CENTRE FOR EUROPEAN REFORM
policy brief

# Beyond banking: What the financial crisis means for the EU

★ The financial crisis seems to be reinforcing existing global trends, such as the power shift from west to east, hostility to economic globalisation and rising nationalism. It will have a huge impact on the shape of European politics and economics for years to come.

★ Since there is no single European treasury, expectations about what the EU could do to bail out banks were overblown. Yet after a series of unilateral decisions and ineffective snap summits, Europe's leaders have shown that they can work together.

★ The EU is heading for recession and faces a prolonged period of very weak economic activity. An early recovery is unlikely unless the countries that have been running large external surpluses do more to stimulate domestic demand, including through increased government spending.

★ The economic downturn is likely to strengthen populists on the left and right across Europe. Fears of rising unemployment and falling incomes will trigger new calls for protection against imports, foreign investment and immigrants.

★ The financial turmoil could make some people in the Nordic countries and Central and Eastern Europe keener to join the euro. But it also poses a serious test for the long-term viability of the single currency.

★ The crisis has exposed weaknesses in the EU's regulatory system. As a result, the EU will adopt tighter rules for the financial sector, and the debate over whether it should have a pan-European financial services regulator will intensify.

★ Fears of recession have emboldened those countries that argue that cutting carbon emissions would damage their economies. Their opposition makes it less likely that the Union will meet its original climate change targets. The EU's claim to global leadership in this area is now at risk.

★ The EU will also find it harder to reach agreement on issues such as enlargement, economic reform, energy and migration. However, the chances of the Lisbon treaty finally being ratified by all member-states have risen a little.

★ The western-centred financial crisis will reinforce the perception that the US and the EU are becoming relatively weaker. The US will remain the dominant global power, but its ability to set the agenda for tackling problems such as the Iranian nuclear programme may be impaired.

★ Russia could be among the biggest losers from the financial crisis. The country may become more aggressive, authoritarian and autarkic. China can hope to come out of the crisis relatively unscathed. But the chances of it agreeing to binding reductions in carbon emissions at the 2009 Copenhagen climate change summit have diminished.

★ The financial crisis has reinforced the case for a serious reform of the institutions of global economic governance. The Europeans should take a lead, for example on making the G8 a larger and more representative body.

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Since the end of the Cold War, several trends have been clear. Globalisation has created more interconnections and interdependence among the world's economies. Partly in reaction to globalisation, nationalism and populism have become more potent. Meanwhile the power of Asia has grown, relative to the West.

Some other trends have been less clear. Multilateralism – which may be defined as the influence of rules, treaties and institutions on international relations – has had its ups and downs. On the one hand, world leaders have established a plethora of clubs and bodies to regulate many aspects of our lives (and agreed on useful targets like the millennium development goals). The EU itself, a multilateral creation, has flourished, enlarging its boundaries and establishing a single currency. On the other hand, over the past decade multilateralism has seemed to be in retreat: President George W Bush pulled out of several international treaties and invaded Iraq without United Nations approval; efforts to make the UN Security Council more representative have failed; and Russia 'solved' its problem with Georgia by invading it.

## The bigger picture

So far, the financial crisis seems to be reinforcing these trends. Nationalism and populism have reared their ugly heads. More power seems to have ebbed away from the US and the EU. The actions of particular states rather than multilateral bodies have dominated the world's response to the crisis. However, history seldom moves in a linear direction. In the long run, provided there is leadership, the crisis could yet strengthen global and indeed European institutions.

In Europe, the financial crisis will not only affect the immediate economic outlook, but also financial regulation, economic reform, trade and perhaps even the future of the euro. The crisis has emboldened those European politicians and commentators who have always disliked what they call Anglo-Saxon capitalism or neo-liberalism. Predictably, opponents of flexible labour markets or competition in services have seized on the mistakes and excesses of Wall Street bankers to argue that the entire liberal economic model is discredited. The bail-out of Europe's banking sector will make it harder to resist state support for other industries, while weaker economic growth may lead to greater calls for protectionism. The banking crisis and a prolonged period of little or no economic growth will also provide the first real test of the eurozone's sustainability.

The impact of the financial crisis will extend far beyond economics. The downturn is likely to have an adverse impact on environmental policy, by making European businesses and governments more reluctant to cut emissions of greenhouse gases. The consequences of the crisis will also affect the EU's relations with the US, Russia and China, and could lead to changes in global governance. One winner from the financial crisis is likely to be populism, which in its left- and right-wing variants has in recent years become a real force in about half the EU member-states. Europe's populists are usually hostile to liberal capitalism, globalisation, free trade and the EU. The right-wing variety of populism also tends to oppose immigration and liberal social values.

This CER policy brief examines how the financial crisis will affect the politics and economics of the EU. It argues that the EU will emerge relatively unscathed from the current crisis only if its governments can successfully co-ordinate their policies, reduce dangerous economic imbalances and resist populist impulses.

## Europe faces a severe downturn

Europe's economic prospects have deteriorated alarmingly over the past six months. The EU now faces a prolonged period of very weak economic growth, and quite possibly of declining output. Even before many banks hit trouble in the late summer of 2008, business and consumer confidence was plunging in many European countries, and export orders had started to weaken. Once the extent of European banks' exposure to bad debts became clear, along with their diminishing capacity to absorb mounting losses, the scene was set for a collapse in confidence.

The end of the credit boom has brought into sharp relief the unsustainability of the imbalances in the world (and European) economy. For the past few years, Spain and the UK, along with Ireland and many of the newer member-states, contributed a disproportionate share of the growth in European demand. They did so, however, at the expense of mounting consumer debt and surging trade deficits. Such macroeconomic imbalances could not keep rising indefinitely – and they are now set to unwind. Property prices are already falling in Ireland, Spain and the UK, and will continue to do so. The IMF warns that the economic downturns in these countries could be deep and prolonged, as a hangover from their house price and credit booms. Domestic demand will remain very fragile while over-stretched households rebuild their finances. The IMF expects both the British and Spanish economies to contract in 2009.

If the EU as a whole is to avoid a prolonged recession, those countries that have been running large external surpluses – most notably Germany – will need to take up the slack. Unfortunately, there is no sign that they are ready to do so. Because consumer and business confidence has collapsed across Europe, domestic demand in Germany will almost certainly weaken further. The German government has already slashed its GDP growth forecast for 2009 from 1.2 per cent to 0.2 per cent, and some private-sector forecasters think the German economy could even contract next year. The EU as a whole, therefore, is unlikely to grow by more than 0.5 per cent in 2009, and the euro area may not grow at all.

With tax revenues diminishing, unemployment rising and some governments having to bail out ailing banks, public budgets across the EU will come under a lot of pressure. Many countries will overshoot the Maastricht budget deficit limit of 3 per cent of GDP by some distance. However, given the exceptional conditions that EU countries face, the European Commission is unlikely to make much of a fuss about this.

Europe will not be able to rely on strong growth in external demand to stimulate exports. The US, having provided a disproportionate share of growth in global demand in recent years, faces a protracted period of sluggish economic activity as it struggles to cope with the aftermath of the credit crisis. Many European firms have placed high hopes on major emerging markets, but these countries now face challenges of their own. The sharp fall in the prices of oil and other commodities in the autumn of 2008 will hit growth in Russia and other resource-rich countries.

Emerging markets that used to rely on export-led growth, such as China, will suffer from the downturn in demand from the US and Europe. This slowdown in exports will force China to rely relatively more on domestic demand to sustain growth. However, it is not clear how far the Chinese authorities are willing to support this process, for example through higher investment in infrastructure or more social spending. The trouble in the US may even reinforce the belief of many in the Chinese leadership that accumulating foreign exchange reserves and building up ever larger external surpluses is still the right thing to do.

## The EU reaction: too little, too late?

Europe's most immediate challenge (like America's) was to stem the catastrophic loss of confidence in the financial system. Initially, the EU did not seem up to the task. In contrast to the governments, the monetary authorities did work well together from the start. Led by the European Central Bank (ECB) and the Bank of England, Europe's central banks injected huge amounts of liquidity into money markets and allowed banks to borrow against a widening range of collateral. On October 8th they participated in co-ordinated interest rate cuts, with the world's other leading central banks, in a bid to restore confidence to financial markets.

But as the crisis unfolded, it became clear that actions by central banks, though necessary, were not sufficient to stem the loss of confidence. Interbank markets remained frozen in fear, despite huge liquidity injections. With banks hoarding cash and refusing to lend to each other, flooding the money markets with liquidity had become as effective as pushing on a piece of string.

European governments were slow to wake up to the systemic nature of the crisis and to forge a co-ordinated response. Some initially reacted by blaming the crisis on the US and by denying that it would have major repercussions on Europe. When this period of denial came to an end, governments responded in an unco-ordinated, reactive and ad hoc manner while paying little attention to the impact of their actions on their neighbours. A case in point was Ireland's unilateral decision to guarantee bank deposits – a move that reassured nervous local depositors but potentially harmed non-Irish banks with less generous deposit insurance schemes by encouraging customers to shift their money to Ireland. The EU's nadir was probably the October 4th summit in Paris to which Nicolas Sarkozy had invited the leaders of the other EU countries that are also members of the G8 – Britain, Germany and Italy. Their inability to produce any substantive plan of action contributed to the following week's mayhem in the financial markets.

However, nothing concentrates minds quite like staring into the abyss. Faced with the possibility of a complete collapse of confidence in the financial system, the member-states started to co-operate seriously and adopted national measures to address the root causes of the problems. The turning point came in the second week of October, with Gordon Brown's plan to put huge amounts of government money into recapitalising Britain's banking sector and into guaranteeing interbank lending. Within a week, the eurozone governments, including France and Germany, had adopted the main points of the British plan (as the US did soon afterwards). In the two weeks following these announcements interbank lending rates declined, albeit modestly. But more substantial declines are likely as the measures take effect. In short, after a slow start, EU governments have been getting on top of the problem.

Nevertheless, the EU has been heavily criticised for its performance during the crisis. Is this criticism justified? Expectations of what the EU could achieve were overblown, partly because people made the mistake of comparing the eurozone with the US. Unlike the US, the EU does not have a central treasury that can step in to ensure the solvency of financial institutions. When the member-states designed the euro, they decided not to build centralised economic and fiscal institutions. To criticise the EU for not having them in a moment of crisis misses the point (and it is particularly puzzling that the criticism was harshest in the British press: the UK has long been the leading opponent of a bigger EU budget and of more centralised banking supervision).

The go-it-alone tactics of some EU countries may have looked unseemly. But bail-outs of banks obviously had to happen at the national level, because that is where the money – and the political accountability – lies. In principle, the idea of a centralised EU bank bail-out fund is a good one, since some European banks have outgrown their home countries (which was the whole point of trying to build a single market in financial services). But the French idea that such a bail-out fund could be set up in the middle of a financial crisis was unrealistic, and

could even have further undermined confidence by raising expectations that the EU could not fulfil. National governments were unlikely to make taxpayers' money available for bailing out banks in other countries at a moment when their resources were already under severe strain.

The EU may not have had a direct role in the bank bail-outs but it certainly helped indirectly. The countries of the Union have had decades of experience in working together on everything from state subsidies to university exchanges. So when Fortis became the first cross-border bank to get into trouble, three governments (France, The Netherlands and Luxembourg) immediately got together and worked out a joint strategy. The initial rescue plan did not work, but the same governments quickly sorted out the problem by nationalising the bits of the bank in their own countries. Had the three governments been Venezuela, El Salvador and Uruguay, they might still be talking. Moreover, although solidarity among the EU countries was shown to be lacking at certain times, there was at least a very clear expectation that governments should not do anything that harmed their neighbours. And those that did cause problems for their neighbours had to justify themselves and in some cases modify their measures. Ireland, for example, was forced to extend its bank guarantee scheme to foreign banks operating in its territory, after the Commission expressed concerns. That same expectation does not exist between, say, the members of Nafta.

By the time eurozone leaders (and Gordon Brown) met in Paris on October 12th, the EU's response to the crisis was starting to look coherent. The eurozone countries decided to adopt their own variants of the British plan for recapitalising banks and guaranteeing credits in the interbank market. And when the heads of government from all 27 EU countries met a few days later in Brussels, they endorsed the same plan. It would be hard to argue that the Bush administration acted more speedily or effectively to deal with the crisis.

The financial crisis will affect many of the things that the EU does. The rest of this policy brief considers its impact on key areas of policy-making.

## Financial regulation and accounting

As confidence slowly stabilises, eyes are turning to the regulatory response to the crisis. A lot of politicians have blamed the excessive volatility of markets on fair value accounting rules, which require assets to be valued at their latest market prices, rather than their book value. The rules, they claim, may force banks into a vicious spiral of forced asset sales in order to raise capital – resulting in further falls in asset prices, more write-downs and capital losses. So the EU governments have persuaded the International Accounting Standards Board (IASB) to ease its rules on fair value accounting. But France and some others want the EU to go further by seeking a 'carve-out' from IASB rules if necessary.

This idea should be resisted. For one thing, it is far from clear that seeking exemptions from international accounting standards would help to restore trust. For another, it would be a retrograde step to adopt regional rules just as the world seems to be converging on a single set of global standards.

Once the immediate crisis is past, the attention of legislators will inevitably turn to the design of the regulatory regime for banks. With tax payers being asked to dig into their pockets to bail out bankers, the clamour for a tightening of the regulatory screw will be impossible for politicians to resist. Governments and EU institutions need to think carefully about what new regulations they design, rather than rush ahead with proposals that reassure voters but have not been thought through properly.

The best thing they can do is to try and reduce the pro-cyclicality of bank capital rules. The current regime for capital adequacy does little to constrain credit booms, because it does not discourage banks from chasing less creditworthy borrowers at the top of the economic cycle – that is, when banks' risk management models tell them that risks are lower and that they have plenty of capital for new loans. Regulatory rules should counter this tendency by forcing banks to hold more capital when lending and asset prices are growing strongly – or, as Spain does, by making banks increase their provisions during such periods. The Basel Committee on Banking Supervision, which has a huge influence on banking supervisory legislation adopted by the EU, is discussing ways in which capital requirements might be scaled up during economic upturns.

Other changes are already in the EU's legislative pipeline. On October 1st, for example, the European Commission proposed an amendment to the Capital Requirements Directive which would require banks to ensure that the originators of securitised assets retained a 'material' economic interest in them (which the Commission defines as at least 5 per cent). The Commission is also proposing to regulate credit rating agencies. Both sets of proposals aim to tackle one of the key problems highlighted by the current crisis – namely the way securitisation ratcheted up risk because originators had no interest in assessing the credit-worthiness of borrowers, and because credit rating agencies were not doing their jobs satisfactorily. Banks and credit rating agencies will not like these proposals. In particular, many European bankers complain that having to retain a 5 per cent material interest in securitised assets will drive this business to other parts of the world. But their lobbying power is diminished.

Other regulatory changes could be in the offing further down the line. The single market commissioner, Charlie McCreevy, has talked of proposals to force the trading of derivatives onto properly regulated exchanges. The president of the Commission, José Manuel Barroso, has appointed a group of experts headed by Jacques de Larosière (formerly governor of

the Banque de France and head of the International Monetary Fund) to propose better regulatory arrangements, particularly for banks with cross-border activities. The crisis has exposed severe weaknesses in the EU's current system. One is the emergence of banks that are 'too big to fail' but have outgrown their home country's capacity to rescue them. Another is the capacity of some home countries to honour liabilities to depositors from other member-states. Under the so-called 'passport arrangements', a depositor with the branch of, say, a German bank in the UK is covered by the German deposit protection scheme. However, doubts about Iceland's ability to compensate depositors who opened accounts with the foreign branches of Icelandic banks that subsequently failed raises questions over the viability of the arrangement. (Iceland is not an EU member, but has signed up to the rules of the single market through its membership of the European Economic Area.) The questions over bail-out funds and deposit insurance will therefore provoke discussions about revising current arrangements – and could revive old arguments about the need for a pan-European financial services regulator.

Following the partial nationalisation of leading banks in several EU countries, it is inevitable that policy-makers and the public will focus on reforming financial regulation. But it would be unfortunate if broader lessons about macroeconomic policy were not learned. For the root cause of the current crisis was not only the inadequacy of regulatory regimes but also the huge imbalances that built up in the world economy. When the global financial system returns to a degree of normality, the leading international economic fora will discuss how financial stability can best be reconciled with the free circulation of capital. Since emerging economies such as China will need to be included in such talks, the key institutions of global governance will have to be reformed.

## The Lisbon agenda and economic reform

The economic downturn is bound to fuel opposition to economic reform and deregulation. The financial crisis has not only shaken popular confidence in banks, but also in the market economy as a whole. The crisis has strengthened the position of those who have argued that the superior performance of the US economy – the implicit benchmark for the EU's 'Lisbon agenda' of economic reform – stems from debt-fuelled excess rather than from its competitive markets and investment in human capital. Inevitably, opponents of flexible labour markets or tough competition policies have seized on the financial crisis to argue that it discredits every aspect of the market-based model.

Europe is not about to abandon its market economy. It is unlikely that any of the big EU member-states will elect an avowedly anti-capitalist government, even though support for populist political parties of both the left and the right is likely to rise. Most mainstream political leaders recognise that open markets offer Europe the best chance of fostering the dynamism and innovation that it needs to keep raising living standards in a globalised world.

However, there is a real risk that politicians will use the crisis to justify opposition to further liberalisation. For example, it will be harder to win the argument for freer trade in services across the EU. Similarly, the precedent of government bail-outs of banks could make it difficult to resist calls for state aid to other businesses, such as the crisis-hit car industry.

Silvio Berlusconi, the Italian prime minister, has gone further than other leaders in his anti-market rhetoric, saying that "state aid, which until yesterday was considered a sin, is now absolutely essential". He has also demanded new rules to protect Italian companies from foreign takeovers. Nicolas Sarkozy, the French president, has suggested that EU countries set up their own sovereign wealth funds to buy stakes in European companies whose shares are trading cheaply, and protect them from takeovers from outside Europe. The idea is unlikely to get very far, but it reveals how the intellectual climate has shifted away from economic openness.

The growth of state involvement in the financial sector also has major implications for the single market and competition law. The Irish decision to give a blanket guarantee to all deposits, both personal and corporate, may have been unavoidable. But it has injected potentially significant distortions into the European financial system. Moreover, Japan's experience shows that such distortions can be long-lasting. Tokyo took similar steps to guarantee deposits in the early 1990s, following the collapse of Japan's banking sector, and found it hard to withdraw such guarantees once they were established.

## The euro

The financial crisis seems to have lifted support for eurozone membership among several EU countries that are still outside. If Belgium and Ireland had not been members, the strains on their banking sectors could have easily provoked the kind of currency crisis that Iceland – outside the euro area – has experienced. In Central and Eastern Europe, Slovenia, which has already joined the euro, and Slovakia, which is close to doing so, have not faced the kind of pressures that those more distant from euro membership, such as Poland and Hungary, have done (though in Hungary's case, worrying macro-economic imbalances played at least as big a role as the absence of the euro). The contrast between the experiences of Ireland and Iceland, and Slovakia and Hungary, has emboldened supporters of eurozone membership – although the decision of the ECB to make a €5 billion loan available to Hungary gave some comfort to non-euro members.

Denmark, whose participation in the exchange rate mechanism makes it a virtual member of the single currency, has felt the political costs of keeping its own currency – it was not invited, for example, to the extraordinary summit of eurozone leaders on October

12th. The debate over the merits of joining the euro has revived in Iceland, and could do so in Denmark and Sweden. Some Central and Eastern European countries may want to accelerate their timetables for joining the euro, though the impact of the downturn on their budget deficits will make that difficult. Eurosceptic Britain, where the question of euro membership has been politically dormant for the past five years, is unlikely to change its stance.

Ironically, just when support for joining the single currency is rising in some non-eurozone countries, the long-term stability of the eurozone is likely to face a serious test. The spreads between the yields on German government bonds and those from Italy, Spain and Greece have widened steadily during 2008. In mid-October, the spread between German bonds and Greek ones was almost a full percentage point, while for Italy it was 0.9 per cent and for Spain 0.6 per cent. Those spreads are the highest since the introduction of the single currency in 1999. They suggest that investors have some doubts about these countries' ability to honour their debts, or even to stay in the euro.

There are several reasons for investor concern. The financial markets were unnerved not just by EU countries' belated and ad hoc responses to the financial crisis, but also by their willingness to adopt policies with little apparent regard to the consequences for their neighbours, at least initially. This reminded the financial markets that the EU is not a unitary state. Unlike the US, the eurozone has no central fiscal mechanism to transfer funds to a member-state suffering an economic crisis. And there is no reason to believe that other member-states would step in to bail out a government that ran out of money. In Italy, in particular, some investors see the roots of the economic problems as political. Successive governments of left and right have proved incapable of carrying out the structural reforms that would boost the country's levels of productivity and competitiveness.

The eurozone is not about to fall apart, but the coming downturn will provide a major test of its sustainability. The bloc experienced a downturn after the dotcom bubble burst in 2001, but it was fairly shallow and short-lived. The challenge posed by the world's deepest financial crisis since the 1930s will be of a different order altogether. The credit crunch should test conclusively whether it is sustainable for countries to share a single currency without a political union. If the financial crisis leads to better co-ordination of macroeconomic policies among the members of the eurozone, and a strengthening of the Euro Group (the forum where the 15 finance ministers of the euro area meet), it could yet bolster the single currency's long-term viability.

## Climate change

The EU was always going to find it harder to put in place policies to cut emissions of greenhouse gases than to agree on ambitious targets for such reductions. Even before the deepening of the financial crisis, many member-states were arguing that it would be difficult to honour the '20-20-20' targets that they signed up to in March 2007 (EU leaders agreed that by 2020 the Union would cut greenhouse gas emissions by 20 per cent, improve energy efficiency by 20 per cent and draw on renewable sources for 20 per cent of its energy). The French presidency of the EU plans to forge an agreement on how to implement those targets by the end of 2008, on the basis of proposals put forward by the Commission. With the economic downturn now putting a range of industries, from chemicals to car manufacturing, under intense competitive pressure, the obstacles to an agreement are growing. At stake is the credibility of the EU's claim to global leadership on climate issues.

At the EU's summit on October 15th and 16th, Italy and a group of member-states including most of the Central and East Europeans threatened to veto the Commission's package, unless their concerns were taken on board. Nicolas Sarkozy was forced to concede that the final agreement on the climate package would be taken by unanimity rather than qualified majority vote. The choice is now between no agreement and a diluted one. The position of the Italian government has hardened significantly as the economic downturn has deepened. It now argues that the EU should not take any measures that would increase the costs faced by European businesses.

In the EU's emissions trading scheme (ETS), companies trade the right to emit carbon, and most permits are currently given to companies for free. The Commission wants the full auctioning of most emissions permits. But the German government claims that full auctioning would undermine the competitiveness of its industries and force them to migrate to locations where energy prices are lower and environmental standards weaker. The Germans want the Commission to lengthen the list of industrial sectors that could continue to receive emissions permits for free under the ETS, when the third phase of the scheme begins in 2013. So far, the Commission has indicated that only very energy-intensive companies, such as cement, steel, aluminium and pulp could qualify for this exemption.

The new member-states, led by Poland, are particularly keen to get concessions for countries that rely disproportionately on coal to generate electricity. They are steadfastly opposed to the full auctioning of emissions permits for energy producers, on the grounds that their high degree of dependence on coal means that their energy prices would rise disproportionately.

The member-states have agreed to reach a deal on the Commission's climate package by December 2008. However, mounting opposition to elements of the package means that negotiations could drag on into 2009 and hence take place under the Czech presidency. The Czech government tends to be sceptical about the need for strong action to curb carbon emissions. Moreover, if negotiations drag on,

there may be no agreement before the end of the European Parliament's current term in June 2009, and hence no legal commitment. This would undermine the EU's negotiating position ahead of the UN climate change summit in Copenhagen in December 2009. If the EU is to persuade not only the US, but also emerging economic powers such as China and India, to get serious about curbing emissions, its member-states must agree to make meaningful cuts in their own output of carbon.

The French presidency may still be able to put together an agreement that meets the key concerns of sceptical member-states while preserving the EU's overall targets. But Sarkozy will have to make it a major priority during the remainder of his EU chairmanship. The Commission will need to concede to German demands and postpone the move to full auctioning in a broader range of industries than it had hitherto considered. Such a move would probably address the key concerns of the Italian government.

The new member-states will need to be given greater financial compensation. Under the Commission's existing proposal, industries covered by the ETS that are based in poorer countries would receive relatively more permits than those in wealthier countries. Industries in Central and Eastern Europe could be given a still more generous allowance. But richer member-states would then have to shoulder a greater share of the cost, and some of them will be reluctant to do so.

## Trade policy

As recession hits and unemployment queues lengthen, protectionist voices will grow louder. People fearing for their jobs tend to blame foreign competition. In times of economic hardship, politicians are more likely to promise protection to their constituents, and to demand that the European Commission take a tougher stance in trade negotiations.

The EU may react by resorting to more anti–dumping actions and other selected trade defences. But the risk of a significant increase in trade protectionism – of the sort that provoked the Great Depression of the 1930s – is remote. EU countries still trade mostly with each other, and these flows are governed by the strict rules of the *acquis*, which does not allow tariff or non–tariff barriers. The EU's hands are also bound when it comes to trade with the outside world. Since the Great Depression, the world's trading powers have conducted eight rounds of multilateral trade negotiations. As a result, tariffs on almost all manufacturing imports into the EU are low, and there are clear rules governing the use of 'safeguard' measures (to stop sudden surges in imports) and anti–dumping and anti–subsidy duties (to punish overseas producers that sell at artificially low prices).

Countries in the EU and elsewhere could try to resort to more protectionism through non–tariff barriers such as health and safety regulations and other sorts of red tape. However, the EU's rulebook provides reasonably strict limits on the use of such measures. Neither the EU as a whole nor its members separately are allowed to apply new regulations to trade and investment that target specific non-EU countries, because of the principle of non–discrimination that is enshrined in World Trade Organisation and OECD commitments.

The financial crisis may well reduce the already slim chances of the WTO's Doha round being concluded in the foreseeable future. The collapse of these multilateral talks on trade liberalisation last July will not substantially affect developed countries' trade regimes. The same may not be true of developing countries: many of them apply tariffs that are lower than the rates they signed up to in previous trade rounds. This means that countries such as Mexico, India, South Africa or South Korea could raise their levels of tariff protection without breaching WTO rules. The EU would then come under pressure to retaliate, which could further sour the atmosphere in international trade negotiations.

For the past few years opinion polls have shown declining support for free trade among Europeans, and the financial crisis is likely to accentuate the trend. Their growing ambivalence towards open markets could be reflected in the composition of the next Commission, due to take office at the end of 2009. Those member-states that have criticised the current Commission for its free-trading zeal will hope for the appointment of a more 'pragmatic' trade commissioner who pays greater attention to the views of farmers and other lobbies.

## Energy

The chances of the EU making quick progress on energy market liberalisation have fallen further. The voices of those EU governments (mainly the UK and the Nordics) that have argued the case for more market and less state in this key sector were growing fainter even before the crisis. Many people had started to question whether market liberalisation was the best way to achieve security of supply, fight climate change or guarantee low energy prices. The turmoil in the financial markets and the resulting nationalisation of banks across the EU will make Europeans more cautious about liberalisation of any kind, and particularly in vital services sectors such as energy.

Politicians will be more focused on containing the impact of high energy prices on households and industries than on the liberalisation agenda – although falls in global commodity prices should alleviate price pressures. The Council of Ministers and the European Parliament are expected to reach an agreement on the Commission's third energy liberalisation package by the end of the year. Full 'unbundling' – the breaking up of vertically integrated energy companies – is no longer on the cards. And it looks unlikely that many companies will follow the example of some German power firms, which are voluntarily selling their grids or pipelines.

## EU enlargement

Enthusiasm for further enlargement of the EU was already muted before the financial crisis. Fewer than half of EU citizens (46 per cent) were in favour in late 2007, according to a Eurobarometer poll, and support was even lower in Germany (28 per cent), France (32 per cent) and the UK (36 per cent). Usually, support for enlargement tends to correlate with a country's performance on growth and employment (Austria, with a successful economy but strong opposition to enlargement, is an exception). With Europeans now fearing for their jobs and incomes, opposition to the Union taking in more poor countries will most likely rise further. The fact that the pace of reforms in would-be members, such as Turkey and several Balkan states, has been generally slow does not help their cause. And since these countries are themselves being squeezed by the global downturn, their appetite for further liberalisation and economic reform will be muted.

## Migration

The financial crisis threatens to make Europe a less attractive place for immigrants. When unemployment rises, immigrants are inevitably less welcome. Even in the relatively prosperous period that preceded the current financial imbroglio, there was a persistent and widespread perception in many EU countries that levels of immigration were rising out of control. That perception is unlikely to change in the current environment, especially if economic problems elsewhere increase the incentives for people to leave their homes to seek better lives in the West. So the economic downturn may make it less likely that EU countries will follow through with plans to co-ordinate better their immigration policies and to take steps to attract badly-needed skills from abroad. Member-states are unlikely to embrace common action unless it helps to strengthen borders and return illegal immigrants to their home countries.

## Ireland and the Lisbon treaty

When the Irish government moved to guarantee savings in domestically-owned banks, its unilateralism went down badly in other member-states. Many of them were already frustrated with Ireland because of its rejection of the Lisbon treaty in a referendum in June 2008. Most member-states have already ratified the treaty and argue that it is vital for the good functioning of the EU.

The Irish government is under intense pressure from the French presidency and other EU partners to hold a second referendum to reverse the outcome of the first. But the chances of the government winning a second popular poll on the treaty look slim. The Irish economy currently faces its worst economic downturn in decades, as the bursting of the credit and housing bubbles hits consumer spending, jobs and growth. The government has been forced into a raft of severe and unpopular cut-backs in public spending. Pressure or even intimidation from other EU countries would only generate anger and make it even harder to get a Yes on the treaty.

Ireland is likely to hold out until at least the end of 2009 before chancing a second poll, in the hope that an economic recovery will be underway by then. The treaty's reforms have important implications for the future composition of the European Commission. Hence the EU may need to ask the current Commission – due to step down in November 2009 – to stay in office for a transitional period until the fate of the treaty becomes clearer.

In the end, however, the financial crisis may aid the treaty's ratification. First, it has helped to demonstrate the need for a longer-term and more stable EU presidency – as envisaged in the treaty – that could do a better job of handling crises than the current system of six-month rotations. Second, and more importantly, the crisis has underlined Ireland's reliance on its membership of the EU and the eurozone; outside the euro, Ireland would have faced a run on its currency. Even though the country cannot be forced to leave the Union, a second referendum will inevitably raise questions over its position in the EU. So if Ireland's politicians do choose to hold a second referendum – on the same treaty, but with added reassurances and clarifications – they may be able to sell it more convincingly than before. Proponents of the Lisbon treaty could argue that a second No would weaken Ireland's position in the EU and also hamper any nascent economic recovery.

## Populism and European politics

Even before the financial crisis, populism was on the march in several European countries. In Germany, the far-left Linke party is taking votes from the Social Democrats that rule in a grand coalition with Angela Merkel's Christian Democrats. The French socialists fear that the emergence of the new anti-capitalist party led by Olivier Besancenot will do similar damage to their party. Hard left parties have also weakened more moderate ones in The Netherlands and Denmark. In Austria two far-right parties won 29 per cent of the votes in early October while in the Flemish part of Belgium the far-right has attracted a similar share of support. The populist right-wing Northern League is part of the ruling coalition in Italy.

Populism has also become a feature of the political systems of some of the new member-states in Central and Eastern Europe. Slovakia's government is led by the populist leftist Robert Fico and includes the nationalist HZDS, whose party leader is the former prime minister and pugilist Vladimir Meciar. In Poland, the right-wing populist Law and Justice Party (led by Jaroslaw Kaczynski) left office after the October 2007 election, although its share of the vote went up and it still holds the presidency. Partly because of the constraining effect of EU rules, in neither Poland nor Slovakia have populist governments undone the sensible economic reforms of their predecessors.

Across Europe, populist parties will probably benefit from the increased sense of insecurity and the opprobrium now being heaped on bankers and capitalists. Growing unemployment will increase calls for protection against imports, foreign investors, and immigrants. When voters feel insecure, they are more likely to support politicians who offer firm leadership and a strong state. Even before the near meltdown of Wall Street, few European politicians were prepared to speak out in favour of economic openness, immigration, EU enlargement or supranational solutions. For many populist leaders, the EU – as a symbol of globalisation – will become a convenient whipping boy.

## Relations with the US, Russia and China

Like the Iraq war, the financial collapse has damaged American soft power. Fewer people look to the US as a political and economic model to admire and emulate. The fact that the financial crisis started in the US, and got worse after Congress initially voted down Hank Paulson's rescue package, may make it somewhat harder for the US to persuade and cajole others to follow its wishes.

Many commentators have been predicting that the arrival of a new administration in Washington will herald a new dawn in transatlantic relations, especially if (as opinion polls in October suggested) Barack Obama wins. The Europeans will be glad to see George W Bush gone. But that does not mean that they will be ready to shoulder new global responsibilities. For example, any new US president will want the Europeans to send more troops to Afghanistan. This looked unlikely before the economic downturn and looks even less likely now that European budgets are under severe strain and Europeans are preoccupied with their own problems. Most EU leaders will be reluctant to make expensive and politically unpopular troop commitments to Afghanistan – or to other security crises that may emerge. When the Americans urge the Europeans to spend more money on improving their military capabilities, they will find few governments willing to step up. In a time of straitened finances, European politicians are much more likely to cut than to increase defence budgets.

One priority of the new US administration will certainly be Iran and its nuclear programme. But the relative decline of American influence could make it harder for the EU and the US to convince Iran to give up its nuclear enrichment capabilities. If the EU-led diplomacy is to have any chance of success, the US will have to join the talks, bringing to them potentially powerful carrots (like diplomatic recognition and economic assistance) that can balance possible sticks such as much tougher economic sanctions. But in its current state the US may find it rather difficult to convince the UN Security Council of the need for more sanctions, especially since the war in Georgia damaged its relations with Russia. Some EU member-states may also become less keen on economic sanctions against Iran, fearing the impact on their own industries.

Russia could be among the biggest losers from the global financial crisis. As the least diversified and developed of the larger economies, it is especially vulnerable to the general collapse in confidence. Russian share prices have plummeted two-thirds since their peak in May, and the government closed the stockmarket several times in September and October while struggling to shore up a highly fragile banking and financial sector. The economy's over-dependence on energy exports has been brutally exposed by the crash in oil prices (which fell from $147 in May to below $70 in mid-October). Domestic and foreign investor confidence is extremely low; capital flight led to foreign exchange reserves dropping from $600 billion in early August to $515 billion in late October. Russia's still substantial gold and currency reserves provide some insulation against economic misfortune, but could soon diminish if the current-account surplus melts away. Most economists predict that growth, which before the crisis was running at 7-8 per cent, will tail off to around 4 per cent in 2009.

Faced with economic hardship and a – from a Russian perspective – hostile international environment in the aftermath of the Georgia war, Russia's foreign policy is likely to be aggressive, while authoritarian and autarkic tendencies will strengthen at home. The anti-American rhetoric that has come from Prime Minister Vladimir Putin and President Dmitri Medvedev reflects both the depth of the regime's anxiety, and its disillusionment with the so-called Anglo-Saxon model of capitalism. EU-Russia relations are unlikely to improve, with Moscow in no mood for compromise on EU monitors in Georgia, the common neighbourhood or energy liberalisation. Instead, Russia is likely to ratchet up its great power rhetoric, attempt to carve out spheres of influence in the former Soviet space, and maintain an unco-operative stance on issues such as Iran, non-proliferation, counter-terrorism and European security.

China should be able to come out of the crisis relatively well. Although exports to the US and EU are falling, Beijing is already reorienting production to its potentially enormous domestic market. The government faces a major challenge in persuading a traditionally savings-obsessed population to spend more, but can take encouragement from the growing consumerism of Chinese society. China will benefit considerably from the fall in world oil and other commodity prices. Unfortunately, this will hamper progress on energy efficiency and the development of alternative, cleaner sources of supply. The estimated fall in national economic growth (from 12 per cent to 7-9 per cent, according to most estimates) means that quantitative indicators such as gross output will become relatively more important, compared with ideas that had been circulating such as 'green growth'. There is not much chance that a China worried by slowing economic growth will agree to binding commitments to cut greenhouse gas emissions in the lead-up to the 2009 Copenhagen summit, especially since a recession-hit America is less likely to make significant concessions of its own.

The western-centred financial crisis will reinforce the perception that the West is growing weaker. However, China will not challenge American political, military and economic primacy for at least a generation. A circumspect foreign policy will continue to reflect the principles of 'peaceful development' and 'a harmonious world'. Conflict over Taiwan is improbable. The likely slowdown in Chinese exports to the EU will reduce the latter's burgeoning trade deficit with Beijing. Yet EU-China economic relations could become more fractious, thanks to protectionist pressures in Europe and China's defensiveness over an under-valued renminbi, its failure to protect intellectual property, and its barriers against foreign investors. With Beijing focused on minimising the impact of the global downturn on its export industries, it will deflect European complaints about unfair trade practices and remain obdurate on the substance of the arguments.

## Global governance

The economic downturn will hit many Asian economies less severely than those of Europe and North America, and reinforce the perception that power is shifting from west to east and south. This will rekindle calls for reforms of global governance. Politicians and think-tankers have been demanding such changes for so many years that it has become a cliché. But not much has happened so far. The IMF and the World Bank have undergone modest reform, and the G8 has become the G8+5, so that Brazil, China, India, Mexico and South Africa can join some of the discussions held by the established western powers plus Russia. But most of the important institutions – and especially the UN Security Council (UNSC) – are increasingly unrepresentative. Partly because of the inadequacy of the formal institutions of governance, a whole range of informal bodies – ranging from the Financial Stability Forum to the Proliferation Security Initiative – have emerged, some of them playing important roles.

To its shame, the EU has failed to lead on reform of global governance, partly because it cannot agree on who should have permanent seats on the UNSC, and partly because it is reluctant to diminish Europe's over-representation in many institutions. But the financial crisis seems to be spurring serious efforts to reform the current system. By damaging the soft power of the West, it has made the under-representation of emerging powers seem even more ridiculous. It may not be a coincidence that in the same month that the US financial system came close to collapse, the US administration signalled that it was willing to abandon the principle that the head of the World Bank needs to be an American. The EU should reciprocate by saying that the IMF need not always be run by a European. The Europeans should take a lead on reform of the IMF and World Bank, on the conversion of the G8 into a larger and more representative body, and on the creation of new bodies to bring together financial regulators. Presidents Bush and Sarkozy have called for a special international summit to start designing a 'Bretton Woods 2' system of economic governance. The EU needs to make sure that it contributes serious and thought-through proposals to the effort.

## A crisis is what you make of it

Just as European leaders have shown themselves capable of learning during the financial storm, so world leaders will also – hopefully – come to appreciate the benefits of closer economic co-operation. As this policy brief has argued, there are good reasons to be concerned about the impact of the crisis on various EU policies. But strong leadership could yet change the course of history for the better.

At the start of summer, many people were deploring the apparent lack of leadership in the EU. The European Commission, criticised by some for the modesty of its ambitions, had only just over a year to run; approaching elections and coalition bickering were weakening Angela Merkel's German government; Britain's Gordon Brown was one of the most unpopular leaders in Europe; and France's Nicolas Sarkozy, though undeniably energetic, had upset many of his European partners by his unfocused activity and sometimes unilateral initiatives. Moreover, the Czech Republic – not always known for its EU-enthusiasm – was due to take over the rotating presidency in January 2009.

But recent months have shown how quickly perceptions can shift. After the Russia-Georgia war, Sarkozy established his EU leadership credentials (with some help from Merkel) by speaking for the whole Union and forging a common position at the September 1st EU summit. And when the financial crisis struck, though Sarkozy's initial moves achieved little, he soon rallied the 27 governments behind a sensible course of action. Meanwhile Brown became the surprise winner of the crisis, emerging not only as a European but as a global leader with his large-scale bank bail-out plan. The divisions that opened up after several countries unilaterally guaranteed their bank deposits were forgotten relatively quickly. So it is not inconceivable that EU governments will co-operate to prevent the crisis from triggering the kind of introversion that would lead to increased hostility to immigration, free markets and further EU enlargement.

If a popular new US president worked together with Europe's senior leaders – and hopefully those from emerging powers too – to mitigate the negative consequences of the crisis, they could achieve a lot. They could decide to revive the Doha round. They could resist the tide of trade and investment protectionism. They could agree not to let the economic slowdown deflect them from the task of tackling climate change. And they might even – especially if the Europeans give a strong lead – undertake a serious reform of global governance.

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