1. Introduction and Outline

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The credit crunch and the ensuing financial and economic crisis of 2007-2009 did not only strike hard at the economy in the Western world itself, but also at its policy-makers, many of whom lost their bearings, at economics as a scientific discipline and, specifically, at the process of European integration itself. The latter aspect of the crisis was the theme of a conference held at the European Parliament on 2 June 2010 in Brussels, under the title 'The Economic Crisis and the Process of European Integration'. Obviously, the other aspects mentioned were never far away. The papers in this volume are a selection of the keynote addresses and of the contributions to this conference.

In Part I European governance issues are discussed. De Grauwe, in Chapter 2, argues convincingly that the present sovereign debt crisis in a number of Western economies finds its origin in unsustainable debt accumulation in the private sector and the operation of automatic stabilisers set in motion by the economic crisis. A tightening of the parameters of the Stability and Growth Pact of the European Monetary Union (EMU), regardless of the fact that this pact did not work well in the past, is therefore not the right answer. De Grauwe subsequently asks the question why there is presently such a high degree of macroeconomic divergence in the eurozone. After having dismissed a number of alternative explanations, like structural rigidities on labour markets, he concludes that 'idiosyncratic' (i.e. national) credit-fuelled 'animal spirits' must lie at the source of the crisis and the divergence across countries it created. The European Central Bank (ECB), being responsible not only for price stability but also for financial stability, is in his view the right instrument to deal with this. Its ability to apply differential minimum reserve requirements and to impose anti-cyclical capital ratios should be used to the full, and it should follow up its presidency of the recently created European Systemic Risk Board (ESRB) by action, and not only by issuing warnings.

Ioannou and Heipertz, in Chapter 3, write in the same vein. They forcefully advocate more political integration in the EU. Their thesis is that, more than being desirable as a matter of principle or from a normative, federalist
point of view, increased political integration, in the face of the economic crisis and the divergence it caused across EU member states, should be seen as a necessary pre-condition for improving socio-economic performance in the EU. They argue that a ‘quantum leap’ in the political governance of the EU is necessary to continue to be able to provide ‘SEES’ (‘stability, equity, efficiency and security’ (Padoa-Schioppa et al., 1987)), in a period when the crisis has incited nation states to retreat behind their own borders, possibly endangering the long-term survival of the eurozone itself.

While the sovereign debt lapse is indeed a consequence rather than a cause of the present difficulties in the EU and the EMU, it became at the same time of course also a problem in itself. In Chapter 4, Lejour, Lukkezen and Veenendaal therefore examine in a technical way the sustainability of government debt in Europe. They carefully provide results for a number of alternative but related key indicators of debt sustainability under a few scenarios. The ‘usual suspects’ surely come out, but there are also some surprises. When the extra costs related to an ageing population are taken into account, Germany, France, the Netherlands, Spain, Italy and Portugal have to make larger efforts than the present ones to maintain sustainability of debt. Surely, in Greece and Ireland these efforts should be even more considerable.

In Chapter 5, Coniglio and Prota look into intra-country regional convergence/divergence and the role of economic and financial crises herein. They note that current growth theory does not yield consistent answers, and they therefore come up with a challenging hypothesis that would explain the observed ‘accordion effect’, i.e. the succession over time of increases and decreases of the movement towards convergence in many EU member states. The clue would be that less developed regions are hit by the negative shocks more severely than rich regions because existing firms localised in central regions are on average more modern and technologically more advanced, and thus better able to adjust their production to the shocks. Moreover, in the lagging areas spells of unemployment in the workforce induced by adverse shocks will with a higher probability lead to a permanent loss of skills and to a faster obsolescence of the stock of equipment and infrastructure (hysteresis).

In Chapter 6, Sarisoy Guerin deals with a more specific question of European governance. She examines empirically whether Bilateral Investment Treaties (BITs) have the desired positive effect on FDI inflows and outflows. She also addresses the question whether the transfer of competences from the member states to the EU for the conclusion of new BITs and the ‘grandfath-erising’ of existing BITs by the EU is expected to be beneficial.

Part II of the book is devoted to the effect of the crisis on global economic imbalances. Bagliano and Morana, in Chapter 7, ask the question whether economic and financial crises in the US have had an influence upon eco-
onomic convergence in the euro area. They use a factor vector autoregressive (F-VAR) econometric methodology. They convincingly show that the interaction between US and Euro Area (EA) real and financial markets are complex and involve not only first, but also second and third moments. One of their results is that there is no evidence for a linkage between the state of the US business cycle and inflation dynamics in Europe. This result is, however, less striking than it may seem, in the light of Leijonhufvud’s argument that (in spite of the new-classical and new-Keynesian inflation-targeting rhetoric of the Fed and also of the ECB) the inflation rate in both regions, in reality, is determined by not much more than massive and cheap but highly price-elastic imports from China (Leijonhufvud, 2008).

Lee, in Chapter 8, also uses a VAR econometric methodology, the S-VAR (structural vector autoregression) method popularised by Blanchard and Quah (1989), but in a context in which he examines whether a US dollar peg or, alternatively, a euro peg system for the Chinese yuan would be warranted in the light of sufficient symmetry between these entities of aggregate demand and supply shocks. His conclusions are mixed. His relatively positive evaluation of the euro peg alternative is not derived from any observed tendency to greater symmetry between macroeconomic shocks in Europe and China, but rather from the longer-term convergence one might expect on the basis of the endogeneity argument of Frankel and Rose (1998).

In Chapter 9, Berger and Nitsch examine the source of the observed increase in trade imbalances between countries (EU, EMU and non-EU), and more in particular the role of inflexibilities, both on labour, exchange and goods markets. Their empirical econometric approach is a neat and transparent one. Their conclusion is, not surprisingly, that all three of these inflexibility types matter to explain the persistence and sometimes increasing degree of trade imbalance, but that this should not lead us to doubt the efficiency of a monetary union if at the same time one tries to introduce more flexibility on national labour and goods markets.

Qian, in Chapter 10, goes in great detail into the issue of the supposed excess liquidity in China and its possible relation to financial risk. He questions the results obtained by Zhang and Pang (2008) and Zhang (2009). With the help of a careful econometric study he finds that excess liquidity has not significantly affected China’s CPI inflation rate. Rather, a large amount of the over-supply of money has entered the real estate market through direct FDI and other channels. That in itself is, however, sufficient to conclude that the risk of a Chinese real estate bubble is not to be taken lightly.

In Part III of the book we have collected papers that deal with the euro perspectives and financial perspectives in Central and East European countries (CEEC) after the crisis. In Chapter 11, Lewis, in a sweeping empirical study of the main indicators, demonstrates that it is mainly the Maastricht
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deficit criterion that creates a problem. What seemed, before crisis, to be a
cyclical issue, now turns out to have a structural character. But also the prob­
lems with the exchange rate, inflation and interest rate criteria seem to be
challenging. Overall the euro prospect is receding in CEEC, at least in the
medium run.

Pirovano, Vanneste and Van Poeck, in Chapter 12, examine empirically
the patterns and determinants of the inflow of portfolio and short-term capital
in the new and potential EU countries. They differentiate explicitly between
'push' and 'pull' factors. New and potential member countries show a clearly
different pattern. All in all, they observe that the potential member countries
are on average less exposed to short-term capital inflows, while many of the
new member countries rely heavily on this form of financing. It also appeared
that portfolio and other investment flows (bank loans, trade credits, transac­
tions in currency and deposits and other short-term capital) are very different
in nature and can hardly be grouped under the same heading.

Chapter 13, by Horobet and Dumitrescu, focuses on the role of diversifi­
cation in investment behaviour in old and new EU member states and in a
few important non-EU countries. More in particular the authors consider the
possible, but theoretically ambiguous, benefits for eurozone investors of
holding internationally diversified portfolios, as compared to other investors.
It would seem that diversification benefits are still high for a eurozone inves­
tor and they have slightly increased after 2004. In times of financial crisis
international diversification may bring attractive benefits in the form of low
portfolio volatility, although these benefits are smaller than in normal times.

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