

CENTRE FOR EUROPEAN STUDIES  
POLICY BRIEF

## EUROPE WITHOUT THE EU?

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### 1. Introduction and executive summary

The aim of this paper is to conduct a simple albeit daring exercise in counterfactual history: we discuss what the consequences for European countries would be, in the midst of the current economic crisis, if the European Union did not exist.

The EU is both a monetary union and a political and institutional union, and in this study we consider both aspects. As a monetary union, the EU manages the common currency, the euro, through the actions of the European Central Bank (ECB). As a political union the EU serves many purposes, the most important of which, with respect to the current economic crisis, is to provide a privileged forum to coordinate Member States' anti-crisis policies. As a matter of fact, since the beginning of the crisis, European leaders have held numerous European Council meetings as well as preparatory G-8 and G-20 meetings, confirming the urgent need for policy coordination and cooperation both at EU and international level.

In this study we pose and answer the following two questions:

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1. What would the consequences of the current crisis be for European countries if the euro had not been introduced ten years ago; that is, if European Monetary Union (EMU) had failed?
2. What would the consequences of the current crisis be if the EU were not acting as the instrument of coordination for Member States' responses to the crisis?

We are fully aware that the political coordination within the EU is far from perfect. Unlike the United States, where the Federal Government can implement policies that are applied systematically across all 50 states, EU-wide actions reflect compromise among national authorities and Member States keep some freedom not to abide—at least partially—by the directions of the EU. We take this feature of the European integration process fully into account, and many of our findings are based on this reality.

We find that if the EU as such had failed to exist, Member States would have needed to deal with the following problems, in addition to the economic situation which they are currently experiencing:

#### *The consequences of the lack of a common currency (the euro)*

- More macroeconomic instability in terms of internal prices and exchange rates.
- Substantial 'flight to quality' (investors abandoning high yield/high risk assets in favour of safer ones) leading to appreciation of traditionally strong currencies (German mark) and to depreciation of weaker ones (Italian lira, Spanish peseta, Portuguese escudo). With the following consequences:
  - for strong-currency countries, a larger drop in exports, internal demand, income and employment;
  - for weak-currency countries, inflation, increases in nominal and real interest rates and more than likely a larger drop in internal demand, income and employment.
  - No shield effect against the crisis for weaker/smaller countries, thus exacerbating all of their current economic problems.

#### *The consequences of the lack of coordination at the EU level of Member States' anti-crisis policies*

- The risk of running into the 'national champion' dilemma: without EU coordination, Member States would have incentives not to help troubled banks and firms; otherwise they would reveal to the market that the bank/firm is in trouble, thus exacerbating its problems. As a consequence, Member

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States would not intervene as much as they should to support the economy and above all would not intervene in the right way: only the less efficient banks and firms would be supported.

- The risk of 'negative contagion': without EU coordination, because of the problem of 'free riding', the Member States would not intervene in a timely enough manner to support the economy, and in extreme cases would not intervene at all or would intervene in a protectionist way (i.e., the 'beggar thy neighbour' phenomenon).
- The risk of diminishing 'positive contagion' effects. Positive contagion consists in the EU adopting good policies that have been implemented by some of its Member States to prevent EU-wide competition, and is a consequence of EU integration and policy coordination.
- The risk of a possibly total reversal of positive contagion, leading to classic protectionism in the form of barriers to trade and to free movement of production factors.
- The risk of failing to set up a new regulatory framework for financial markets.

The structure of the paper is as follows. Section 2 briefly discusses the advantages and disadvantages of having a common currency, the euro. This excursus is necessary for us to assess, in Section 3, the possible consequences of the current crisis if the euro had not been introduced. Section 4 studies the consequences of the current crisis in the case of a lack of coordination at the EU level of the anti-crisis policies of Member States. Section 5 concludes with some final remarks.

## **2. Europe and the euro**

This section is devoted to reviewing briefly some of the general advantages and disadvantages of EMU with respect to inflation levels, macroeconomic stability, pan-European trade, financial integration and the fostering of structural reforms in Member States, thereby supplying the necessary background analysis for assessing, in the next section, what would be happening today in times of financial and economic crisis in the absence of the single currency.

Mongelli and Vega (2006) and Buti and Gaspar (2008) offer compact overviews of the main advantages of EMU. From an aggregate point of view, Buti and Gaspar (2008) recall that during the first decade under EMU, inflation in the euro area was on average close to but not below 2%, which is the definition of price stability prescribed by the ECB Governing Council. Excluding energy and the price of unprocessed food, the average inflation rate would have been 1.8%. The ECB has maintained well-

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anchored inflation expectations. The degree of credibility of the ECB is particularly remarkable given that it was at the beginning a new institution without a track record.

At the same time, the volatility of real variables like output has also moderated, thus increasing macroeconomic stability. Although average real GDP growth has remained virtually unchanged at slightly more than 2%, during the period since 1999 more than 18 million jobs have been created (much more than in the previous decade). While it would be incorrect to attribute job creation mainly to the euro, the environment of macroeconomic stability and the ensuing labour market reforms in the run-up to EMU contributed to making the labour markets more flexible, supporting competitiveness and ultimately growth.<sup>4</sup>

As for the effects on trade, there is broad agreement that the euro has had a positive effect on the euro area, in terms of an increased level of trade integration without trade diversion. As pointed out in a recent ECB report (ECB 2008), estimates of the size of the effect have provided very heterogeneous results, largely due to the adoption of different methodologies for analysis. Economists now seem to have reached consensus that the single currency has boosted the growth of trade among euro area countries by 2 to 3 percentage points on average (Bun and Klassen 2007). Had the single currency not been introduced, this extra growth, largely the consequence of diminishing transaction costs,<sup>5</sup> would not have materialised.<sup>6</sup>

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<sup>4</sup> According to Bernanke (2004), one of the most striking features of the economic landscape over the past twenty years or so has been a substantial decline in macroeconomic volatility. The variability of quarterly growth in real output (as measured by its standard deviation) has declined by half since the mid-1980s, while the variability of quarterly inflation has declined by about two-thirds. Several writers on the topic have dubbed this remarkable decline in the variability of both output and inflation 'the Great Moderation'. Similar declines in the volatility of output and inflation occurred at about the same time in other major industrial countries, with the recent exception of Japan, a country that has faced a distinctive set of economic problems in the past decade.

<sup>5</sup> 'Transaction cost' refers to the cost of providing for some good or service through the market rather than having it provided from within the firm. In order to carry out a market transaction it is necessary to discover who it is that one wishes to deal with, to conduct negotiations leading up to an agreement, to draw up the contract, to undertake the inspection needed to make sure that the terms of the contract are being observed and so on. More succinctly, transaction costs are search and information costs, bargaining and decision costs and policing and enforcement costs.

<sup>6</sup> This does not mean that average growth in each euro area country would have been lower. For this to be the case a strong *ceteris paribus* clause is required including among other things the assumption that, in the absence of EMU, some form of exchange rate coordination would have remained in place. Failing this, each country would have been free to set its own monetary, fiscal and exchange rate policy. Growth rates would have been much more variable across European countries,

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Another major advantage of EMU is the acceleration in the process of European financial integration. On the supply side, banks and investors in fixed income markets have become more focused on the characteristics of individual borrowers rather than the nationality of the issuer and have built up expertise to evaluate credit risk (Galati and Tsatsaronis 2003).

European equity markets have also been affected by the enhanced ability of investors to build strategies with a pan-European perspective, as prices increasingly reflect risk factors specific to industrial sectors rather than individual countries. Between 1997 and 2005 euro area residents doubled their holdings of equity issued in another euro area country—as a share of their total portfolio of shares issued in their own country and elsewhere in the euro area—to reach 29%. On the other hand, the share of euro area equity assets held outside the euro area remains much lower and increased only slightly in the same period. In other words, since the launch of the euro there has been a portfolio reallocation from holdings of domestic equities to holdings of equities issued elsewhere within the euro area (ECB 2007).

Finally, on the issue of structural reform, Mongelli and Vega (2006) conclude that even if euro area countries as a group have undertaken more structural reforms than they are normally given credit for, larger euro area countries have thus far been slower to do so than others since the start of EMU. This, together with a certain slackness in the adoption of the growth-enhancing reforms envisaged in the Lisbon agenda, is currently restricting the adjustment mechanisms in euro area countries, hindering their ability to cope with economic developments and reducing the net benefits from EMU for all euro area countries, especially those that are more interconnected.

### **3. The consequences of the lack of a common currency**

Based on the overview of the (many) advantages and (few) disadvantages of EMU, this section discusses what might be happening today, in the midst of the crisis, in the absence of the single currency.

#### *The consequences of flight to quality*

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*possibly slightly higher in countries experiencing relative exchange rate depreciation. Inflation rates, on the other hand, would certainly have been higher.*

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In times of crisis, one of the first effects on financial markets is ‘flight to quality’. This consists in risk averse investors abandoning high-yield/high-risk assets in favour of safer ones. Flight to quality may be related to financial accelerator mechanisms which magnify the effect of portfolio switchovers on the stability of domestic financial systems (Bernanke et al. 1996).

Knowledge of past episodes of financial turbulence in European monetary and financial markets (Eichengreen 2000) makes it more than reasonable to suppose that, in the absence of the single currency, the flight to quality induced by the current financial and economic crisis would have led to the appreciation of traditionally strong currencies (read German mark) and to the depreciation of weaker ones (read Italian lira, Spanish peseta, Portuguese escudo).<sup>7</sup>

As a consequence of this, strong-currency countries would probably be experiencing a bigger decline in the level of net exports, which would lead to a contraction in domestic aggregate demand and would in turn cause a decline in income and employment levels and generate additional deflationary pressures.

Weak-currency countries would initially gain from the improvement in the price competitiveness of their domestic production but would suffer financially due to the fact that nominal and real interest rates would increase as a consequence of internal inflationary pressures and increasing risk premiums. Overall it is difficult to conclude that weak-currency countries would be better off if free to depreciate.<sup>8</sup> Rather, the increases in real interest rates would lead to lower investments and aggregate demand, with a consequent drop in income and employment levels.

## *No shield effects*

In a recent interview with a German weekly magazine,<sup>9</sup> the President of the European Commission, J. M. Barroso, evoked the idea that the euro is a ‘protective shield’ amid the global economic crisis, dismissing

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<sup>7</sup> *The main counter-argument to this scenario rests on the observation that financial institutions in strong-currency countries appear to have been affected relatively more significantly by the impact of the current crisis than their counterparts in weak-currency countries. This and the debt burden accumulated as a consequence of the government-sponsored bank rescue plans might partially compensate for the effects of flight to quality and its macroeconomic side effects.*

<sup>8</sup> *There are good reasons to expect that financial markets exert greater influence on governments after EMU. This change might serve to heighten the perceived danger of default in Europe. At the same time, however, financial markets appear to reward governments for the fiscal consolidation and increased market liquidity that flow from the single currency (Mosley 2004).*

<sup>9</sup> *Source: <http://www.eubusiness.com/news-eu/1233746222.37>.*

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fears of a eurozone break-up and recalling that the situation was much worse outside the eurozone than within it.

The shield effect and the overall advantages of introducing the euro have been questioned by the recipient of the 2008 Nobel Prize for Economics, Paul Krugman, who recently wrote (2009), 'Contrary to what everyone seemed to be saying even a few weeks ago, being a member of the euro zone doesn't immunize countries against the crisis. In Spain's case (and Italy's, and Ireland's, and Greece's) the euro may well be making things worse', and then claimed that this was due to the euro area's apparent institutional inability to react to the severe crisis we are facing at present.

However, with respect to the claim that Europe has been unable to effectively counter the crisis, Lorenzo Bini-Smaghi, member of the Executive Board of the European Central Bank, writes (2009) that Krugman's claims are in no way supported by empirical evidence. The fiscal stimulus in European countries is wholly comparable to that seen in the United States, particularly when taking into account measures to cushion the effect of automatic stabilisers.<sup>10</sup> The perception that more has been done in the United States probably stems from the extensive financial measures adopted in support of the US banking system. It should be pointed out, however, that the US banking system was in greater need of such measures than was the European banking system. When overall stimulus measures are considered in relation to the situation, the differences are indeed fairly small.

Furthermore, European market rates are more or less in line with those observed in the United States and are even lower in some cases. For example, 6 and 12-month interbank interest rates in Europe are slightly lower than their US equivalents. Furthermore, real interest rates are markedly lower in Europe than in the United States, and retail interest rates on mortgage lending and lending to non-financial corporations are of a comparable magnitude, if not somewhat lower in Europe. As for actions taken by the central bank, following the initial liquidity injection of €90 billion in August 2007, the ECB's balance sheet has steadily grown, increasing by approximately €600 billion to reach a level of 16% of GDP (compared with 13% of GDP for the US Federal Reserve).

The claim that for countries such as Spain the euro is making things worse is based on what Krugman perceives to be the two essential shortcomings of EMU: absence of a central government budget to

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*10 For instance, for the period 2009–2010 discretionary measures adopted in Germany total 3.5% of GDP compared with 3.8% in the United States. In some European countries, Italy for example, the impact of such stimulus measures is relatively limited owing to the high levels of debt, but in other countries the total fiscal stimulus is larger than in the United States.*

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smooth the effects of local shocks, and poor labour market integration and reduced labour mobility (Krugman 2009).

However, the turmoil that many European countries, which do not participate in the monetary union, are currently going through—from Latvia to Hungary and from Iceland to the Czech Republic—and a series of economic arguments which are briefly discussed below, lead us to be at least sceptical of this reasoning.

Krugman's conclusion is based on the theory of optimum currency areas (OCA). Briefly, this theory states that economies should have a single currency if the costs of having different ones—exchange rate risks, transaction costs, the standing temptation for governments to inflate their way out of trouble and so on—outweigh the advantages, which include the ability to de/re-value or float the currency and the ability to set independent interest rates (Patterson 2006).

According to the initial formulation of OCA theory (Mundell 1961), an area needs a separate currency if, in the event of some macroeconomic shock, the costs of adjustment through changes in wage and price levels, or through factor mobility (labour and capital), would be higher than those of altering the exchange rate. McKinnon (1963) added that exchange rate policy was in any case an inappropriate instrument of adjustment for any small, open economy trading a substantial proportion of GDP. Any two countries reacting to a shock in the same way—i.e., symmetrically—and trading significant proportions of their GDP bilaterally, should therefore fix their exchange rates or form a currency union. Milton Friedman (1953) had already observed a long time ago that a group of countries 'all of which firmly adhered to [...] the free movement of goods, people and capital without restrictions [...] would in effect be an economic unit for which a single currency would be appropriate'.

In suggesting that Spain (and other European countries) might be better off to abandon the euro area to regain price competitiveness for its exports, Krugman in our opinion is downplaying some of the most unpleasant consequences that such a choice might have.

Given the level of economic and financial integration already attained by euro area countries including Spain, it is very likely that Spanish citizens, anticipating the depreciation of 'Spanish euros' vis-à-vis 'EMU euros', would try to avoid capital losses by shifting as much of their financial assets as possible out of Spain. This would generate huge outflows and a credit crunch as banks would face the consequence of serious deposit withdrawal. With domestic lending partially drying up, the Spanish government and Spanish companies, both financial and non-financial, would face higher interest rates if they tried to borrow on international capital markets. European creditors would ask for their loans to be converted

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from Spanish euros into EMU euros with the effect of administering a further shock to the Spanish economy. Inflation would pick up and growth would decline.

The point we are trying to make is that the unilateral abandoning of a fixed exchange rate regime by an economically open and relatively small country can produce very severe consequences both in the short and the medium term—the more so the more financially integrated the devaluating country is with respect to its reference currency area.

Moreover, the technical difficulties of reintroducing a national currency should not be minimised, nor is it obvious that the economic problems of the participating Member States can be significantly ameliorated by abandoning the euro, although this possibility cannot be dismissed. And even if there are immediate economic benefits, there may be longer-term economic costs, and political costs of an even more serious nature as well, as Eichengreen (2007) correctly points out.

#### **4. The consequences of lack of coordination at the EU level of Member States' anti-crisis policies**

The financial crisis heavily affected financial systems worldwide. The initial subprime crisis in the US has generated bank losses estimated to range from 1,000 to 2,000 billion dollars. The credit capacity of banks is a multiple of the assets which they held, and this financial leverage, which is a fundamental tool to expand credit in normal times, has played the role of amplifying, by the same multiple, the credit crunch. It is estimated that overall the credit capacity of banks has been reduced by approximately 20,000 billion US dollars.

This credit crunch has of course hit firms and the real economy. In this situation, banks need to be recapitalised; that is, they need to find new financial capital to replenish reserves in order to restore credit activity to its normal level, and firms need to be supported whenever possible. Almost every European state is currently running some programme to provide banks and firms, directly or indirectly, with the new capital required. These state aid programmes are necessary, in the current situation, because banks and firms cannot rely on private investors to finance the restoration of their economic activities. Investors, indeed, are currently not willing massively to buy bonds and other financial instruments issued by the private sector and will not be willing to do so for some time to come.

In this next section we examine the effectiveness of Member States' responses to the crisis if there were no coordination of the interventions at the EU level, not even the admittedly partial and imperfect

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coordination that is currently occurring. Each of the following four subsections examines a consequence of this hypothetical lack of EU policy coordination.

## *The 'national champion' dilemma*

If a state takes direct steps to recapitalise a bank, it signals to the market that this bank is in trouble. This in turn makes private investors even less willing to finance the bank and can lead to even more trouble for the bank. Hence a bank which may otherwise want to ask for state intervention but in fact is not in such a difficult financial condition that it is willing to risk a further market devaluation of its assets, would not apply for this state intervention.

As a consequence, only the banks with a financial structure more inefficient than that of others, which means those that have been affected more severely by the crisis and are experiencing the most serious financial imbalances, have the incentive to apply for state aid. On the other hand, those financial institutions that find themselves in 'intermediate' situations, experiencing some difficulties that may lead them towards more serious troubles but not yet at their breaking point, will not want to signal to the market that troubles may be looming ahead and thus will not apply for government help. As a result, the state will intervene to recapitalise in general only the less-efficient banks, leaving with less support those that have been better able to protect themselves from the crisis.

This type of process is well known in economics and is called 'adverse selection'. In Europe, as far as the process of supporting banks is concerned, the adverse selection problem is going to be dramatically exacerbated. In fact, if a state considers its banks as national champions, it is considerably less willing to signal to the market that those banks are facing difficulties. Thus in such cases the adverse selection process is twofold and self-enforcing: it is not only the banks that do not ask for public intervention unless they have extremely serious problems, but it is also the state itself that prefers to help its financial institutions only in extreme cases, agreeing to signal to the market that the champion is in bad shape only when, as a matter of fact, it is almost dead.

This national champion dilemma would lead the states not to intervene as much as they should to support the financial system, and above all not in the right way: only the less-efficient banks will be supported. Furthermore, the same reasoning applies not only to the public support of banks but to the support of industrial firms as well. Hence the practical capability of individual Member States to sustain their economies, whenever these states consider their relevant economic actors as national champions, turns out to be strongly jeopardised by the adverse selection problem.

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It is known in economics that the adverse selection problem can be mitigated, and it is known how this should be done (see Myerson 1991). In particular, a 'coordination authority' is needed that is able to establish an institutional framework of action which

1. can be enforced by the authority itself;
2. provides for the right incentives to banks and firms: those in financial difficulties have nothing to gain by mimicking those in better shape and not applying for public subsidies;
3. provides for the right incentives to individual states, so that those with champions in difficulty are not tempted to mimic those that are not experiencing the same problem and not help the champion or not help it enough.
- 4.

It is only the EU that can play the role of such an authority. To consider an example where this is already happening, consider interventions of the 'bad bank' type. Such interventions, among those that are under discussion in the EU and worldwide, deal better with the adverse selection problem. The United Kingdom, the Netherlands and Germany are considering proposals to split off the bad assets of banks into a separate bad bank to prevent more banks from failing, as did Sweden in the 1990s and Switzerland in 2008. Against this backdrop, Germany is considering a plan that would shift bad assets from banks into special-purpose securities with government guarantees. In general every action taken by the state to buy bad assets from banks is of the bad bank type.

However, these programmes will be effective only if undertaken by (almost) all EU states. In fact, in such a case, every state will agree to signal to the market its 'bad champions', thus overcoming the national champion dilemma and mitigating the adverse selection issue. Member States seem to be aware of this need for coordination, and indeed in response to the actions of Germany and the United Kingdom, the ECB has been asked to draw up guidelines for European governments to initiate interventions of the bad bank type. The EU is thus playing the role of a coordination authority.

### *Negative contagion*

As correctly pointed out by Chailloux et al. (2009), one of the key issues facing central banks and national governments during the current crisis has been distinguishing between 'troubled markets' and 'troubled institutions'. Troubled institutions can be dealt with on a case-by-case basis, as was done in the initial stages of the financial crisis. Troubled markets, however, require a more coordinated approach since the effects can span a range of countries and economies.

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Indeed in a time of globalised and interlinked economic activity, extensive cross-border banking and industrial activity by a number of European economic actors has demonstrated that serious problems in one country can have a substantial impact on economies elsewhere. National governments may face extensive downturns that are associated with the activity of financial and industrial firms in other countries (OECD 2009). For example, as financial firms react to a financial crisis in one area, their actions can spill over to other areas as they withdraw assets from foreign markets to shore up their domestic operations. For instance, as Icelandic banks began to default, Britain used an anti-terrorism law to seize the deposits of the banks and prevent them from shifting funds from Britain to Iceland (see Benoit et al. 2008).

Europe is an example of such an integrated economic system. As a consequence of the fact that European markets are indeed pan-European, as soon as a market gets into trouble, for example the credit market, and as soon as the necessity of restoring this market's functioning emerges, a fundamental related problem emerges as well: who should take the responsibility for the recovery intervention? In other words, who should pay the bill?

This is a typical free-riding problem, a form of coordination failure well known in economics and game theory. Assume that two (or more) states have a common interest in, say, saving a bank or a large industrial firm, due for example to the fact that the bank holds assets in both countries. Assume that for each of these states the recovery intervention is costly. Then each state, in order to avoid paying the cost of the intervention but nonetheless trying to enjoy the benefits, is tempted to wait and try to convince or even force the other state to intervene alone. The result of this strategic behaviour is one of the following:

- 1 no state intervenes;
- 2 the intervention is postponed (until the two states realise that each one is free riding on the other);
3. each state intervenes only on that 'portion' of the bank that is more directly relevant for that state's economy.

The latter is a form of protectionism: protecting the domestic economy with the associated effect of damaging the economy of other countries. This is called the 'beggar thy neighbour' phenomenon in the current debate on the consequences of the crisis.

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The free-riding problem generates 'negative contagion'. European national economies are strictly interlinked with each other, and if a Member State believes that the others are going to intervene to sustain the economy, this state will free-ride, it will neglect its own responsibilities and will not intervene. Anticipating this, the other states will not intervene either. Hence the contagion.

In Europe this negative contagion is indeed going on. The well-known difficulty of reaching an agreement on the sharing among Member States of the burden of the anti-crisis interventions is delaying properly coordinated anti-crisis actions thereby magnifying the economic and political consequences of the crisis for Member States.

Again, the free-riding, negative contagion problem has a solution, similar to that of the adverse selection problem: an authority is needed which has the political force to make individual states negotiate intervention agreements, and the power to make these agreements binding.

In this respect, it is the EU that is acting as such an authority. The EU is helping Member States to negotiate binding coordinated agreements to boost national economies. Undoubtedly the EU is providing invaluable help to mitigate the free-riding problem.

To take one example, on 27 November 2008 the European Commission proposed a \$256 billion Economic Recovery Plan (ERP) that would fund cross-border projects, including investments in clean energy and upgraded telecommunications infrastructure. The ERP asks each EU member to contribute an amount equivalent to 1.5% of its GDP to support the plan. Thus the ERP provides for a sharing rule that prevents free riding. The members of the European Council approved the plan in a meeting on 12 December 2008. Most European countries have announced some form of an economic stimulus package.

Without the initiative of the Commission, no such plan would have been proposed nor would it have survived the free-riding temptation of individual states not to pay their share. It is advisable that burden-sharing rules be introduced by the EU also for the managing of future fundamental issues such as the regulation of financial markets. As pointed out by Goodhart (2009):

Absent fiscal powers at the European level, ex ante burden-sharing arrangements can be agreed. Such burden-sharing arrangements would allocate the burden of a cross-border rescue to national member states according to some pre-specified key. [...] The [de Larosière] report rightly observes that ex ante burden-sharing is controversial, as it implies a partial surrender of sovereignty by member states. But

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without this final step of burden-sharing, European supervisory and stability arrangements cannot weather a future financial crisis.

## *Positive contagion*

The EU structure gives the individual members considerable latitude to formulate their own policies in response to crises. In some cases, this has meant that the EU has had to adopt good policies that have been implemented by some of its members to prevent a sort of EU-wide competition. For instance, EU members were pressed to support a broad set of measures to increase the guarantees on bank accounts for depositors in response to actions by Ireland, Greece and Germany. Some EU members are also considering procedures to deal with the bad loans of banks within their jurisdictions, which has pushed the EU as a whole to follow and to consider the best approach to deal with the toxic loans of EU banks.

These are examples of positive contagion. In an imperfectly integrated union there is plenty of competition among its members, the competition being triggered and reinforced by the removal of barriers to trade and the movement of production factors. In this situation, if a member adopts a very efficient strategy on some issue, the other participants are forced to follow. Hence the positive contagion. Note that in a fully integrated union these positive contagion effects may lessen, because participants may not be allowed to adopt different strategies on certain issues (for example, on intra-union trade policy) and so competition vanishes. Note furthermore that without integration the aforementioned positive effects of interaction almost certainly disappear. Countries will be allowed to compete in fact in a less-costly way: by setting trade barriers and constraining the free movement of production factors; that is, by adopting classic protectionist policies. Of course, in the long run the cost of such protectionist policies will be enormous and wipe out their short-term apparent benefits.

Another example of positive contagion in Europe became clear at the euro area summit on 12 October 2008. The Eurogroup countries along with the United Kingdom urged all European governments to adopt a common set of principles to address the financial crisis. The measures which these nations supported were largely in line with those that had been proposed by the United Kingdom, which played on that occasion the role of the smart competitor to be followed.<sup>11</sup>

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<sup>11</sup> Measures included governments' promise to provide funds to banks; to buy shares in the banks that are seeking recapitalisation; to offer debt guarantees for any new debts including inter-bank loans issued by the banks in the eurozone area; and improved regulations.

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Our examples show that had the EU not existed (in its general current form of partial integration among different countries) no positive contagion would have materialised in dealing with the crisis by Member States.

## *New regulation of financial markets*

Over the long run, countries worldwide will likely search for a financial regulatory scheme that provides for greater stability while not inadvertently offering advantages to any one country.

The EU system, however, is different from the US system in ways that may complicate efforts at coordination. For instance, the ECB is not strictly comparable to the Federal Reserve in either the scope of its regulatory role or its role in supervising banks. In the EU system each EU member has its own institutional and legal framework for regulating its banking market and national supervisory authorities are organised differently in each EU country with different powers and accountabilities.

A coordinated response will likely need to address such issues as financial market regulation, oversight of financial firms and institutions, greater transparency and the role of independent credit rating and auditing institutions. Significant differences remain, however, among EU members and between some EU members and the United States over issues of financial supervision and regulation that could significantly complicate future efforts to craft a coordinated approach to supervising financial markets at an international level.

Some EU members favour a strong central authority that can monitor financial markets, while others favour strong national authorities with a weaker role for an international body. EU members recognise that economic integration means that financial and economic crises can spill across national borders, but their efforts to implement a coordinated response are being hampered by very real differences in the impact the economic recession is having on individual EU members.

In this respect, a coordination role for the EU appears to be both unavoidable and invaluable. This is a widely felt necessity, which has led to the proposals contained in the recent de Larosière report.<sup>12</sup> This EU-wide coordination is also ultimately needed to safeguard intra-EU solidarity and for cohesion in both Western and Eastern Europe.

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<sup>12</sup> See Goodhart (2009) for a first evaluation of the de Larosière report.

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## 5. Conclusions

This paper has pointed out the importance of the EU in dealing with the current financial and real economic crisis. We considered the EU both in its role of monetary union and in its role of coordinator of Member States' anti-crisis policies.

- While admitting that not everything is perfect, the EU is extremely important in reacting to the crisis. In times of crisis the perceived causation 'stability is needed to ensure growth' might actually give way to its contrary: 'growth is needed to ensure stability'. In this respect, the implementation of certain economic policies believed to foster growth, such as a greater focus on monetary policy to stimulate output rather than prevent inflation, or implementing fiscal policies without taxation and therefore with higher public debts, seem to be slowed down by the current architecture of the EU.
- In particular, an important factor that is affecting the EU's response to the economic recession is the need to develop new policies in a manner that meshes with the carefully crafted and highly negotiated directives that already exist within the EU framework. These directives act as guiding principles for EU members. In particular, the call for economic stimulus has created a conflict for some EU members who are politically and philosophically committed to the goals of the Growth and Stability Pact on the one hand, and the development goals of the Lisbon Strategy on the other.

The EU could improve its functioning in the crisis if the following clear responsibilities were identified and political governance established. This might be the case for

- exchange rate policies vis-à-vis large economic blocks outside the euro area (the euro having been for many economists too overvalued relative to the US dollar in the last few years);
- public debt management which remains largely uncoordinated, contrary to what happens at the Member State level (see Germany's coordination of Länder issues and Federal government issues).

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Pushing forward by learning from mistakes is the best way to ensure that the gains already secured through a common currency and a common forum for discussing and coordinating policies will be consolidated and strengthened in the near future.

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