The beginning of the new millennium appeared to pave the way to the success of the liberal model on a global scale. The striking growth of the emerging economies, together with positive growth rates in developed countries, was expected to give rise to a win-win situation which could make significant pay-offs available to everybody.

The current severe economic crisis may represent a rude awakening from this ‘liberal dream’. A crisis that originally seemed to be rooted in American problems and miscalculations, has shown its seriousness by affecting the entire world and changing its nature from a strictly financial to an economic crisis. The race towards continuous growth has come to a halt and a period of systemic crisis has started.

In other words, the most striking features of the current crisis are not only its systemic dimension but also the clear-cut demonstration of impressive and strict linkages between the international financial system and the real economy. An analysis exploring these linkages and the effectiveness/sustainability of the measures undertaken by states (particularly the European ones) to face the crisis is therefore required.

The initial bankruptcy of Lehman Brothers and the ensuing negative spiral in the banking system may represent a good starting point for such an analysis. These events have led to sweeping changes and unexpected state interventionism in the economy in just a few weeks.

In an increasingly uncertain context verging on real panic, some people have raised doubts about the liberal system itself and its own future sustainability. As a consequence, the crisis has engulfed not only the international markets but also the liberal approach itself, which showed unexpected drawbacks in what is a truly global economy (not to mention the problem of its sustainability in environmental terms).

But this view seems too extreme. Rather, the crisis is bringing back to the surface recurring, if not old, questions on the liberal economic system:
the presence of the state in the economy; market failures; proactive use of fiscal policies; participation in international economic governance; the environmental sustainability of capitalism etc.

These questions are not particularly original as they have characterized the capitalist system since its origins, but the depth and size of the current crisis are placing new emphasis on their importance.

This is particularly true if one considers that national responses to the current crisis run the risk of using traditional ‘recipes’ instead of searching for wide-ranging and original solutions (requiring strong political commitment). Indeed, state debts have been dramatically increased since the crisis exploded in October 2008. The message sent by national authorities is crystal clear: extraordinary times require extraordinary interventions. But growing national debts raise many problems in terms of national income redistribution in the short/medium run and sustainability in the long run. In addition, the perceived need to stimulate the economy by raising new national debt may give rise to harmful competition among states (which would be obviously more disappointing in the European Union). The situation may be aggravated by the return of a recurrent ‘spectre’ in times of crisis: economic nationalism and protectionism.

In contrast to these approaches, the need for coordinated measures to exit the crisis still exists, not only for fiscal policies but also for regulation. Financial markets are regulated mostly at the national level but they operate on a global scale. They require more coordinated, if not centralized, institutions and regulation.

In order to outline these new coordinated measures, it is not necessary to criticize the entire model of economic development that we have been experiencing so far. However, a demand for an urgent rethinking of global economic governance is emerging. Therefore the approach to economic governance is not strictly economic but also political. A growing widespread consensus is surfacing as a consequence of the surge of new economic powers (China, India and Brazil). This process should lead to a new Bretton Woods redefining the rules in a truly globalized world.

The fact that the crisis broke out in the United States, which has been unable to tackle it effectively and prevent it from acquiring a systemic nature, may be interpreted as the diminishing power of the US. Today, at least in the economic field, this power needs to be shared not only with the United States’ traditional and trusted European allies but also with the big emerging powers. In a nutshell, the outburst of the crisis has made the search for a new world economic governance more urgent.

This volume attaches great importance to the role the European Union can play in this search. The unpreparedness to face such a severe crisis was clear not only in the United States but also in Europe, where a lack of real
federal bodies and competencies has made the political leaders’ task even more difficult, though not necessarily less effective.

The rationale for such a European difficulty lies primarily in the EU’s continuous search for a balance between the potentially federal competencies given to European institutions and the preservation of national sovereignty that is not merely formal.

Several decades ago, some of the European Union’s historical goals in the economic field were simply considered impossible (that is the Single Market and above all the Economic and Monetary Union) but they are now a reality.

Even at the political level, some important steps have been taken (such as the ‘co-decision’ procedure which puts the European Parliament and the European Council on an equal footing). But it has not been possible to repeat the pace and importance of economic cooperation in the political realm.

The European Union is an unfinished puzzle to which new pieces are constantly added. This feeling of continuous ‘work in progress’ is more evident when the EU is confronted with serious international problems, such as the current economic crisis. In such cases, the European Union shows the inconsistencies of an incomplete job: a common currency which has not yet created an optimal currency area; a monetary policy given to a ‘federal body’ (the European Central Bank) but with few tools at its disposal for effective bank supervision (still in the hands of the national central banks); fiscal policies undertaken at the national level (despite the efforts made by the Stability and Growth Pact).

These institutional problems have made the identification of a common policy very difficult in the wake of the crisis, thus leaving room for the member states’ initiative (under the active leadership of Mr Sarkozy, President of the EU in the second half of 2008).

Indeed, the interventions decided in the European financial system in October/November and the subsequent recovery plans may be regarded as a simple sum of national interventions, or in the best case an attempt to coordinate them.

In addition to these institutional constraints, member states’ ‘atomistic’ answers have also originated from the effects of the crisis not being spread evenly across the European countries. The risk of the above-mentioned harmful competition raising new debt to finance national packages has made things even worse.

Bearing all this in mind, many questions arise concerning completion of the European puzzle, including during the crisis: the institutional development of the European Union; its role in the new world order; the coherence of its common monetary policy with national fiscal policies; the regulation of the financial system; the future sustainability of the measures
adopted to support national economies; the coherence of the current measures with ambitious future targets (such as those addressing climate change).

This volume intends to tackle all these issues by relating them to the main features of the current crisis: its systemic dimension and the strict financial markets/real economy linkage.

Chapter 1 by Jacques Mistral starts this analysis by providing an interpretation of the challenges facing the world economy today. The author maintains that we are not facing a cyclical adjustment after which we should go back to ‘business as usual’ but rather a severe crisis jeopardizing the entire globalization process. An open world economy now calls for better international governance. The author devotes the second part of his chapter to the search for this would-be governance of the world economy. In this regard, the G20 initiative should not go through a series of successive rounds of negotiation, as it should be placed in the context of a ‘global grand bargain’. Evidently, this approach would imply a bold strategy bringing many issues into the hands of political leaders but at the same time leaving room for possible trade-offs. Mistral concludes his chapter by proposing the creation of a new “United Nations Economic Security Council” and by analysing a viable role for the European Union in this new context.

These proposals provide a general framework but they need to be further developed to include specific sectors. As far as the financial system is concerned, the current crisis, and above all the options for a viable solution to it, are still a conundrum for many financial authorities and operators, politicians and academic economists. They are still striving to understand the core of the problem. Franco Bruni attempts to contribute to this understanding by stressing ‘forbidden’ questions instead of elaborating complete answers, in Chapter 2. According to Bruni, it is extremely important to raise these questions as at least for the time being it does not seem possible to answer them in a clear-cut way. In addition, this allows us to emphasize ‘left-aside’ issues and show the drawbacks and weaknesses of economic and financial theory. Firstly, Bruni lists the arguments in favour of and against an explanation of the crisis centred on an alleged ‘excessive liberalization’. He stresses that many express the desire to increase the regulation and supervision of financial markets or expand the role of governments in placing constraints to ‘wild free markets’, whereas requests for considering improvements in monetary strategies are less noticeable. In this case, the ‘forbidden’ question is the role of monetary policy in crisis prevention, even in the normal long run. Secondly, Bruni wonders whether we are experiencing a lack of qualitatively adequate regulation, or also quantitatively scarce regulation. Indeed, regulation cannot be simply considered a limitation of market mechanisms as it often allows for their
reinforcement. Simply put, the cure does not necessarily consist of adding and reinforcing regulations, as it may also imply changed, reformed and streamlined rules. Thirdly, attention is placed on today’s widespread criticism of new financial instruments. Bruni does not deny the excessive reliance on opaque over-the-counter transactions, but at the same time he states that innovative instruments are extremely important for the economy since they contribute to risk management and allocation and to the efficiency of forward-looking, expectation-driven financial markets. Moreover, Bruni tackles the issue of adequate level of supervision. The absence of strict supervision has been a fact, but it is not the same thing as the lack of regulatory powers. Building on these and other ‘forbidden’ questions, the author concludes his chapter by highlighting some implications and suggestions for European monetary and financial governance.

Chapter 3 by Karel Lannoo is closely linked to Bruni’s chapter, but more particularly presents policy recommendations aimed at identifying steps to be made towards a more integrated financial oversight. In the first two sections, Lannoo provides an overview of the impact of the crisis on the entire European financial system. He stresses the effects on the European banking system by presenting estimates of the total losses related to the subprime crisis and recent trends in profitability and capital/liquidity ratios. In addition, he makes a comparison between the EU and the US banking systems, particularly in terms of recent leverage levels. The analysis also encompasses the impact of the crisis on the European insurance sector, which is quite a small actor in the financial system as compared to banks (its total assets being about one-fifth of the banking sector). In this regard, Lannoo points out that the insurance sector has been less affected by the crisis due to limited transparency of the published accounts. Besides, the author provides an analysis of the most severe effects of the crisis on the activity of the financial markets, and international and European policy responses to the full-blown systemic crisis. Following this detailed description, Lannoo discusses models of European regulatory and supervisory reform. He aims at highlighting the shortcomings and inconsistencies of proposals which have been debated for some time: upgrading the Level 3 Committees, strengthening the role of the supervisory colleges, expanding European supervisory cooperation through memoranda of understanding, and a clearer role of the European Central Bank (ECB). Lannoo proposes to overcome these limits by establishing a new and effective supervisory system to deal with today’s and tomorrow’s European challenges. But EU policy-makers will be required to take a quantum step in terms of institutional changes, to take full account of these limits. Following the example of the creation of the European System of Central Banks in 1998, Lannoo suggests preparing a roadmap leading to a European System of Financial Supervisors (ESFS). This roadmap would
require the European Council to mandate the High Level Expert Group on EU financial supervision to make concrete proposals for the creation of the ESFS, the groundwork of which should be laid by a European Financial Institute. Finally, a European Resolution Trust would be a necessary corollary to an ESFS and would represent a safety net for the short-term financial problems of EU-based financial institutions.

The analysis of the financial and monetary aspects of the current crisis is completed in Chapter 4. Daniela Schwarzer focuses on the evolution of the Economic and Monetary Union (EMU) in the first euro decade, and further changes EMU governance may go through as a result of the crisis. The first part of the chapter is devoted to the internal governance dimensions of the EMU. The author presents the EMU’s economic record in terms of growth, inflation and employment from 1999 to 2008. She underlines that the ECB has delivered solid monetary policy results in the first decade of the EMU but also stresses that divergence in Europe has increased, and that the ‘one-size-fits-all’ monetary policy has consequently intensified cyclical developments in some regions and member states. In 2005, the European Stability and Growth Pact (SGP) – which lays down rules for fiscal policy coordination – was reformed in order to enable more political discretion in its application. In other words, governments were allowed to take cyclical conditions into account, as the stabilizing role of fiscal policy had become a concern. Schwarzer also considers the institutional innovations of the EMU and attaches great importance to the creation and evolution of the Eurogroup (which the Lisbon Treaty will give a legal basis in an EU treaty for the first time). After her analysis of this first decade, the author stresses the impact of the crisis on the EMU in the second half of 2008, by analysing the first Eurozone summit and the role played by the ECB and member states in stabilizing European financial markets. In the second section, Schwarzer analyses the external dimension of the euro, underlining its international success in terms of its attraction for the opt-out countries, safe haven for Central and Eastern Europe, external value etc. The author concludes that a different view has been taken on the role of discretionary fiscal policy in the EMU in the last years, especially as it turned out that the EMU is not evolving towards an optimum currency area as quickly as was expected when the Maastricht Treaty was drafted. These problems may be aggravated by future challenges for the Eurozone (the up-coming Eastern enlargements, the impact of the Lisbon Treaty etc.). Particularly within the context of the current crisis, it is striking that risk and benefit evaluation still runs along national lines rather than in view of EMU aggregates. The world’s second largest economy cannot count on instruments which are habitually available for truly integrated economies.
Chapter 5 by Altomonte, Passarelli and Secchi, and Chapter 6 by Zuleeg and Martens, move the analysis to another relevant aspect of the current crisis: fiscal policy and the spreading of the crisis beyond the borders of financial markets. These two chapters can be considered complementary. Indeed, Chapter 5 provides a detailed examination of the impact of the crisis on EU fiscal policy and the compatibility of the fiscal stimulus with the Lisbon agenda, whilst Chapter 6 examines the long-term implications of the crisis on European fiscal policy, by stressing the need for more prudent public finance once the current crisis has passed. In particular, Altomonte, Passarelli and Secchi place emphasis on the conventional wisdom behind the EMU: discretionary fiscal policy should not be used as a tool to stabilize output over the cycle (the stabilization role being normally left to monetary policy in the entire euro area, with the condition that price stability is not endangered). Only automatic stabilizers will work in the case of asymmetric shocks among member states. As a consequence, the euro 200 billion set of common discretionary fiscal policy actions (Recovery Plan) suggested by the European Commission to limit the effects of the crisis on the real economy can be considered a veritable ‘revolution’ in the traditional economic set-up of the EMU. Therefore, the authors assess the ‘extraordinary’ nature of these measures, if not for their size at least for the nature of the policy under consideration. The reasons behind the Recovery Plan can be found in the peculiar aspects of the current crisis; a liquidity crisis transformed into a solvency crisis with ensuing consequences in terms of the drying up of credit for new investments, and hence low growth rates in the medium run. These reasons make monetary policy virtually useless in stimulating the economy. But the authors are well aware of the problems discretionary fiscal policies can create and they provide a detailed analysis of the significant lags traditionally shown: information, decision and implementation lags. These lags are obviously considered within the context of the current crisis, whilst the Recovery Plan is also assessed in terms of its coherence with the aims of the Lisbon Agenda. Finally, the authors stress the fact that the structure of national incentives for national governments (to minimize debt and maximize employment) is not in line with EU-wide needs, the ideal solution being a federal set-up for fiscal policy and deficits in the Union’s budget. But this is clearly not possible, hence the authors suggest multi-level coordination of economic policy actions: a strengthened role for the Eurogroup (also used more frequently at the head of state and government levels); a clear link between fiscal policy actions and the Commission’s annual monitoring of the Lisbon Agenda; some explicit form of centralization of fiscal policy at the EU level, namely the possibility to raise EU-level debt managed by the EU institutions.
This analysis is completed in Chapter 6, where Zuleeg and Martens highlight the political economy of discretionary fiscal policy, examining its interaction with fiscal consolidation and the long-term sustainability of public finances. The authors do not argue against the Recovery Plan and a proactive use of fiscal policy, as the current crisis is not a ‘normal’ cyclical downturn and government responses need to be adapted accordingly. But they do warn against the longer-term effects, and suggest a careful assessment of the principles that should underpin long-term fiscal policy in the EU. In particular, in order to examine the EU’s current and future position on fiscal policy, the authors contrast the EU position with that of the US (from bad to slightly better and from bad to worse, respectively). Building on the insights provided by this comparison, Zuleeg and Martens suggest some policy recommendations for the EU: the SGP should focus on longer term sustainability, and national fiscal sustainability programmes should be drawn up in order to assess whether any level of deficit or surplus in a member state is in line with the long-term trends and the current state of the economic cycle (with economic prospects preferably assessed by an independent expert body); fiscal policies should be considered one of the key components of structural reform; a European Futures Fund should be established to start accumulating assets in order to deal with future challenges (ageing population, pollution etc.).

The final chapter of the volume, written by Antonio Villafranca, deals with climate change and more particularly with the search for a revised multilevel governance in fighting climate change. This issue is particularly significant in the context of the current crisis for at least two reasons. On the one hand, the enormous problems created by the crisis must not hide the urgent need to fight global warming, partly as there are some important deadlines just round the corner (identification of the post-Kyoto targets, hopefully at the United Nations Framework Convention on Climate Change (UNFCCC) Copenhagen Conference in December 2009). With the aim of playing a leading role in fighting climate change and developing new ‘green technologies’, the European Union is the first region to have already identified binding targets for its members in the post-Kyoto period. Its aims and mechanisms (including the European Trading Scheme) can be an example for other areas around the world.

On the other hand, the search for a new global economic order urged by the crisis may be considered an unprecedented occasion to include the issue of a better-shared governance of climate change (involving the US and large emerging countries). This is perfectly in line with Jacques Mistral’s ‘global grand bargain’. In particular, this chapter places emphasis on the current ‘spontaneous’ governance by analysing all levels of intervention (global, regional, state and sub-state) with the aim of highlighting inconsistencies at any level. The author suggests ‘non-revolutionary’
changes which can potentially make fighting climate change more effective. The UN system should be reformed and developed countries should provide emerging countries with ‘all-inclusive packages’ (including financial aid, new trade agreements and qualified participation in international institutions). Regional actors (that is the EU) can be regarded as ‘transmission belts’ to help make global targets coherent with national constraints and have their members respect a solidarity principle, if requested. State and sub-state levels should strengthen their cooperation (possibly through an ‘internal pact’) to increase the magnitude of their intervention and its coherence with regional and international targets.

The following conclusion can be drawn from the seven chapters: we are still deep in the ‘age of turbulence’ and it is hard, if not impossible, to predict when this will be completely over. Therefore, this volume does not attempt to identify a possible deadline for the crisis, but it does shed light on its nature and on viable options for facing it. The reader is thus given a number of insights and policy recommendations which could improve European governance, not only in the context of the current economic crisis but also in view of the future recovery.

This volume has been realized within the framework of the EEGM (European Economic Governance Monitor), a network of leading European think-tanks: Istituto per gli Studi di Politica Internazionale (ISPI) in Milan, European Policy Centre (EPC) in Brussels, Institut Français des Relations Internationales (IFRI) in Paris, Stiftung und Wissenschaft Politik (SWP) in Berlin, and Chatham House in London. Chapter 3 has been provided by the Centre for European Policy Studies (CEPS) in Brussels.

The editors wish to wholeheartedly thank Compagnia di San Paolo for its support for this volume and other EEGM initiatives, through which it demonstrates its constant, special attention to the European Union and its integration process.

Special thanks are also extended to Mr Pöttering for his Foreword and to all the authors for their chapters. Their suggestions, constant help and enthusiasm have ultimately made this volume a reality.