EUWatch

The EU from a Critical Perspective

A selection of articles from EUWatch

Independence/Democracy Group in the European Parliament

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Preface

Our choice to publish a compendium of the 'best' articles from the first thirteen issues of EUWatch (June 2006 to December 2008) was based on our conviction that these articles are not only well-researched, but are, in today's political context, as actual as ever.

To select the 'best' from among a plethora of excellent contributions was an extremely difficult exercise, largely influenced both by the general topicality and by the main political guidelines of the Independence/Democracy Group in the European Parliament.

We also express our gratitude to Prof. Kurt W. Rothschild, whose article "Prisoner's Dilemmas, Locomotives and the EU", reproduced in Chapter 6 "Financial Crisis", was a special contribution to this 'best of' edition.

The selected articles have hence been categorised under the following topics:

- The future of the European Union
- Democracy
- Subsidiarity
- The Charter of Fundamental Rights
- The future of the euro
- The financial crisis
- Defence
- Immigration
- Energy
- Europe in numbers

Although the Independence/Democracy Group is known for its eurosceptic, EU-critical and EU-realist positions, this publication has remained independent and has also included many EU federalists' views.

Our aim, however, was to provide a much-lacking balance to the Europhile Europeanist view within mainstream politics. This view subscribes to the dogma that there is only one goal, namely that Europe has to be ‘strong and powerful’, and that this can only be achieved by the political structure envisaged in the rejected EU constitution, today embodied in the Lisbon Treaty.

The doctrine that a ‘strong and powerful Europe’ could only be beneficial to European citizens is questioned, as are the ‘democratic’ credentials of this new entity that creates new terms to describe old political processes and entities.

This book seeks to unravel this doctrine and provide rationales as to why we should be rethinking the future by learning from the past and not repeating it.

Klaus Heeger and Karoly Lorant
Chief Editors

Note: The EUWatch issues quoted in some of the articles and interviews can be found on and downloaded from the following website: http://indemgroup.eu/48/

Chapter 6

Financial crisis

Kurt W. Rothschild, EUWatch, May 2009:

Restrictions on national monetary and fiscal policies in the EU make it difficult for member countries to initiate a national policy aiming at recovery and employment. But there could still be room for expansive action in some EU countries which then could act as locomotives for the EU as a whole. But since these expansive actions can only be modest within the present EU rules they would only be taken if there is some certainty that they will have a visible effect in the home markets and not be dissipated at once to other countries... But exactly this is forbidden through the "single market" and competition rules of the EU which demand that public projects must be announced EU-wide with contracts offered to the best bidder. This necessarily reduces the motive for a country which – in line with EU policy – is responsible to secure prosperity within its borders to act as a locomotive. It would have no guarantee that the home market would benefit sufficiently from such an action.

Peter Henseler, EUWatch, December 2008:

Undoubtedly the Euro protects itself against irrational speculative currency attacks, but neither does it prevent the slopping over of the crisis to the real economy nor does it remove real economy disparities. On the contrary, as the present automobile industries crisis and dramatically increasing unemployment show, the real economy crisis will even intensify.

János Plenter, EUWatch, December 2008:

Rules of globalization in general and the complex maze of EU regulations have hamstrung the ability of national governments to protect the economies and the financial structures of their countries from harmful external effects.

PRISONER´S DILEMMAS, LOCOMOTIVES AND THE EU - SOME CONSIDERATIONS IN CONNECTION WITH THE WORLD CRISIS*

By Kurt W. Rothschild (May 2009)

Conformity of judgement is not the rule when it comes to characterisations and explanations of economic phenomena. But hardly anybody would deny that the economic crisis which started in 2007 is the biggest set-back since the World Economic Crisis of the thirties of last century. Both with regard to extent and severity they show sufficient similarity to ask for comparisons. And the swiftness of world-wide action to prevent a break-down of the banking sector and the development of deflationary spirals shows that it is not impossible to learn from history.

But while the two world crises are comparable with regard to extent and severity they are not completely identical in nature. The world of 2007 was not the world of 1929. And this demands a consideration of special elements and policies in the present environment. Two elements which are of special importance in the new situation as compared with the earlier crisis are the vastly increased importance of the financial sector both in general and in its role as the main trigger of the crisis, and the existence of the European Union with its unifying effect on economic policy in the decisive European countries. The following considerations will deal with aspects connected with these special factors.

The dramatic changes in the financial sphere in the USA and their rapid global extension which started the World Crisis were the reason that to begin with one talked only of a Financial Crisis. The opinion was widespread that remedial action in the fields of financial policy and financial institutions would be sufficient to bring the crisis to a quick end and hopefully would provide a basis for avoiding such crises in the future. The quick reaction of national measures to prevent bank failures was a first and impressive result of this position. That the financial crisis could affect the “real economy” to some extent was of course realized in principle from the very beginning, but the force with which the real economy was ultimately hit, turning the Financial Crisis into a formidable Economic Crisis with world-wide effects on economic growth and unemployment, was only fully realized when the process was already on its way.

But when we look at the widespread discussions and actions dealing with the crisis and the means of ending it (please note that this article was written in spring 2009) one can see that considerations regarding fighting the crisis and planning reforms for a better future are far more directed to the field of finance than to matters connected with the “real economy”, with the world of goods, services, employment etc. which after all is the basis of material and social welfare. To some extent this priority of the financial aspect can be explained by the earlier appearance of the financial crisis with its discussion already in full swing when the extension into the real field became visible. And the financial problem remained of course relevant in connection with securing satisfactory conditions for the real field. Nevertheless it seems strange and dangerous that there is not an equally intensive and critical discussion about shortcomings and necessities for reform and action to overcome present and future setbacks in the real economy. This is particularly dangerous because the social and political consequences of a deep and long-lasting economic depression are – as history has shown – formidable.

On the theoretical front this tendency to concentrate on the financial aspects of the crisis can be partly explained by the basic assumptions of neoclassical and neoliberal economics which include the belief that free national and international markets for goods and services are a sufficient guarantee for a more or less stable development provided that the financial basis is sound and inflation can be kept under control. This belief found its expression in the idea of a new age of "successful moderation" expressed before 2007 by many economists including the present head of the Federal Reserve Bank Bernanke, meaning that with the achievement of low inflation an undisturbed economic development had been secured. Seen from such an angle it is of course understandable to regard the financial crisis as the principal cause of the present economic crisis which has to be tackled in order to be able to return to "business as usual". A different picture is however presented by "heterodox" theories with their long tradition of studying trade cycles and other disturbances. Their studies show the existence of endogenous instabilities in the market process as such which cannot be dealt with (solely) through manipulations of the financial apparatus. In fact the force and speed with which the recent financial crisis has pushed the "real economy" into recession and depression can only be explained by taking into account the fragility of the free market system.

It seems therefore that the present situation demands an equal amount of deliberations and efforts in the field of the real economy as has been devoted to the financial sphere. *Direct* action for achieving economic growth and full employment should be given equal weight to the financial strategies now and later if crises of the recent and present extent are to be avoided and overcome. Quite a lot of experiences and recommendations from earlier periods exist already which could be used as a starting point. I am not going to discuss this wide and partly contradictory field in detail, but want only point out a particular difficulty in starting an upward development with special reference to the EU.

The decisive aspect of an ongoing recession is the widespread insufficiency of demand in the consumption and investment sectors with mutually negative enforcements. In a more or less "free" market economy this presents a particularly telling example of a "prisoner´s dilemma" situation. This is particularly obvious in the investment aspect. All firms have an interest in a lively and growing economy where production and investment is profitable. Seen from the side of a single producer the ideal situation would be that all other firms have high employment and pay high wages leading to a high level of demand while he or she can keep wages and other costs at a low level and thus be particularly competitive. With isolated action firms have no possibility of influencing the first part of such an (individually) "ideal" scenario and are therefore led to the sole acceptance of the second part, concentrating on attempts to reduce wage demands and other costs including investment expenditure. With all firms following this strategy in search of competitiveness total demand – investment and consumption – remains depressed. All firms would be better of if they could come to an agreement *collectively* to invest and to pay growth-oriented wages which would move the economy to a higher level.

But such collective action is not possible in a purely privately regulated market system. Some sort of economic policy action must come from the outside when a quick exit from a recession is to be achieved. One obvious improvement could be to have a large sector in the economy which is not infected by the prisoner's dilemma logic of the private market economy. This idea was stressed by the American economist Hyman Minsky who already in the eighties of the last century foresaw the danger of repeated financial and other crises. He suggests the need for "big government", i.e. the need to establish a state-controlled sector for a broad range of public and semi-public goods and services whose running and investment expenditures would have a noticeable impact on the economy as a whole. By an anti-cyclical investment and expenditure policy such a sector could help to set a floor to recessions and to ease recovery. It is not difficult to see that such a policy runs counter to the current neoliberal tenet which demands "slim government" and the *privatisation* of as many public activities as possible in order to widen the field for profitable private activities.

Less far-reaching are indirect actions, i.e. policies which aim at improving demand and cost conditions in order to induce firms to increase production and investment. One possibility is the use of monetary policy. By lowering the rate of interest and creating conditions for easier access to credits the costs of investment are reduced and – so one hopes – recovery will be encouraged. This hope rests however on insecure assumptions. In a recession or crisis when demand is low and the future chances for recovery are uncertain investment does not necessarily respond readily to lower credit costs. Waiting for better times is preferred to risky action in bad circumstances.

Another doubtful strategy are measures to create downward pressure on wage demands and trade union rights. This is – quite apart from social and fairness considerations – largely counterproductive because the cost advantages so gained are lost to a large extent by the decrease in consumer demand due to the reduction of wage incomes. Wage constraint and protectionist measures can however improve the competitiveness of exports and thus lead to increased demand and employment. This involves however a "beggar-my-neighbour" situation. The advantage is achieved at the cost of other countries whose balances of payment deteriorate and who suffer from the reduced demand for their products with subsequent unemployment effects. And if many or all countries try to follow such an export-driven employment policy it will only lead to lower wages and protectionism all round with negative effects on employment.

Since these indirect methods of starting a recovery are of such doubtful effect the most promising public action in absence of a large public economic sector is a sizable increase in expenditure on goods and services by the government and regional authorities even if this involves budget deficits. This increased demand and the following multiplier effects on production and employment will in turn lead to an increase in tax revenues. But while this is an efficient policy it too is hampered by a Prisoner´s Dilemma situation. It will work well when many or all countries decide collectively to follow such public expansionary policies. But if they are applied only in one country a considerable part of the expenditure and the additional incomes will be spent on imports. Instead of creating the desired employment effects the country would be faced by an undesired deterioration of the balance of payments. (This effect does not occur when most countries follow such an expansionary policy so that imports and exports increase simultaneously in all countries with limited balance of payments difficulties.) This balance of payments problem can of course be reduced by protectionist measures, keeping the rise of imports under control. But this would not only lead to efficiency losses; retaliatory action by other countries would hit exports and would thus undermine the desired expansion.

This problem of leakage of public expenditure to other countries is much greater for small countries and small regions than for big countries which spend a larger part of income within their own area and have therefore lower import propensities. This fact provides the basis for the "Locomotive" concept which came into use after the "golden years" in the sixties of last century had come to an end. The idea is that in the case of an international recession one or several big countries with a dominant home market should start a large-scale expenditure offensive which would stimulate immediately their domestic economy but would also lead to increased imports connected with this expansion (*comparatively* smaller than in the case of smaller countries but considerable in view of the *size* of the economy). This will start a positive development in other countries leading to an all round recovery of international trade, growth, and employment. Two examples of such Locomotive effects were the stimulating effects of the German reunification boom on the surrounding smaller countries and on a larger scale the US consumption and expenditure explosion on many developed and underdeveloped nations.

In connection with the infection of the "real world" economy through the Financial Crisis the emergence of a "Locomotive" would have been (or still is) an understandable proposal. But the problem is to find such a Locomotive. The US, with their huge domestic market a "natural" candidate, have dropped out because they are too deeply involved in the crisis which they have initiated. Neglecting the very special case of China (which *potentially* could act as an impressive Locomotive) Europe is an obvious theoretical alternative. If the European Union had achieved the status of a fully united political and economic body with a common economic policy not only directed towards price stability but also towards full employment it could indeed have played an important role as an initiator of international recovery. But in its present stage of partial integration where policy questions regarding economic growth and employment are left to the responsibility of the national governments the EU as such is not capable of making such a contribution.

But could not Europe be a positive influence if a Locomotive can be found *within* the EU leading to a recovery in the European area as a whole which then could spread to other parts of the world? Could not Germany or France or – even better – Germany and France combined take on such a role? The answer is that under the present framework of the EU such a strategy cannot be expected. The core of the difficulty lies in the neoliberal basis of the EU concept with its belief in the efficiency of a system of free unregulated markets and competition in a world characterized by change and disturbing elements. This outlook is particularly visible in the institutions of the independent Central Bank with its uncontrolled power to follow a single-minded policy of price stability and the Maastricht Treaty with its strict limitations on the fiscal policy of the member governments. This arrangement means that both monetary and fiscal policies which have been the main tools of governments to deal with recessions and other disturbances are taken out of their hands while at the same time leaving them with full responsibility for achieving national prosperity. This contradiction is justified by an ideology which maintains that if price stability is secured private markets and competition will be the best way to overcome economic disturbances. Interference through government action (monetary or fiscal) would make things only worse. While it is easy to see from historical records that this view cannot be maintained it is equally easy to see that it corresponds very well with the interests of the big financial and transnational concerns which have become increasingly dominant with the new possibilities for international organisation and activities created by the micro-electronic revolution.

These restrictions on national monetary and fiscal policies in the EU make it difficult for member countries to initiate a national policy aiming at recovery and employment. But there could still be room for expansive action in some EU countries which then could act as locomotives for the EU as a whole. But since these expansive actions can only be modest within the present EU rules they would only be taken if there is some certainty that they will have a visible effect in the home markets and not be dissipated at once to other countries. More concretely: If a country wants to stimulate production and employment in the private sector it must advertise its projects in order to obtain tenders from private firms being then able to choose the most favourable offers. If the object of a project is not only its usefulness but also or even predominantly its role as an impulse for the national economy an optimal result will be achieved if tenders of domestic firms are given priority. This will make certain that at least the first round of the added demand will be effective within the country. But exactly this is forbidden through the "single market" and competition rules of the EU which demand that public projects must be announced EU-wide with contracts offered to the best bidder. This necessarily reduces the motive for a country which – in line with EU policy – is responsible to secure prosperity within its borders to act as a locomotive. It would have no guarantee that the home market would benefit sufficiently from such an action.

It should be stressed that the EU argument in support of this prohibition of nationally oriented projects, viz. that they are protectionist and therefore – sinning against the free trade dogma – inefficient, cannot be maintained. Like many other cases this is an example where traditional policy propositions which are meaningful in a stable full employment economy lose their validity in times of recession and unemployment. Permitting a country to uphold national restrictions in its expansionary activities does not destroy free trade conditions, but on the contrary lays the basis for a recovery of an international trade which has been reduced because of the recession. The force of the Financial Crisis has already led to the revision and neglect of the strict budget rules of the Maastricht Treaty. Other revisions in the EU constitution should follow giving more weight to meet the problems and dangers in the "real economy".

NOTE:

* This article is a special contribution of Prof. Kurt W. Rothschild to this EUWatch issue and has not been published in previous EUWatch editions.

THE FINANCIAL CRISIS: STRENGTHENING OR WEAKENING THE EU?

By Peter Henseler (December 2008)

THIS ARTICLE COMMENTS ON SOME RECENT ANSWERS GIVEN TO THE OLD QUESTION 'DO WE NEED A EUROPEAN ECONOMIC GOVERNMENT?' (GOUVERNEMENT ÉCONOMIQUE) WHICH AT THE SAME TIME COULD ALSO GIVE AN ANSWER TO THE QUESTION OF WHETHER THE EU WILL BE STRENGTHENED OR WEAKENED BY THE CURRENT FINANCIAL CRISIS. THESE QUESTIONS WERE RAISED IN THE CONTEXT OF THE PREPARATION OF THE WASHINGTON FINANCIAL WORLD SUMMIT (G-20 SUMMIT, IN PUBLIC OPINION ALSO CALLED 'EMERGENCY SUMMIT') BY THE EU HEADS OF STATE OR GOVERNMENT IN THE RUN-UP TO THEIR INFORMAL MEETING ON 7 NOVEMBER 2008. ANGELA MERKEL GAVE HER ANSWER TO THE FIRST QUESTION IN HER PRESS BRIEFING ON THE MEETING'S MAIN RESULTS. THE SECOND QUESTION RELATING TO THE STRENGTHENING OR WEAKENING OF THE EU MAY BE ANSWERED TWOFOLD: (1) FROM THE POINT OF VIEW OF THE RELATION BETWEEN DECENTRALIZED AND CENTRALIZED INSTITUTIONS AND COMPETENCES, AND (2) AS FAR AS THE EU'S ROLE IN RELATION TO THE USA AND THE REST OF THE WORLD WITHIN A GLOBALIZED ECONOMY IS CONCERNED.

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

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

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

Yes, he may be right, but it applies only within the context of the financial markets' view [*Finanzwirtschaft*]. In terms of the 'real' economy [*Realwirtschaft*] there is no reason to forget all the economic and social disparities between Euro-countries putting the Monetary Union (MU) at risk – even if its collapse, in particular if compensation mechanisms (for some examples see below) are not sufficient in the absence of the well known criteria of an 'Optimum Currency

Area' (OCA). These criteria are in particular wage flexibility, labour mobility and freedom of capital. Only a political union could ultimately guarantee all the functioning of these compensation mechanisms. This was pointed out clearly by the OCA economists, among them *Robert A. Mundell* (Nobel Prize winner in 1999) and *Paul De Grauwe* (distinguished financial economist at the University of Leuven and adviser to EC President *Barroso*) – see the interviews with *De Grauwe* reprinted in EUWatch, Issue 3 (Oct./ Nov. 2006). One essential element of a political union and at the same time necessary (even if not sufficient by itself) condition for its functioning is an economic government.

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

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

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

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

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

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

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

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

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

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

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

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

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

Apparently *Sarkozy* – perhaps following his specific personal ambitions – is trying to revive the old idea of an economic government by setting up the Euro-Group in the composition of the heads of state or government. Yet this has not found consensus at the informal meeting of heads of state or government on 7 November 2008. Thus, the opportunity to institutionalize undoubtedly necessary re-regulation procedures of deregulated financial markets was wasted because not even the institutional structure to manage this kind of re-regulation has found consensus. Also, when differentiating between supervision and regulation, it is the supervision of deregulated markets that may be given priority, not necessarily more regulations. But even with respect to this more 'modest' approach, the summit did not give satisfactory answers. (The real cause of this may be found in the independence ideology of the ECB.)

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

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

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

- submit rating agencies to registration, surveillance and rules of governance;

- adopt principles of convergence of accounting standards;

- decide that no market segment, no territory, and no financial institution should escape proportionate and adequate regulation and at least oversight; establish codes of conduct to avoid excessive risk-taking in the financial sector, including the systems of remuneration;

- strengthen the role of the IMF by giving it initial responsibility, together with the Financial Stability Forum (FSF), of recommending the measures needed to restore confidence and stability.

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

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

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

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

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

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

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

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

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

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

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

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

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

THE EU IN THE TURMOIL OF THE FINANCIAL CRISIS THE PARTICULAR VULNERABILITY OF CENTRAL AND EAST EUROPEAN COUNTRIES

By János Plenter (December 2008)

THE CURRENT FINANCIAL CRISIS WHICH IS PLAYING HAVOC WITH THE ECONOMIES OF OUR PLANET HAS BEEN LONG FORESEEABLE. IT STARTED IN AUGUST 2007 AND FOR A WHILE THERE WERE HOPES THAT IT WOULD GET MORE MODERATE IN 2008. YET, CONTRARY TO THOSE EXPECTATIONS AND DESPITE EFFORTS TO CONTAIN IT, THE CRISES HAS BECOME MORE WIDESPREAD AND MORE SEVERE IN RECENT MONTHS AND THE GOVERNMENTS AND FINANCIAL AUTHORITIES APPEAR TO BE UNABLE TO FIND AN EFFECTIVE, UNIVERSAL SOLUTION TO THIS GLOBAL FINANCIAL PHENOMENON.

It is beyond the scope of this paper to discuss the substance of this financial crisis. Nevertheless, in view of the extraordinary nature of this financial calamity a statement is warranted about its true cause. And, to put it simply, the root cause of this global disaster is the extremely large debt burden which has been built up in the industrialised world over the past several decades; a debt burden which grew so big that the real economy was unable to service it any more. To put it more bluntly, we are witnessing the bankruptcy of the global real economy in face of the global debt burden, imposed upon it by the financial dictatorship of the global banking system.

The forms of this unprecedented financial disruption which brings back the memories of the 1930s are numerous and the crisis has reached a stage where it is beginning to seriously hurt the real economy in many countries, particularly in those of the OECD group.

The purpose of this paper is to provide a brief review of how this global financial crisis affects the economies of the EU and, more specifically, Central Europe, which is a region with special economic and social characteristics within the European Union. The basis of such an analysis can only be a clear understanding of how the financial crisis has so far affected the major economies that are the sources of this financial turmoil.

THE FEATURES OF THE CURRENT FINANCIAL CRISIS

The facts indicate unequivocally that in the leading economies of the West the major consequences of the financial crisis are so far the following:

A world-wide liquidity crunch in the credit markets, more specifically in the money markets;

The circulation of money has almost completely frozen up in the banking system, interbank lending is in deep freeze, banks are reluctant to transfer any funds to each other;

A dangerous erosion of capital for all the major banks and financial institutions, due to the large amount of non-performing assets in the banking system and a sharp decline of the market value of shares in the banking sector, both in the US and Europe;

A sharp decline in the stock markets world-wide, with huge losses for investors, and with serious damaging effect on household wealth;

A sharp tightening of credit conditions for home owners, declining real estate prices, with steadily growing number of individual bankruptcies;

Massive financial intervention of the states in order to save the banking system with taxpayers' money, in sharp contrast with the prevailing economic policy of neo-liberalism, which has been hostile to any role of the state in the economy;

Indications of a gradual spill-over of the financial troubles into the real economy (falling sales, production cutbacks, and layoffs);

Huge increase in government budget deficits, as a consequence of the massive bailout of the banking systems by the states.

As the financial crisis has been spreading from America to Europe over the past 12 months, so grew the recognition in Europe of the need to set up a financial defence mechanism in order to contain the looming financial disaster. It has turned out, in the meantime, that the banking system of Europe has become much more deeply involved in the speculative financial games of Wall Street than it was previously thought. The huge sums of bail-out agreed upon by the 15 eurozone countries on October 12 appear to have saved the European banking system from a meltdown, but the problems of the real economy, which is now facing an unprecedented de-leveraging and lack of access to funds, remain unanswered.

It is a remarkable feature of this financial crisis that it was first believed to be an isolated American affair. Of course, in a world economy of a globalised nature, where business is dominated and determined by a closely integrated global network of banks and other financial institutions, the turmoil was bound to spread and to affect every economy, although in different ways and to different degrees. The region of the EU and the CEEC countries in Europe is a clear case in point.

THE PARTICULAR VULNERABILITY OF THE CEEC COUNTRIES

The economies of the CEEC region (Central Europe, for simplicity) have several common features which play a role in the way the global financial crisis affects these economies.

In pointing out just some of them, their by far most critical common problem is a relatively high foreign indebtedness. According to some very recent data, the external debt of e.g. Hungary amounts to about 96 percent of the country's GDP, and the relevant data in the case of both Bulgaria and Estonia is 101 percent, in Poland, around 81 percent, in Romania around 70 percent, in Slovakia 80 percent. The Czech Republic has the best external debt position, with 40 percent of the GDP.

In a statement issued in October 2008, the IMF came to the conclusion that due to the large foreign debts, Central Europe is the most exposed region among the emerging economies. In view of the huge debt service burden, the IMF analysis forecast the collective current account deficit for this region to rise in 2008 to a whopping 7.2 percent of total gross domestic product, which is twice the shortfall as recently as in 2002.

In order to re-finance the huge current account deficits, the countries of Central Europe need massive new loans from the world banking system, but the current contraction of the world credit markets and the reluctance of the banks to lend, pose enormous difficulties for the region to maintain its overall financial and economic stability.

A recent report from a financial research institute paid special attention to the quality of sovereign debt from this region. The outcome was rather frightening. In the event that counterparty risk should spread from corporations to sovereigns, the countries in Central Europe among the most at risk would be Bulgaria, Estonia, Lithuania, Ukraine, Latvia, Romania and Hungary. The most recent troubles of trading in bonds issued by Hungary appears to be a sad confirmation of this forecast.

In order to highlight the true dimensions of external debt, here are some data concerning the total foreign debt of several CEE countries, in absolute figures, as of early 2008, in billion US dollars:

Bulgaria	44
Czech Republic	58
Hungary	110
Poland	268
Romania	84
Slovakia	56

Closely related to the grave problem of external debt is the fragile nature of the currencies of the CEE countries. The national currency of many countries in the region is particularly vulnerable because of the vast current account deficits associated with external debt. These currencies could come under attack quickly if any doubts occur in the financial markets about the ability of some country to service its external debt. It was an ominous sign to this effect that in September 2008 the Romanian leu lost 5.9 percent against the euro, the Hungarian forint 9.9 percent, the Polish zloty 6.6 percent, and the Czech crown 3.3 percent. The Hungarian forint lost a further 2 percent in one day, October 14.

Of course, national banks are supposed to have enough foreign currency reserves to stave off attacks on their currencies, but history shows that even some major industrial countries proved unable to withstand a massive attack on their currencies.

LACKING POSSIBILITIES OF NATIONAL GOVERNMENTS TO PROTECT THEIR ECONOMIES AND FINANCIAL STRUCTURES

Next to the number one problem of external debt, another serious weakness of most CEE countries is the limited possibilities of the governments to control the economic and financial situation in their own countries. Rules of globalization in general and – after the 2004 adhesion to the European Union – the complex maze of EU regulations have hamstrung the ability of national governments to protect the economies and the financial structures of their countries from harmful external effects.

While expanding eastward, the major tenet of EU economic policy was – and still is – the free flow of goods and capital. But it has proved to be a oneway street, as it had been predicted by many at the time. Essentially, capital moved only from the major western economies to Central Europe and no investment capital was flowing from Central Europe to western countries, since in the poorer Central European region there was no capital of any significance for investment in Western Europe. The same story applied to the free flow of goods. After 1990, when Central Europe's economies became liberalized, western multinationals launched an unprecedented invasion of Central Europe, and with the active cooperation – or connivance – of local governments they have acquired the most valuable productive assets and destroyed thousands of smaller local firms which did not have the financial strength to withstand that brutal onslaught, in the name of the freedom of the markets.

As a result of that onslaught, the share of foreign direct investment (FDI) in Central Europe is stunningly high. A survey in 2005 established the following data (in percent of GDP):

Bulgaria	34,3
Czech Republic	48,1
Latvia	28,7
Lithuania	29,1
Hungary	55,9
Poland	31,3
Romania	24,2
Slovakia	32,8

To understand the true significance of these figures one should note that the average FDI in the 15 EU members before the enlargement was 33.1 per cent, but this was more than offset by a 42.7 per cent direct investment of these economies in other countries.

The harmful economic and social consequences of this extreme dominance of foreign capital are now becoming especially clear, when the multinationals, under financial pressure themselves, are trying to reduce their own problems at the expense of other economies where they operate, mainly by closing down production in various regions, including that of Central Europe. And the countries of Central Europe have hardly any production structures of their own to fall back on in times of crisis, since most of those structures and plants have been destroyed.

Furthermore, when reviewing the special situation of Central Europe, we cannot miss a brief reference to the state of the financial markets in Central Europe, more particularly to the banking sector:

Like most of the production facilities in the real economy, the banking sector is also dominated, directly or indirectly, by foreign banks, mostly from France, Germany, Austria and Italy. In Poland, for instance, foreign banks own 70 percent of the entire banking system. In Hungary, the only Hungarian bank with significant Hungarian ownership (OTP Bank) is struggling to survive. If it fails, the banking industry in Hungary would be 100 percent under foreign control. In Slovakia, the total banking sector is already under the control of foreign banks which acquired the previous Slovak banks in the process of their privatization. In response to the global financial crisis, Slovakia took certain steps in order to prevent foreign banks from drawing assets from their Slovak branches, in case some of those banks wanted to solve some of their problems at the expense of their operations in Slovakia.

This is, indeed, only one specific risk under the given circumstances. A much greater risk, however, is that the governments of Central European countries have no knowledge of the true financial conditions of the banks which operate large networks in their economies, since the headquarters are beyond their jurisdiction. If any of them collapses, the failure would cause the collapse of their networks in Central Europe, with huge financial and economic losses for these economies.

DISCRIMINATORY AGRICULTURAL SUBSIDIES

Finally, one should recall the treaties of 2004 which provided the framework for Central Europe to join the EU. These treaties forced Central Europe to accept a highly discriminatory arrangement concerning agricultural subsidies. Although Central Europe pays the full contribution to the EU's own resources, the initial subsidy received by the new Member States was only 25 percent of the subsidy enjoyed by the previous members and -through a slow gradual increase- parity will be reached only in 2013. As a result, the highly subsidised agricultural products of these countries are being dumped on the markets in Central Europe, destroying agricultural production, increasing rural unemployment and contributing to the current account deficits.

The list of factors which make Central Europe more vulnerable to the global financial crisis could be expanded further, beyond the several points mentioned above. Nevertheless, even the several points made should prove beyond doubt that the unprecedented loss of financial and economic freedom of this region, reminiscent of colonial dependences of the past, makes this region much more exposed to the financial turmoil and much more defenceless than the dominating economies of the European Union.

Most governments of Central Europe hold an opposite view, but these are the same governments which were claiming just a few months ago that the financial turmoil would have no meaningful impact on Central Europe. These governments do not level with the public, although such hypocrisy will only increase the misery of the unprepared individual.

As a matter of fact, in Central Europe we can already pinpoint some of the most damaging economic and social consequences of the financial turmoil. Some of them are already quite visible, others are emerging. Notably:

(1) Countries with large current account deficits and exposed to large external debt will have difficulties refinancing foreign debt. As a result, their currencies will be under serious pressure, including speculative attacks on the currencies. The IMF and other institutions will pressure these governments to continue servicing their external debt at any price, including further cuts in social spending, cuts in government spending in general and increasing taxes. The economic and social byproduct of the austerity measures will be further unemployment and further misery of the people. Unemployment and poverty will be exacerbated by the fact that in the wake of destructive globalization very few locally owned companies are left over to absorb the newly unemployed.

(2) As a consequence of high external debt, the percentage of debt service in the export revenue of Central Europe is bound to grow, leaving less for national consumption. A survey in 2005 revealed a level which was excessively high already at that time:

Bulgaria	31,5
Estonia	13,7
Hungary	31,0
Latvia	37,4
Lithuania	16,5
Poland	28,8
Romania	18,3

(3) Real estate prices will decline; particularly single family homes purchased with bank loans will be hit hard. As banks tighten credit conditions, loans for buying homes or refinancing existing debt will be hard to obtain, and the credit squeeze will cause – in all probability – an increased number of foreclosures and repossessions. Lower property values will reduce the aggregate wealth of the nations. .

HAS THE EUROPEAN UNION BEEN BUILT ON FALSE ECONOMIC AND MONETARY-FINANCIAL PREMISES?

In conclusion of this brief analysis one can raise a final and fundamental question about the European Union itself. It is now obvious that the modern world has been built on false economic and monetary–financial premises. Does this conclusion apply to the European Union as well? If the answer is yes, what are the areas where changes would be most needed and – realistically – what changes can be expected, if any? This is an important issue, while the eventual response of the EU in the area of economic, monetary and fiscal policy, or in the area of institutional arrangements, will significantly determine the way Europe and its people will adapt to a changing world and the eventual response of the EU will also determine the ability of Europe to maintain at least a minimal prosperity and well-being of its population for generations to come. Ultimately, Europe‘s political and economic order could be at stake.

What are, then, some of the most urgent changes to be made in the realm of the EU and within its competence?

First and foremost, interference with the smallest details of business and industry should be abandoned. Thousands of directives, describing in minute details how a product should look like, how it should be made or produced, should be scraped. The maze of unnecessary regulations kills business initiative, destroys employment and results in shrinking absolute purchasing power of the European public. And the numerous scandals show that even the stated objectives of this policy are far from being achieved. 19th century Europe knew hardly any governmental system of product regulations, yet the economy was booming. If Europe wants to be competitive in a global world, the first task is to restore the freedom of business – and freedom of the individual – to produce things they wish and the way they decide to produce, with full responsibility for any wrong decision. This would be the best economic stimulus the EU could provide in fighting recession in Europe.

It might also be opportune to examine, within the framework of a judicial review, whether the myriads of EU business regulations and restriction are contrary to fundamental human rights that include the right and freedom of everybody to use his or her own resources according to his or her discretion, for the purpose to achieve his or her best happiness.

As it is now, the EU harmfully restricts the business initiative of millions in Europe, while in actual fact not protecting the health and safety of the public. Statistics show this.

Secondly, it is time to review and modify the Stability and Growth Pact, which is an integral part of the Maastricht Treaty. More particularly, the provision to keep the budget deficit of the member countries under three percent needs a thorough reexamination. It is an arbitrary number, never proved scientifically, and most member states have been permanently having trouble implementing it. Unfortunately, monetary theory is of no help in solving the problem. The issue is closely related to the creation and supply of money, another big area of theoretical uncertainty.

In our era, in the era of fiat money (or paper money), when money is created at the discretion of human beings (mostly by the banking system, including the Central Banks), fiscal imbalances can occur due to monetary imbalances, outside the control of governments. In order to be able to respond to changing monetary circumstances, governments need more fiscal flexibility. The three percent limit denies them this flexibility. One idea could be to link the advisable limits of budget deficit to unemployment.

Thirdly, it is time to create a totally free market within the EU for agricultural products, as it is for manufactured goods. The current, restrictive agricultural policy, together with any forms of CAP, should be abolished. It is an economic absurdity that with the help of quotas and subsidies the EU effectively restricts the optimal use of land within Europe, although land is the most valuable and irreplaceable asset in every economy. If freed from all the political shackles, the agriculture of Europe could absorb a great number of rural and urban unemployed – a highly desirable objective.

Fourthly, for the benefit of all the peoples of Europe, the world financial crisis necessitates a thorough review of the role of the European Union in the framework of pan–European efforts to create an 'ever closer Union'. Two grave shortcomings of the EU are already obvious:

- First, while in many areas the EU is enforcing a harmful policy of restrictions, in other areas it is pursuing a reckless policy of liberalism, notably in trade relations with other continents. These harmful policies made Europe an easy victim of the world financial crisis and they are largely to blame for the great hardship and misery that the peoples of Europe have to suffer in order to contain the economic consequences of the financial collapse.

- The other shortcoming is the lack of efficiency of the EU when confronted with a global economic and financial disaster. Where was the EU when the crisis started in 2007? What actions did the EU take ever since? Practically nothing! All measures of financial defence were taken by the member states separately, each on its own behalf. The EU is only a framework for these actions, which could have been taken without the current framework of the EU, in a coordinated way. The euro as a common currency however has proved to be a much more efficient instrument of cohesion and joint action than the EU policies. This fact should be a sobering lesson.

As a counterweight to this lack of efficiency, we can witness a visible surge of sovereign decisions by many member states. This is inevitable, since the EU – despite all its rhetoric to the contrary – has proved unable, so far, to project an economic vision of Europe, where sacrifices and benefits of member nations are well balanced for the common well-being of all the peoples of Europe. No doubt, this is an enormous challenge. But Europe will see a slow but steady re-emergence of the role of sovereign member states in shaping their own economic and financial destiny, and the EU might find itself irrelevant if a truly common economic and social vision is not found.

Beyond the empty rhetoric, like competitiveness, cohesion, convergence, etc., the EU needs a thorough reappraisal of its policies. In view of the growing economic and social instability in Europe the EU should offer solutions for the common fear of the great majority of Europeans, and its proclaimed objective should be the economic and social security of every European through the common efforts of every European.

By the mere weight of its threat the global financial crisis appears to have jolted the EU out of its self-delusion and complacency. Important changes appear to have gained momentum in at least three areas.

First, the benefits of the eurozone have become obvious as a main instrument of monetary and financial defence, particularly for smaller countries. There are indications that for most of the smaller countries outside the eurozone the crisis will accelerate the process of adhesion to the zone.

Second, after decades of benign neglect the banking sector will be subject to more scrutiny – and possibly supervision – on the part of the EU. Since money is the central instrument of economic activity, monetary issues cannot be merely left to the banking system. The real economy – and the taxpayers – must be protected against the greed and monopolistic power of the banking network.

Third, the rule of reckless liberalism in economic policy is likely to be over. This fact can turn out to be a great benefit of the global financial crisis, even if the price for this change is terribly high. As part of the changing philosophy, the state is again an acceptable partner in the economy as it is actually saving the reckless free market from extinction. It is an absurdity to deny the state its role in the producing sphere of the economy, but to demand from it to fix all economic and social damages caused by the free market, notably in the field of unemployment. For the EU, to acknowledge and support the role of the state in the economy is absolutely essential. It could be the touchstone of its sincerity to change.

FINAL REMARKS

Looking ahead into the future one cannot emphasize enough that a way out of the present crisis can only be found if one tries to treat its true cause, not the side effects. And the true cause is the huge global imbalance between the astronomical sums charged to the real economy on a global scale and the inability of the real economy to service this debt.

The European Union can do much to answer this challenge within its own sphere of responsibility. Fundamentally, the EU needs to revise its financial structure, de-centralise the collection of public revenues and abandon some of its pet projects. Some suggestions to this effect:

Member states should be encouraged to reduce their VAT by 1 or 2 percent, and at the same time empower the municipalities to impose a local levy on local commerce, as a way to improve their impoverished financial situation. More money would be spent for issues that really affect the life of the citizen, with less bureaucracy.

Instead of financing various local projects, the EU could much more effectively help the economic efforts of Member States by abandoning such activity and by reducing the Member States' contributions to the EU's resource based on the gross national income (GNI), which accounts for around 69 % of total EU revenue.

The ability of the banking sector to deluge the public with credit must be restrained. This can be achieved though various means, e.g. by establishing a legally binding higher capital requirement within the EU. Contrary to official views, the problem is not too little credit (debt) but too much credit, which becomes an impossible burden to service anymore. The global financial crisis demonstrates that any boom built on credit is a false boom. There is a great opportunity for the EU to develop an economic system where boom and lasting prosperity is not built on credit (debt!), but on a more rational concept of the economy, where production and consumption is determined by the existing purchasing power in the economy, without credit.

There is a widely held economic assumption that man's economic activities are driven by two factors: fear and greed. In substance, the neoliberal concept of economic policy has been one that approves and advocates greed, with all its disastrous consequences as we are seeing today. The EU could take the initiative to construct an economic model that severely restricts the role of greed in economic relations amongst human beings, while maintaining individual incentive to work. A move in this direction would be of epochal significance in the history of mankind.

In times when the EU is struggling with so many issues of immediate concern, the idea appears to belong to fantasy. But people are really prone to new ideas only when in distress. And Europe is now in distress.

Yet as the world crisis brings new institutional arrangements into being (G-20 Group, enhanced role of the IMF, etc.), the European Union will lose some of its powers to solve its own problems at its own discretion, while EU Member States will be under pressure at home to find their own solutions. All this is bound to weaken the position of the European Union.

THE IMPACT OF THE FINANCIAL CRISIS ON THE EUROPEAN UNION

By Mogens Ove Madsen (December 2008)

> *"Speculators may do no harm as bubbles on a steady stream of enterprise. But the position is serious when enterprise becomes the bubble on a whirlpool of speculation. When the capital development of a country becomes a by-product of the activities of a casino, the job is likely to be illdone"*
>
> J.M. Keynes (1936): The General Theory of Employment, Interest and Money

No doubt, neither the collapse of Wall Street in 1929 and the following depression are forgotten, nor is Keynes' monetary theory of production and his policy-proposals.

Recently, Citigroup economists wrote in an equity research report that the heart of capitalism is under pressure and, much more horrifying, that much of the economic pain still lies ahead, including job losses, business failures, mortgage arrears, repossessions and debt warnings. But this crisis did not start yesterday. As a matter of fact it is one of the best-predicted crises in history, and it manifested itself a few years ago, in 2004, when the US interest rates began to be raised. At that time the US housing market began to suffer, with prices falling and a rise in homeowners defaulting on their mortgages. In recent years, banks have switched over to a new model, selling the mortgages on the bond markets. This made it much easier to fund additional borrowing, but it has also led to abuses, as banks no longer had the incentive to carefully check the loans they granted. By 2005, sub-prime lending had spread from inner city areas to the entire United States. But as a consequence of the American monetary policy, by 2006 default rates on sub-prime loans in particular rose to record levels. From the beginning of 2007, the value of mortgage bonds started to fall to about 20% to 40% of their original value, and the banking sector faced huge losses as a result of the sub-prime crisis.

In the summer of 2007, the sub-prime mortgage lending began to ripple, setting off financial problems around the world. Two Examples: In August, the French bank BNP Paribas triggered a sharp rise in the cost of credit and told investors that they would not be able to withdraw money out of two of its funds, because it could no longer value the assets in them owing to a complete evaporation of liquidity in the market. Banks began to refuse to do business with each other and the interbank Libor rate went up – a measure of how much banks distrust each other. The UK bank, Northern Rock, relied heavily on the markets, rather than on savers' deposits, in order to fund its mortgages lending. The onset of the credit crunch dried up its funding by September 2007. Not that the business plan of Northern Rock was different from those taken by most other banks – it was the rapidity of its expansion that led to its downfall. The result was a loan from the Bank of England that amounted to Ł25 billion.

As a result, conditions in the interbank credit markets became strained, and banks turned to their central banks for liquidity. This development reached a peak in September 2007, but there have since been a number of further waves where tensions have risen as more losses were revealed. In 2008, the financial turmoil has developed more heavily. In March, Bear Stearns become the American Northern Rock and in the most dramatic rescue of a major US bank for years, the Federal Reserve Bank of New York and its commercial rival JPMorgan Chase agreed to a temporary cash injection. In early September two large US firms, Fannie Mae and Freddie Mac, which account for nearly half of the outstanding mortgages in the US, were taken into conservatorship by the US government. The Treasury Secretary stated that the two firms' debt levels posed a "systemic risk" to financial stability and that in the absence of action the situation would worsen. In the UK, the Nationwide announced that it would merge with two smaller rivals, the Derbyshire and Cheshire Building Societies. And a few days later, the Wall Street bank Lehman Brothers posted a loss of many million dollars for the three-month period ending in August.

The financial crisis has led to substantive measures being taken in an attempt to restore market confidence and provide market liquidity where it was needed. Further weakness in the financial institutions has resulted in some nationalisations. The Icelandic financial sector expanded dramatically overseas and in October 2008 Iceland became the first Western nation to ask the IMF for support even if the state took over the country's three biggest banks.

The crisis has taken effect worldwide and requires urgent global action. Leading economists like Barry Eichengreen and Richard Baldwin recommend three basic policy responses: Quick bank recapitalization, deposit and loan guarantees and a macroeconomic stimulus; all three actions globally coordinated. The Belgian economist Paul de Grauwe argues that the crisis has reached a stage that is beyond the reach of central banks alone. He recommends instead full-scale nationalisation of the core parts of the banking system as the only option through which lending to the nonbanking sector can be resumed.

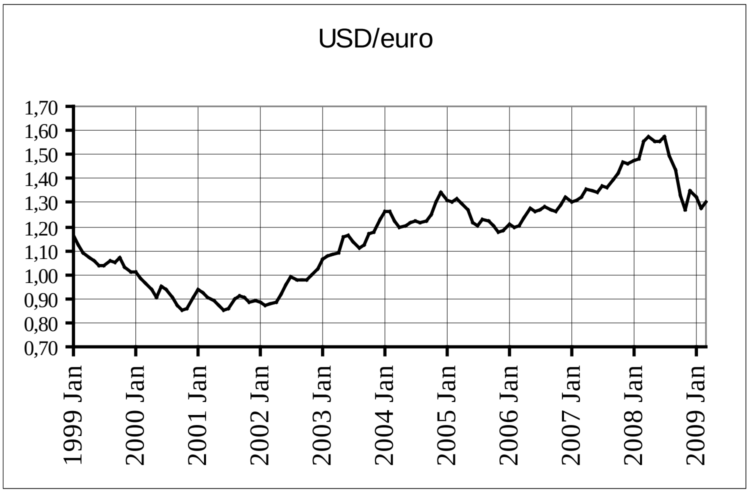
And what about the European Union? What is the impact of the crisis and will it be possible for the EMU to deal with it? In a paper from the European Commission (29.10.2008) it is stated that all Member States will be affected by the crisis and it is likely that unemployment will increase, demand will fall, and fiscal positions will deteriorate.

But the Commission's paper is unclear on several points, especially regarding the problem-description, and in particular the one related to the institutional arrangements in the EMU. Let us take three examples:

European banks have been extremely busy in using the potentials of free capital movements. According to the Bank for International Settlements, the western European banks account for three-quarters of the total $ 4.7 trillion in cross-border bank loans to Eastern Europe, Latin America and emerging Asia – a sum that vastly exceeds the scale of both US subprime and Alt-A debacles. The lending spree has been a European play. Europe is in jeopardy of becoming the second epicentre of the global financial crisis, which this time would unfold in Europe rather than America. Traders are paying close attention as the contagion moves from the periphery of the eurozone into the core. They are tracking the yield spreads between Italian and German 10-year bonds, the stress barometer of monetary union.

Since July the European single currency has now shed more than a fifth of its value (Chart 1). This is a dramatic fall coming from the threat of a global recession. The US dollar seems to be safer and the ECB might still have room for further interest cuts to pump cash into the economies of Europe, which would mean that the Euro would no longer be as attractive as the dollar or the yen. This will also increase the risk of capital flight from Europe. There will be an imminent danger that Eastern Europe's currency pegs will be smashed (unless the EU authorities wake up to the full gravity of the threat), which in turn would trigger a dangerous crisis for the EMU itself. At the moment, the system is in some way paralysed and it can well offset a very deflationary effect.

Chart 1



Source: http://www.x-rates.com/d/USD/EUR/data120.html

A recent analysis has shown that economic confidence in Europe fell to a seven-year low in September, the worst since 9/11. The financial crisis moves from the banks brokerages to factories, shops and homes. A decrease is expected in exports, consumption and investment. Some of the big Eurocountries are already balancing on the edge of the 3% budget deficit in the public sector. We have come very close to a breach of the requirements of the Stability and Growth Pact, but a quick recovery, or at least an avoidance of a depression, requires the possibility of discretionary fiscal policy.

In some short introductory remarks, the President of the EU Commission sketched a 19/11 plan in Strasbourg. First, the plan will be a timely, targeted, and temporary fiscal impulse, and second the Commission will try to make a “smart mix” of regulation, R&D, state aids, EU and EIB funds to make forward-looking investments in key sectors like cars, construction and enabling technologies. This will eventually be presented as a European plan “from crisis to recovery”.

This might mean that the Commission will go to the borders or maybe beyond the borders of the institutional arrangement of the EMU, and especially of the Stability and Growth Pact. This will certainly be necessary in view of just some of the described problems above. And to go further - remembering the political work of Keynes, a New Worldwide Bretton Woods currency-agreement is more urgent than ever.