exceeding its mandate to resolve severe collective action problems across the EU's banking and financial system. The European System of Central Banks proved a miracle under fire, pooling resources and co-operating with the US Federal Reserve, among others. The ECB rapidly developed a repo market for distressed assets, eased the terms of refinancing for banks in difficulty and loosened monetary policy. It took the lead in ensuring that national systems of deposits were protected, with eventual 100 per cent coverage for the duration of the crisis.

Panic avoided, despite some initial bank runs, the interbank market was slowly revived, and the ECB coordinated the effort internationally. Much largesse was shown to the new member states and neighbouring economies, though one might have wished for more. Budgetary rules were loosened, and fiscal stimulus was encouraged and coordinated, though of course implemented nationally. The EU Commission and the ECB took their place in the new G20 and there was an open admission that the institutional lacunae in EU financial regulation and supervision should be filled, without delay.

In contrast to the 1930s, public authorities largely did the right thing and kept lines of credit open. Beggar-thy-neighbour policies were absent despite the extreme pressure on national governments. ECB and national outlays may yet be recuperated as the bank's balance sheet is restored. But what of the sovereign debt phase of the crisis?

CRISIS: THE SOVEREIGN DEBT PHASE

The sovereign debt crisis should not have been a surprise. It should have been obvious that national debts would concern the markets financing them, first because there was a huge transfer of private debt and toxic assets to national central banks and governments, and second because stimulus measures and automatic stabilisers only added to the debt. Nor was it surprising that the weaker Eurozone economies were worst hit: the experience in the Euro and non-Euro CEE members was there for all to see, and although Greece did 'cheat', and by a considerable amount, this behaviour was well established and the consequences forecast by the IMF (IMF, 2009: 20–21). Anyone who should have known could have known.

The next problem was an apparent failure to separate crisis management from the normal rules of the game. The German government consistently drew attention to the SGP and the imperatives it implied. Yet the G20, EU, and other bodies had accepted for some time that exceptions to normal fiscal prudence would be needed, and international co-operation required to ease the burden for the hardest hit. Aid should not be cut, welfare provision would continue. There would be solidarity.

But suddenly this was denied by one country – Germany. It apparently failed to understand why the financial rescue had been mounted: to safeguard citizens whose future was threatened by financial breakdown. A great deal of money had been thrown at banks, but citizens of the poorest 'old' EU members were apparently worth less. Greek bond spreads relative to German Bunds were still a modest 200–250 points in November–December 2009. But the problem soon spread to Portugal, Ireland, and Spain. By April–May, Greek bond yields were for a short time over 1,000 basis points above German levels.

The German government finally began to worry when it realised that Greek bonds were largely held by German and other EU banks (BIS, 2010: 27). Whatever the German political climate, which included tense provincial elections that drove Angela Merkel's CDU to act tough on Greek 'cheaters', a prompt policy response could have avoided the problem altogether. This was all the more ironic given that Germany and France (and Italy) had cheated themselves by exceeding the SGP's 3 per cent budget deficit ceiling in 2002–2006 during the post-DotCom bubble recession.

Greece of course *did* massage the figures and its deficit and debt grew alarmingly. But the Greek economy is small, poor, and has little weight in the Eurozone or global scheme of things. The initial market reaction to the crisis was therefore relatively calm: Greek debt auctions were oversubscribed until the end of April 2010. But to the bewilderment of all, Chancellor Merkel declared that there would be no rescue until Greece's debt-financing capacity was exhausted. Even in March 2010, when panic was spreading and a bailout a foregone conclusion, Merkel insisted that the crisis should not be discussed at the EU summit because Greece had not requested help.

The German approach only made the problem worse. By 11 April 2010, a €45 billion joint EU-IMF package was on the table. Too late: the 27 April ratings downgrade of Greek and Portuguese bonds to BB+ sent Greek spreads to 1,200 points and the debt skywards. A Greek bond auction failed. The next (2 May 2010) package that eventually stopped the rot was €110 billion, some €32.5 billion extra per week, plus a combined EU-IMF standby bailout fund of €750 billion (BIS, 2010). The failure to adopt an early and appropriate solution also meant risking contagion to other member states. Policy space for the Greek government and much of the Eurozone will be constrained for years to come. The markets trump the people – especially if it is not understood that given EU financial and monetary interdependence it is only a matter of time before they are *your* people.

Three final points:

- One cannot condemn the markets for 'causing' the crisis, as the German government did, while exposing Eurozone partners to market forces in dealing with the debt born of rescuing the banks. Is there public authority and policy in the EU, or only the rules of private competition and national self-interest? Why would small, vulnerable economies want to lose their policy autonomy and join the Euro if the protection of pooled reserves is denied at the most crucial moments?
- Even given serious institutional lacunae, if one has a single currency then in a crisis one must behave as if the Eurozone is a single economic entity. During the *financial* phase of the crisis, the EU led by the ECB behaved in just such a 'federal' fashion, violating its own rules to take on dubious collateral from banks. A repeat performance on sovereign debt was not to be and loans with stringent conditionality were hastily arranged. Most worrying is that creditor government reactions have now infected national politics with populist beggar-thy-neighbour sentiment.
- Finally, Germany and other Eurozone current account surplus economies refuse to look at their surplus position as a problem to be shared with debtors, who currently bear the burden of adjustment alone. Yet who buys creditor exports, if not the deficit countries? In a crisis, one should stimulate them to maintain a reasonable level of consumption so that trade recovers for all. That means internal transfers, one version of which might be a timely rescue. And who benefits most from monetary union in a crisis if not the surplus economies?

What should have been done? Remaining calm at the outset (November 2009), dealing with the matter quietly behind closed doors, and demonstrating to the markets that there was no danger of default would have prevented the whole unhappy train of events, and Greece and others would now have smaller (if still large) debts. There could have been a simple press conference in early December 2009 of ECB President Jean-Claude Trichet, the Commission President, the Commissioner for Monetary Affairs, and the Greek prime minister in which a brief and clear statement was made that there would be no sovereign defaults and that European institutions and partners would ensure that deficit finance and financial sector liquidity were available under all circumstances.

Next, official loans are a poor solution in a monetary union where the central bank can indulge in quantitative easing, or printing money, as in a domestic economy. Loans only add to the debt burden and allow markets to focus on the risk of default once again when loans are due. The ECB should have adopted immediately the same strategy it adopted in relation to the banks: unlimited repo operations in the asset markets concerned (this is now taking place, but too late) that places a floor under the price of bonds and brings the yields down, easing the increase in debt.

This can also be a highly profitable operation if one understands the one and only rule of successful investment: buy low, sell high. The ECB can finance itself for nothing indefinitely (danger of eventual inflation duly noted). Distressed sovereign bonds can be purchased at all time low prices, while income from yawning yield spreads are generous. As the market stabilises, spreads will come down and bond prices will rise, just in time to unravel ECB positions. The pain for Greece would have remained acute, but no German or Dutch taxpayer would have been asked to put up money, thus preventing what became an ugly, populist row across several EU countries.

Of course, this strategy carries with it risks and an exit plan would be required; but the risks were rather less than they were in the case of insolvent banks (Greece is after all sovereign and EU resources can be pooled). Such a strategy would have gone against the ECB's own rules, but no more so than the acceptance of toxic collateral from private banks under its Covered Bond Purchase Programme. Purchasing sovereign bonds before they are distressed is not about saving risk-taking financiers, but about stabilising the future of those whose resources already have been called upon. One should really prefer people to banks, at least if democracy and citizenship are to have any meaning.

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CONCLUSION

There was more than sufficient knowledge of the dangers of financial instability in a liberal integrated financial order to alert private and public authorities. There was no historical evidence to support the approach adopted to liberalise and integrate cross-border finance, nor for the theories which underpinned 'governance light'. This knowledge was not brought to bear and as a result taxpayers and future generations will suffer. Nonetheless, important lessons from the 1930s seem to have been well learned during the financial market phase of the crisis. The financial system was successfully rescued, although at considerable cost, and a serious depression has (hopefully) also been avoided.

Unfortunately, more primitive instincts prevailed during the sovereign debt phase. Domestic anti-European political dynamics were stoked by the very member governments who claim to be committed to an 'ever closer union'. What might have been a noble exercise in *ad hoc* EU governance innovation ran seriously aground. A poor strategy was adopted that saddles Greece and others with yet more debt amid market concerns with the ongoing possibility of default.

The proposed reforms to the stability pact will further constrain national policy space and punish errant debtors, with likely adverse consequences for their political legitimacy and that of the single currency.

Of course, Greece should long ago have reformed its system of tax collection, its accounting procedures, the audit and relative size of its civil service. But France and Germany also cheated in 2002–2005, albeit in better economic times. Perhaps there is something wrong in assuming that the origins of the crisis lay in the failure of government fiscal policy, rather than with the Eurozone's liberal financial and monetary order. In 2009, only six of the twenty-seven EU members held to the SGP's budgetary norm, and Greece did not end 2009 as the worst offender. Still stricter rules are no more likely to work in the future than in the past. Adjustment to global market pressures must be made more compatible with national political legitimacy, and a sensible mechanism for debt crisis management put in place.

'The Eurozone hangs in the balance as a result of serious policy mistakes led by its largest economy, Germany'.

The EU appears to have been looking for a functional equivalent of the lost, mythical Gold Standard: if only the rules are the right ones, and everyone behaves properly, stability will be achieved. Historical experience tells us that this is unlikely. As yet there is no sign of adequate debate or proposals regarding the development of EU institutions to prevent and/or manage future crises. The Eurozone hangs in the balance as a result of serious policy mistakes led by its largest economy, Germany. The worst is that banks were considered more important than fellow citizens, especially those in poorer economies. The poor and the 'other' too frequently appear expendable. There are sombre days ahead indeed for regional governance in the EU.

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