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European Perspectives on the Global Financial Crisis: Introduction*

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Introduction

The global financial crisis, which began in 2007 with the collapse of the US sub-prime mortgage market and which has yet to run its course, is on a scale that has not been seen since the Great Depression. Worldwide losses from the crisis, measured in terms of write-downs on assets originating in the USA, Europe and Japan, could be as high as \$4.1 trillion (IMF, 2009, p. 30). This financial turmoil has had a devastating effect on the world economy, with global gross domestic product (GDP) contracting in 2009 for the first time since World War II and trade likely to experience its steepest fall since this time (World Bank, 2009, p. 1).

Europe has not escaped the effects of the global financial crisis. The European Central Bank (ECB) expects write-downs of \$649 billion on securities and loans by euro area banks alone over the period 2007–10 (ECB, 2009a, p. 103). European Union (EU) GDP fell by an estimated 4 per cent in 2009, the bloc's first recession since the early 1990s and its worst performance on record (Commission, 2009a). This downturn has had a dramatic effect on the labour market, with the number of people unemployed in the

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EU-27 rising by 5.4 million between March 2008 and May 2009 (Eurostat, 2009).

Terrible though this turn of events may be, the global financial crisis represents an extraordinary opportunity for students of European political economy. Firstly it provides a unique natural experiment for understanding the functioning of economic and monetary union (EMU) in a world of intense but incomplete financial integration at the regional and global level. Secondly, it offers a case study into the EU's ability to provide policy co-ordination at home and leadership abroad in the absence of more centralized modes of decision-making. Thirdly, it allows us to observe the response of both the euro area and Europe's distinct models of capitalism to a colossal common shock.

This special issue of the *JCMS* tackles these and other issues from a variety of disciplinary backgrounds. It brings together economists, political scientists and political economists with the aim of putting the European dimension of the global financial crisis in its historical and intellectual context. The overarching themes are developed in the second part of the introduction following a brief, factual overview of the financial crisis from a European perspective.

I. The Financial Crisis in Europe

The flashpoint for the global financial crisis was the collapse of the US sub-prime mortgage market in early 2007 as homeowners who had been granted loans in spite of their poor credit ratings struggled to make repayments in the face of higher interest rates and falling property prices (see Federal Reserve of St Louis, 2009, for a detailed timeline of the crisis). Following the collapse of a major US sub-prime mortgage provider, New Century Financial Corporation, in April 2007, problems quickly spread to the US banking sector and the international financial system at large.

At the beginning of August 2007, the German government was forced to bail out IKB Deutsche Industriebank, one of several European banks to incur large sub-prime-related losses. Within a matter of days, BNP Paribas, one of France's leading financial institutions, took the decision to suspend three of its investment funds, citing a 'complete evaporation of liquidity in certain market segments of the US securitization market' (BNP Paribas, 2007). The ECB responded to this move within a matter of hours, providing nearly €100 billion in short-term financing to banks so as to ensure orderly conditions in the euro area markets. This move was the first of several emergency liquidity measures by the ECB and monetary authorities worldwide.

This initial phase of the global financial crisis in Europe claimed a high-profile victim in the form of Northern Rock. This UK mortgage provider, which had relied heavily on wholesale money markets as a source of finance, faced serious liquidity problems and was forced to apply to the Bank of England for emergency financial support on 13 September 2007 (Treasury Committee, 2008). This move triggered the first run on a UK bank since 1866, leading to the eventual nationalization of Northern Rock in February 2008.

Tensions in the US financial sector continued to mount over the course of 2008. In March, the US Federal Reserve brokered a deal that allowed US investment bank J.P. Morgan to acquire its troubled rival, Bear Stearns. No such solution could be found for Lehman Brothers, leading to the collapse of the investment giant in September 2008. The destabilizing effects of this event, which were magnified when the Federal Reserve was forced to bail out American International Group (AIG), the USA's largest insurance company, quickly became apparent in the EU as one Member State after another was forced to rescue banks so as to maintain confidence in the financial system. In Germany, for example, the government rescued Hypo Real Estate, a Munich-based commercial-property lender, which was destabilized by liquidity problems at its Dublin-based subsidiary, Depfa Bank. In the UK, the government nationalized the mortgage division of Bradford and Bingley and was forced to bail out Royal Bank of Scotland, Lloyds TSB and HBOS.

The intensification of financial integration in the EU, which had led to a number of cross-border bank mergers over the last decade, complicated the task of rescuing European banks. The experience of Fortis provides a cautionary tale in this respect. This Benelux-based bank encountered difficulties in autumn 2008 not only due to widespread liquidity shortages but also because it was highly leveraged following its takeover of Dutch bank, ABN AMRO, in 2007, as part of a consortium with the UK's Royal Bank of Scotland and Spain's Banco Santander. After protracted discussions, authorities in Belgium, Luxembourg and the Netherlands failed to agree on a workable rescue plan and Fortis, which had won the Global Finance Award for the best bank in Belgium and Luxembourg a matter of months earlier, was broken up (see Quaglia *et al.*, 2009).

Events in Iceland at this time were more dramatic still. The country's banking model, which relied to a significant extent on assets and liabilities denominated in foreign currencies, left it highly exposed to the global financial crisis and with limited policy options (Buiter and Sibert, 2008). The government took charge of the country's three largest banks, Glitnir, Landsbanki and Kaupthing, in October 2008. The fiscal implications of this measure only added to concerns over Iceland's economy, however, prompting the government to turn to the International Monetary Fund (IMF) for a $2.1 billion loan (IMF, 2008a).

Within the EU, Hungary was the first Member State to seek external financial assistance. Its economy was rocked in October 2008 by sharp rises in interest rates and a sudden fall in the value of the forint as concerns spread over the exposure of central and eastern European countries to the global financial crisis (Darvas, 2008). Several factors seem to have added to Hungary's vulnerability, including high debt levels, a burgeoning current-account deficit and significant exposure of domestic borrowers to foreign loans (Darvas and Szapáry, 2008). The ECB, mindful, perhaps, that euro area banks had lent heavily to Hungarian borrowers (*Economist*, 2008), provided emergency support to the country's monetary authority, the Magyar Nemzeti Bank (ECB, 2008). In October 2008, the IMF, the EU and the World Bank put in place a more comprehensive rescue package to the tune of €20 billion (IMF, 2008b).

Initial efforts to find a co-ordinated EU solution to this banking crisis foundered as Member States moved unilaterally to reassure savers. In September 2008, Ireland announced a 100 per cent guarantee for all banks' liabilities, including retail, commercial and inter-bank deposits that was initially restricted to the six largest Irish-owned banks. This put UK banks, which were protected by a less generous system of deposit insurance, at a competitive disadvantage and raised concerns that there would be substantial flows of savings to Irish banks (Millar, 2008). Fearful of such beggar-thy-neighbour policies, several EU Member States, including Austria, Denmark, Greece and Slovenia, moved quickly to guarantee bank deposits. Germany's decision to do likewise was especially controversial, coming as it did hours after Angela Merkel attended an extraordinary meeting of EU members of the Group of 8 (G8), which called on Member States to 'ensure that potential cross-border effects of national decisions are taken into consideration' (European G8 Members, 2008).

EU Member States eventually regrouped, however, and, in October 2008, the heads of state and government of the euro area invited the UK prime minister Gordon Brown to an emergency summit, where agreement was reached on a bank rescue plan (Eurogroup, 2008). Under this plan, which was later endorsed by the full European Council, EU Member States pledged €2 trillion to recapitalize and, if necessary, take shares in European banks (European Council, 2008). The plan also provided government guarantees for medium-term debt issuance in the EU and raised the minimum standards for deposit insurance guarantee schemes.

This spirit of co-operation carried over into Member States' preparations for the G20 summit in London in April 2009. The heads of state and government agreed on a 'line to take' on international financial issues at the Spring European Council in Brussels in March 2009 (see European Council, 2009a, Annex I) and EU members of the G20, France, Germany, Italy and the United Kingdom joined by representatives of the Council Presidency and the ECB worked closely together to co-ordinate their positions. European leaders – including French President Sarkozy, who had threatened to quit the summit if reform efforts fell short (Hall *et al.*, 2009) – were also broadly supportive of the summit's outcome, which included an agreement to strengthen and provide additional resources to international financial institutions, such as the IMF and World Bank and to combat protectionism and maintain openness in international trade (G20, 2009). They also supported plans to step up financial services regulation, for example by extending supervisory oversight to systemically important hedge funds and credit rating agencies (CRAs), revising the Basel II accord and clamping down on tax havens and non-compliant offshore jurisdictions.

The EU's efforts to ensure a co-ordinated solution to the effects of the global financial crisis on the real economy have been less successful. The European Recovery Plan, adopted at the European Council in December 2008, committed the EU and its Member States to an immediate budgetary stimulus equivalent to 1.5 per cent of EU GDP. Although the European Recovery Plan broke new ground in some respects (it is the first joint attempt by EU fiscal authorities to stimulate aggregate demand) it fell short in others (the proposed fiscal stimulus is small when compared to the efforts of other countries, such as the United States, and it makes little attempt to share the burden of fiscal adjustment among Member States *ex ante*).

The ECB has been more decisive than EU finance ministers in responding to the global financial crisis. The Bank cut its base rate by 325 basis points between October 2008 and May 2009, taking it to an historic low of 1.0 per cent. Conventional monetary policies have been accompanied by unconventional measures. The latter have included allowing banks to use a wider range of assets as collateral when borrowing from the Eurosystem and a switch from variable to fixed-rate tenders for the Bank's main refinancing operations, thus providing banks with unlimited liquidity at very low interest rates (ECB, 2009b). In May 2009, the ECB also agreed to purchase €60 billion worth of covered bonds, debt securities backed by mortgages or public-sector loans, in an attempt to ease credit conditions in the euro area (ECB, 2009).

The global financial crisis has prompted a rethink of financial regulation in the EU and other jurisdictions. In April 2009, the EU passed a regulation on CRAs (Commission, 2008). The USA also revised its legislation on CRAs (Securities and Exchange Commission, 2009) and the International Organization of Securities Commissions (IOSCO) revised the voluntary code of conduct for CRAs (IOSCO, 2008). In April 2009, the European Commission proposed a directive on Alternative Investment Fund Managers (notably managers of hedge funds and private equities) (Commission, 2009b). The USA is also considering the possibility of revising its legislation on hedge funds and the IOSCO has issued a report on hedge funds oversight in June 2009 (IOSCO, 2009).

The Basel Committee on Banking Supervision (BCBS) has been working on the revision of the Basel II accord, the content of which has largely been incorporated by the Capital Requirements Directive in the EU, which is also in the process of being modified, in parallel to the discussion taking place in the BCBS (2009). In both these forums, the policy debate has focused on the revision of risk weights for securitized products, the trading book review and new rules for liquidity risk management. Policy discussions concerning the revision of accounting standards, in particular the mark-to-market principle and how to evaluate illiquid assets, that is assets for which there is not a liquid market, have also taken place in the EU as well as internationally at the International Accounting Standards Board (IASB).

Discussions over the future of financial regulation in Europe have gone hand in hand with debates over the fate of financial supervision. At the EU level, the de Larosière report (2009), which was published in March 2009, proposed the creation of a European Systemic Risk Council and a European System of Financial Supervision with a view to transform the so-called level 3 committees of national supervisors into EU authorities. Although it is less ambitious than the Obama administration's plans to assign greater supervisory powers to the Federal Reserve (see Department of the Treasury, 2009), the de Larosière report (2009) is significant nonetheless. Specifically, the European Systemic Risk Council would be elected by the General Council of the ECB, thus (potentially) increasing the supranational dimension of EU financial market policy as well as expanding the Bank's own area of competence.

The global financial crisis continues to unfold at the time of writing (July 2009) and is likely to cast a shadow over EU business for some years to come. The European Council in Brussels in June 2009 endorsed de Larosière's ideas for strengthening EU financial supervision but the fine details of reform remain to be agreed and implemented (European Council, 2009b). It remains to be seen whether the crisis will intensify or impede the process of European integration. Iceland's application in July 2009 to join the EU suggests that the economic crisis may bring new political opportunities. Uncertainty over the depth and duration of the recession in the EU and the ability of central and eastern European Member States to meet the criteria for joining the euro area anytime soon are among the factors that point in the opposite direction.

II. Key Themes of the Special Issue

The origins of the global financial crisis are complex and interconnected (see Brunnermeier *et al.*, 2009; Financial Stability Forum, FSF, 2008; Financial Services Authority, FSA, 2009; Group of Thirty, 2009). The contributors to this special issue emphasize different elements of the story although there is broad agreement that the economic and financial instability witnessed worldwide in 2007 and 2008 originated from a combination of domestic and international policy failures.

Failures Foreign and Domestic

Louis Pauly (2009) locates the roots of the crisis in the unwillingness of national governments to engage in cross-border policy co-ordination following the collapse of the original Bretton Woods system in the early 1970s. For all the talk of macroeconomic imbalances in international institutions and forums over the last few years, the United States proved unwilling to reduce consumption and increase savings while countervailing measures were equally unpalatable to China, Japan and other major exporters. A burgeoning current-account deficit in the United States was matched by massive capital inflows, mainly from Asian investors and energy producers keen to hold assets denominated in US dollars. The ground was well prepared for disaster, when deregulatory zeal brought on a credit boom and a widespread mis-pricing of risk.

Iain Begg (2009) suggests that regulatory failures were among the chief causes of the global financial crisis. This failure, he argues, was not restricted to the shadow banking sector but encompassed mainstream and conventionally regulated financial institutions, which left themselves under-capitalized in their search for more profitable but increasingly risky trading strategies. Banking practices may have added to this problem, Begg suggests, by allowing bonuses to be awarded without exposure to risk or before the true value of net purchases or sales could be measured.

For Jacopo Carmassi, Daniel Gros and Stefano Micossi (2009), financial practices of this sort were a symptom rather than a cause of excessive credit expansion and investments. Reckless bets on asset-price increases, they argue, would not have been possible without domestic policy errors in the monetary domain. The pursuit of lax monetary policies following the bursting of the dot-com bubble in 2000, the authors suggest, added fuel to the fire of the credit boom and led a convergence of expectations among investors that asset prices would increase indefinitely. Individuals underestimated the risks from such behaviour not only because of ‘irrational exuberance’ but because central bankers in the USA, and to a lesser extent in Europe, created the misleading impression that monetary policy could 'mop up' in the event of an asset-price correction.

These problems were compounded, Carmassi, Gros and Micossi (2009) argue, by shortcomings in the framework for financial regulation and supervision. A puzzling feature of the current crisis is that some European banks were even less well capitalized than their counterparts on Wall Street in spite of the fact that financial regulation was deemed to be stricter in Europe than in the USA. Financial sector leverage, the authors show, increased by 70 per cent in the euro area over the period 1999–2007 compared with a figure of 40 per cent of GDP in the USA. A possible explanation is that European financial institutions interpreted the Basel accord's capital rules in a perverse way, treating minimum capital requirements as a *de facto* ceiling and neglecting broader risk assessment responsibilities.

Co-ordination at the EU Level but Concerns over Legitimacy

A recurring theme in this volume is that the EU Member States have showed a surprising capacity for ad hoc policy co-ordination in the midst of the global financial crisis. Perhaps the most significant development, Pauly (2009) argues, has been the 'quiet development' of emergency fiscal burden-sharing mechanisms within the EU in the form of reduced profits flowing from central banks back to national treasuries, through the balance sheets of multilateral financial institutions and through regional payments facilities. Thus, although the European Recovery Plan fell short as a form of *ex ante* burden sharing, solidarity between EU Member States was not entirely absent.

Another surprising feature of the EU's response to the financial crisis has been the degree of ad hoc co-operation between the UK and euro area members. The highpoint of this co-operation was Prime Minister Gordon Brown's attendance at the emergency summit of euro area heads of state and government in October 2009 to discuss the UK banking rescue plan. The summit endorsed Brown's ideas and it provided a template for similar efforts in other EU Member States. For Lucia Quaglia (2009), the EU's efforts at co-ordination in this area are an archetypal example of Europeanization in action. Although national interests and priorities were at the forefront in policy-makers' minds in responding to the crisis, the EU facilitated 'learning' (or copying) between Member States in their efforts to tackle weaknesses in national banking systems.

Even if the EU helped to avert financial disaster in Europe, the crisis, Erik Jones (2009) suggests, has taken its toll on EMU's legitimacy. The ECB has responded in a sure-footed manner to the financial crisis thus far, he notes, but less than half of EU citizens express trust in the institution. Similarly, the crisis may have convinced authorities in Iceland that the country's future lies in the EU and euro area, but only 39 per cent of EU citizens believe that the euro has mitigated the negative effects of the crisis. This loss of support for the single currency may be temporary, Jones suggests, but it is symptomatic of EMU's legitimacy deficit. In this respect, the financial crisis has confirmed that the ECB has limited options available for enhancing the perceived benefits of the euro during a period of heightened uncertainty over the economic outlook.

National Economic and Financial Systems under Pressure

How have individual European countries responded to the global financial crisis? In their contribution to this special edition, Iain Hardie and David Howarth (2009) consider the impact of the crisis on the bank-based models of France and Germany. A striking feature of the recent turmoil, they note, is that German banks, which have traditionally been seen as more conservative and regulated than their French counterparts, have incurred significantly greater losses. This is due, the authors argue, to the fact that the German banking sector has experienced a more dramatic process of financialization in recent years as commercial and regional banks have sought to increase profitability by increasing risk-taking through practices such as derivative trading. Ironically, such practices increased the vulnerability of German banks to the global financial crisis as evidenced, for example, by the exposure of Landesbank to the US sub-prime market via asset back commercial paper (ABCP) conduits. The German government's response to the financial crisis may slow down the process of financialization but it is unlikely to reverse it, raising questions about the fate of the country's bank-based model and the role of 'patient' capital in its particular variety of capitalism.

Dermot Hodson and Deborah Mabbett (2009) ask how economic and financial decision-making in the United Kingdom (UK) has been affected by the crisis. UK economic policy over the last decade, they argue, has been underpinned by a New-Keynesian inspired paradigm that prioritized the pursuit of price stability, delegated operational responsibility for counter-cyclical monetary policy to the Bank of England and allowed limited scope for fiscal activism. This paradigm had limited regard for the linkages between macroeconomic policy and financial stability, as reflected in the government's decision to share responsibility for financial crisis management between the Treasury, Bank of England and Financial Services Authority. The UK's New-Keynesian paradigm is under severe strain as a result of the financial crisis. Its credibility has been challenged, *inter alia*, by the failure of monetary policy to prevent a housing bubble from occurring and by the failure of traditional monetary policies to make amends after it burst. In spite of these and other strains, however, there is little sign of a radical reordering of the goals, instruments and institutions of UK economic policy of the kind that heralded the demise of Keynesianism and the rise of monetarism in the late 1970s.

David Mayes (2009) explores the response of Nordic countries to the global financial crisis. He finds little evidence that the financial crisis experienced by Denmark, Finland, Norway and Sweden during the late 1980s and early 1990s left Nordic countries less vulnerable to the effects of the recent financial turmoil than other Member States. One reason for this fact is that the current crisis has a different character from those of the late 1980s and 1990s. The increasing cross-border character of banking in Nordic countries, for example, made it more difficult for national authorities to mimic the financial rescue packages employed 20 years ago. More significant still was the fact that past crises did not pave the way for a radically new approach to financial regulation and supervision in the Nordic countries. In Sweden, for example, attempts to overhaul rules on bank intervention were not yet finalized at the onset of the global financial crisis, making it difficult for national authorities to deal with distressed banks. One reason for the slow pace of reform, Mayes speculates, is that the comparative success of crisis management during the Nordic financial crisis of the late 1980s and early 1990s bred complacency about the need to boost crisis avoidance policies.

Reform is Neither Inevitable Nor, in All Cases, Desirable

The Nordic experience shows that significant reform is not inevitable after a severe financial crisis. Hodson and Mabbett (2009) arrive at a similar conclusion in their analysis of recent reform proposals in the UK. For all the talk of revising or scrapping the UK's tripartite system of financial crisis management, neither the government nor the main opposition party seem willing to contemplate a radical overhaul of the aims and institutions of UK economic policy. The reason, the authors suggest, is that the political constituency for imposing counter-cyclical capital requirements is simply not there. Nor are politicians willing to consider measures that would put the City of London at a competitive disadvantage no matter how much the UK may have suffered during the global crisis from its dependence on financial services.

Carmassi, Gros and Micossi (2009), in contrast, argue that reform in Europe might go too far in response to the global financial crisis. They warn, in particular, of a regulatory backlash by EU policy-makers against forms of financial innovation such as securitization, derivatives and hedge funds. Such measures, they argue, could both hinder financial markets from promoting growth and investment in the EU and distract from the more important task of enhancing the linkages between monetary policy and macro-prudential supervision. To this end, the authors advocate, *inter alia*, the imposition of stricter capital requirements based on a definition of total assets that cannot easily be circumvented.

Begg (2009) critically evaluates the proposals for overhauling the EU's system of financial supervision set out in the de Larosière report in April 2009. Plans to create a European Systemic Risk Council led by the ECB, he suggests, are a step in the right direction towards a quasi-federal system of financial supervision. However, it remains to be seen how national regulators that exist separately from national central banks would be represented on such a body. He also welcomes plans to create a European System of Financial Regulators but remains puzzled as to why such a body would not be given responsibility for overseeing financial entities with substantial cross-border activity. A more fundamental weakness in the de Larosière report, Begg argues, is the failure to address the fiscal underpinnings of EU financial supervision. With an EU tax an unlikely prospect, significant doubts exist about the credibility of EU supervision and the arrangements for burden-sharing in the event that a systemic crisis should occur.

Reform at the EU level must go hand in hand with an overhaul of global economic and financial governance. A striking feature of the global financial crisis is the extent to which it inspired ad hoc attempts to co-ordinate emergency responses internationally and among EU Member States. The G20 emerged as the international venue of choice for heads of state and government seeking a co-ordinated approach to bank rescue packages and macroeconomic stimulus packages. At the technical level, the Financial Stability Forum (FSF) (later reformed as the Financial Stability Board by the G20) was at the centre of various networks of regulators, such as the BCBS, the IOSCO, the International Associations of Insurance Supervisors (IAIS), the IMF, the World Bank, etc. in elaborating the response to the financial crisis.

Pauly (2009) is critical of such adhockery, viewing it as a reflection of the 'thin' institutional framework to maintain macroeconomic and financial stability at international level. The G20 Summit in London in April, he notes, stopped well short of providing binding commitments for macroeconomic policy co-ordination and thus failed to address one of the root causes of the global financial crisis. Likewise, the decision to upgrade the Financial Stability Forum to a Financial Stability Board recognizes the need to give greater attention to macro-financial linkages at the international level but this new body lacks resources and a firm mandate.

Conclusion

The Irish novelist, James Joyce, said of his magnum opus, *Ulysses*, that its many enigmas and puzzles were deliberately put there to keep the professors busy for centuries, thereby ensuring his own immortality. This special issue of the *JCMS* shows that the European dimension of the global financial crisis is enigmatic and puzzling in several respects. Europe's exposure to the crisis challenges our understanding of the role of banks and financial institutions in European models of capitalism and the complex relationship between economic, monetary and financial integration within the EU. The EU's response to these events shows Europe to be both a global vanguard and a victim of global circumstances and invites further reflection on why, from the point of view of their legitimacy, European policy-makers appear to be damned if they do act and damned if they do not. The impact of the crisis on EU decision-making provides an opportunity to explore further the scope and limits of decentralized decision-making and to understand the extent to which economic and financial interdependence can be a driver of, and a deterrent for, European integration. For these reasons and others, the global financial crisis will undoubtedly live long in the debates among students of European political economy.

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