>> POLICY BRIEF
ISSN: 1989-2667

FRIDE
FUNDACIÓN
PARA LAS RELACIONES INTERNACIONALES
Y EL DIÁLOGO EXTERIOR

Nº 19 - SEPTEMBER 2009

A false sense of security: Europe and the politics of financial crisis

Richard Youngs

>> It is a year since the financial crisis deepened dramatically, with the series of bank collapses that shocked markets in the autumn of 2008. The G20 summit in April 2009 made a series of seminal commitments to speed recovery. Progress on these will now be reviewed at the G20 meeting in Pittsburgh on 24-25 September 2009. Most commentators feel that the crisis has bottomed-out. The economic consequences continue to be severe, but the sense of rudderless downward spiral has abated. Some European economies appear tentatively to be emerging from recession.

The economics of the crisis have of course been exhaustively covered. But a year ago many predictions were made that the crisis would also engender a fundamental shift in geopolitics. A year on, the geopolitical impact has been less than many feared. In purely geopolitical terms the crisis has not been a game-changer, but one extremely influential factor amongst many that now condition foreign policy calculations. The politico-strategic impact of the crisis may still be subterranean, set to percolate to the surface gradually over the longer term.

In terms of Europe's international policies, this relative political-economic calm is both boon and bane. On the one hand, it has helped guard against an over-reaction in European foreign policy. A year ago, many were predicting a qualitative shift in international relations. Last autumn some observers detected signs of the EU's core foreign policy tenets collapsing in on themselves. Some indeed were quick to urge the EU to adopt a more hard-headed defence of European interests and a (in sceptics' eyes) less woolly attachment to international cooperation and values. To Europe's credit, this shift has not occurred to the wholesale degree that some foresaw. Governments and diplo-

HIGHLIGHTS

- The EU still needs fully to grasp and address the geopolitical ramifications of the financial crisis
- While the crisis strengthens the case for further enlargement, most European governments have drawn the opposite conclusion
- EU ambivalence towards international trade liberalisation continues to be the Achilles Heel of its response to the crisis
- Another weak spot has been the EU's failure to explore the political aspects of governance reform connected with the genesis of the crisis financial crisis.

›››››› mats have kept a firmer hand on the tiller than might well have been the case.

However, the flip side of the crisis' apparent containment is that some of the urgency has been lost from measures that are still desirable at a deep, structural level in Europe's external relations. This is particularly the case with regards to the reach of Europe's integration model; the EU's international trade policies; and the reform of global governance. Such challenges must be addressed in a more systematic and enlightened fashion by European governments at Pittsburgh and beyond.

CRACKS IN EUROPEAN SOLIDARITY

The crisis has impacted in a profoundly political sense on the dynamics of integration within Europe itself. Czech, French, and other ministers have crossed swords in public. The Commission speeded up the delivery of structural funds to central and eastern Europe and made rules more flexible (dropping so-called 'co-financing' requirements). But new member states still feel embittered at how they have had to turn to the IMF in the absence of more generous EU assistance. Such support was belatedly increased at the April G20 summit. But, the core feeling of solidarity has been ruptured.

Within the EU the crisis has unleashed a fundamental tension between the economic and political spheres. Consensus exists on the need for deeper coordination on economic measures at the European level. But, with rescue packages and broader stimulus measures having been introduced at the national level, governments have become more acutely accountable to their domestic populations. This tension requires European governments to recognise that 'more Europe' in the economic and financial spheres is not enough. Such measures cannot be divorced from the need to re-energise the EU's democratic legitimacy. The lesson of European integration is that economic divergence can easily spill over into political divergence. The financial crisis cannot be solved while parking the political dimensions of integration.

Deepening divisions within Europe have nourished a return to beggar-thy-neighbour thinking within the EU's external relations too. The crisis has intensified the debate over the borders of the Union. Here, EU reactions to the crisis have lacked long-term strategic vision. The EU has failed to address the fact that the countries beyond its boarders have been hit hard. This applies especially to Ukraine and the Balkans. The EU cannot solve its own problems if it abandons these fragile new democracies. A Crisis Response Package was formulated under the Pre-Accession Instrument. However, member states have become more reluctant to accept further enlargement just when the political costs of retracting from their promises to the Balkans and Turkey will be even higher. If the crisis hastens the shift of power from West to East, it surely renders an enlarged EU more desirable in the longer-term. And yet, European governments have reflexively adopted defensively populist positions on this question.

Angela Merkel has insisted that the crisis requires a 'time-out' on enlargement, after Croatian accession. In the middle of the crisis the EU rolled out its new Eastern Partnership offering various areas of cooperation with six countries on its eastern periphery. But France and other states have refused to grant this partnership more significant amounts of money, insisting that two-thirds of overall Neighbourhood Policy money go to the Mediterranean. This looks like inflexible clientelism. The Partnership needs to be linked much more tightly to the means needed to combat the financial crisis in Ukraine and other eastern states.

TOYING WITH TRADE

The EU has resisted any over-whelming retreat into protectionism. Governments have continually committed themselves to avoiding such a

move. The rhetoric has been so firm and insistent that the costs of acting in a manner completely contrary to these promises have been ratcheted-up. However, at a more subtle level European positions on the importance of trade in exiting the crisis have been and continue to be disappointingly ambivalent.

President Sarkozy's controversial enticement of French firms out of eastern European markets is only the tip of an iceberg. Member states such as Spain have defined more economic sectors as 'strategic', exempt from free market principles. Debate has virtually ceased on post-2010 renewal of the Lisbon agenda. EU competition rules in the financial sector have de facto been suspended. Plans to deepen liberalisation in the services sector have been dropped. State aid rules have been jettisoned. The Commission has rubber-stamped the vast majority of member states' requests for exemptions from competition rules. Between October 2008 and August 2009 state aid to banks worth one third of EU GDP was authorised.

The next step must be to address the wider shock-waves of the crisis

The external spill-over of such trends points to covert forms of protectionism. The EU reacted vigorously against the 'Buy America' provisions launched under the Obama presidency, but several similar 'buy national' campaigns have been supported in Europe too. Financial bail outs have gone hand in hand with governments exhorting banks to lend only to national markets. The retrenchment of private capital encouraged by European countries is set to hit emerging economies particularly hard, and in some cases has already done so. Western governments' guarantees of deposits in their own banks have had the perverse effect of dragging capital out of emerging economies into the developed world.

Free trade talks with South Korea have stalled. Pursuit of the EU-Mediterranean free trade area, slated for completion in 2010, slumbers as an empty formality. The EU has reintroduced subsidies in the dairy sector. Many member states such as Germany, France and Italy have introduced new restrictions on Sovereign Wealth Funds. Five days after the April G20 summit the EU imposed anti-dumping duties on a number of Chinese goods.

Economic and monetary affairs commissioner, Joaquin Almunia, lamented after the April summit that member states still held an 'inward perspective' rather than global vision on the crisis. He is right that the EU – despite taking many exemplary steps of coordination during the last twelve months – has been unduly introspective. All the focus has been on shoring up domestic markets, to the detriment of trying to ward off the destabilising effect the crisis is likely to have in Africa, Asia and the Middle East – effects that will rebound on Europe if not stemmed.

Trade has been the glaring omission from the G20 - beyond non-committal pledges to avoid protectionism. A whole year into the 'deep' phase of financial crisis no concrete steps have been taken towards restarting the Doha round. Positions in that round had already reached a lowest common denominator prior to its collapse. Yet revisiting this and re-loading the trade dossier was declared off the agenda in London. Such caution is despite the EU shifting back to a healthy trade surplus in April 2009.

The reversal of financial integration within Europe has sapped any remaining force in the EU's call for service sector liberalisation at the global level. Experts have slammed the EU for focusing on micro-regulation rather than halting the decline in international trade, which is far more necessary to recovery from the crisis. The EU has offered developing countries and emerging markets short-term emergency support, while actually turning their attention away from underlying reform issues that would help integrate such economies into European markets over the longer-term.

››››››

GLOBAL GOVERNANCE

As a result of the crisis, the EU has come to back some reforms to international financial institutions. European governments have agreed to bring forward a reweighting of IMF votes from 2013 to 2011. The G20 conclusions in London waxed lyrical on the shared commitment to redistribute international power and ensure a more influential voice for emerging powers. It has frequently been asserted that the crisis makes deep and balanced multilateralism more urgent and more unavoidable.

In practice European governments continue to resist far-reaching change. The EU has been able to hide behind the US's long-standing reluctance to accept reduced power at the IMF. This has enabled European countries to maintain a studied ambivalence on the question of their own willingness to accept diminished sway.

A preference for informal groupings of the G7, G20 and now the Financial Stability Board club of regulators has taken precedence over a genuine multilateralisation. The Spanish and Dutch governments have squeezed their way into a 'G20 plus', rendering Europe even more over-represented – to the openly expressed chagrin of emerging powers. Options for broad coordination of macroeconomic policy at the global level have been resisted. No European support has been forthcoming for a powerful council at the United Nations to coordinate macroeconomic and social policies. European states are now even more reluctant to give up their vetting of membership to the Basel Committee for Banking Supervision. The crisis has made policy-makers in key European financial institutions if anything more adverse to losing control of decisions and being dragged into policies they deem not to be in the immediate European interest.

This is not to deny that the EU has helped developing states. Some donors – Italy, Ireland, France, the Commission – have cut back planned ODA allocations. But the overall aid commitment remains relatively strong, for now. The April G20 summit agreed a $1 trillion rescue package. In response to the financial crisis the Commission has frontloaded 4.3 billion euros of budget support to African states. Three quarters of all budget support aid allocated for 2007-2013 had been made available by early 2009. More additional aid has been targeted specifically at strengthening social safety nets in developing countries. In an April 2009 report the Commission astutely opined, 'Aid is not a matter of charity but one of the drivers of recovery'. All this is to the EU's credit; many measures have been of impressive speed and foresight.

However, while all this has undoubtedly made additional funds and credit available to developing states and emerging markets, the latter complain that the new IMF (and other) support packages have actually had the perverse effect of increasing the share of 'rescue' funds going to rich European states. European governments have seen the 'multilateral' cooperation of the G20 as an expedient means of accessing cash for their own bail-outs, more than as a rationalised plan for deeper multilateralism.

The EU has placed great stress on the governance dimensions of its response to the financial crisis. Transparency and good governance are presented as key to effective long-term solutions – pivotal to reform both of the international financial institutions and within emerging markets themselves. It is well-known that the G20 has prioritised the regulatory route. Crucially, this has come with promises that new regulation shall form part of a more transparent and accountable mode of financial governance, within and beyond Europe.

But the governance focus has remained extremely narrow. The April G20 summit centred its attention on the exchange of views amongst financial regulators; early warning consultations; prudential regulations; and disclosure rules. Since then, there has been no ini-

tiative to broaden out the 'governance scope' of the G20. Indeed, with many decidedly opaque regimes within the G20, debate has been steered away from anything touching on sensitive politics. Indeed, the G20 promotes the role of finance ministers and central bank governors in a way that renders external policies more technocratic.

The political impact of the crisis on different 'regime types' is still being played out. The financial crisis has brought down a number of governments but it has not directly occasioned regime change. In and of itself it has had neither a democratising nor de-democratising effect. In some countries it has encouraged a centralisation of power and opaque elite deals, struck in the name of managing the crisis. In other cases, authoritarian regimes have been hit hard and as a consequence encouraged to open up slightly towards the West. Ukraine is an example of the former and Belarus of the latter dynamic.

In the midst of such fluidity, it would be wrong to conclude that the financial crisis renders open politics irrelevant, even harmful. In crises the appeal of a 'strong leader' often gains currency. Those of a 'realist' bent will ask, does the financial crisis not make the issue of democracy seem rather irrelevant? Can we really preach democracy's advantage as the West's economic systems come crumbling down? Are we not even more dependent on Chinese liquidity to kick start recovery? Can we talk democracy in Africa with cash-rich China poised to extend its influence there even further?

But open politics offer the accountability and transparent deliberation that are necessary for stabilisation over the longer term. Better understanding is required of the ways in which the crisis could undermine democratic quality internationally, transparency and accountability. Effective democratic responses must be built on a balanced and mutually reinforcing relationship between state, market and civil society. There should be no trade off between effective management of the crisis and deepening democratic quality internationally. The crucial concern is that on all of this, European deliberation has so far been scant.

In sum, on these three clusters of issues – the depth and reach of European integration, international trade, and global governance – a broader response to the crisis is still awaited. European governments have introduced many admirable and skilfully thought-out measures aimed to boost recovery and tighten regulatory structures. The next step must be to address the wider shock-waves of the crisis. The Pittsburgh summit will be important. But even more significant will be how EU countries address the wider political questions that will not be on the G20 agenda in the US. A benign sense of recovered calm must not divert them from tackling such challenges with vigour.

Richard Youngs is director of research at FRIDE.

e-mail: fride@fride.org
www.fride.org