

**The 2007-2008 Financial Crisis:  
Does the EU Matter?**

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**Abstract:** Both realists and institutionalists agree that more empirical research is needed to determine the explanatory value of institutions. This paper looks at the EU's reaction to the 2007-2008 financial crisis for evidence that the EU mattered in shaping the behavior of its member states. Three responses at the EU level – attempts to reform EU banking supervision, the creation of European Economic Recovery Plan, and the push for the November 2008 G20 summit – are examined for evidence of the EU altering member states' calculations of interests, interests, power, and resources. It concludes that the EU mattered only when member states were not motivated by relative-gains concerns to restrain collective action.

**Keywords:** EU, financial crisis, institutions, interests, European stimulus

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## **The 2007-2008 Financial Crisis: Does the EU Matter?**

Greg Fuller

The global financial crisis has provided a unique opportunity to assess the impact of institutions on state behavior. In the debate over whether institutions affect behavior at all, realists and liberal institutionalists have come to one shared conclusion: more empirical study is called for (Mearsheimer 1994/95:26, Keohane & Martin 1995:46). The problem with carrying out such research, as Robert O. Keohane and Lisa L. Martin (1995:47) point out, is that “rarely, if ever, will institutions vary while the ‘rest of the world’ is held constant.” They suggest that one solution to this problem is to examine situations where the opposite is true – where circumstances shift rapidly but institutions remain relatively unchanged.

The worldwide financial meltdown has provided exactly that set of conditions. From the emergence of the tip of the financial iceberg in September 2007 to the radical acceleration of the crisis in September 2008 the European Union has been faced with a rapidly changing situation commonly characterized as the greatest challenge to world economic order since the Bretton Woods system was installed.<sup>1</sup>

The intent of this paper is to determine whether there is empirical support for the argument that the EU has mattered during the financial crisis. The first section will establish some definitions to be used throughout the analysis – particularly what it means to “matter.” The following sections will examine three EU responses to the crisis for evidence of the EU mattering. The first two responses, cross-border financial oversight reform and the development of the European Economic Recovery Plan, reveal the EU as

having only a minimal impact on policy outputs. In the third response, the successful push for the November 2008 G20 summit in Washington, the EU mattered a great deal. The final section considers the role of relative and absolute gains in explaining why the EU matters in some situations and not others and attaches some caveats to an analysis focused solely on observable outcomes.

### **What It Means to “Matter”**

First, it is necessary to establish some semantic ground-rules. I will treat the terms “institution” and “regime” as synonymous (borrowing the reasoning from Mearsheimer 1994/95:8) and defined as “sets of implicit or explicit principles, norms, rules, and decision-making procedures around which actors’ expectations converge” (Krasner 1983a:2). I prefer to use “institutions” in deference to the linguistic objections Susan Strange raises concerning the word “regime” (Strange 1983: 344). Within this definition, I will employ “the EU” in a fairly broad sense, encompassing the principles, norms, rules, and decision-making procedures of the union as a whole and of its constituent parts, from the European Commission down to the Committee of European Banking Supervisors (CEBS). For example, this means that while the European Parliament is governed by one set of decision-making procedures, the European Commission by a second, and the relationship between the Parliament and the Commission by a third, the “EU” label is meant to catch all three. With that said, this paper is primarily concerned with the European Commission, the European Parliament, and the Council of the European Union.

Although defining what it means to “matter” may be more nuanced, there is some agreement between the realist and institutionalist camps. Mearsheimer (1994/95:24)

argues that “what is needed is evidence of cooperation that would not have occurred in the absence of institutions.” Similarly, Keohane and Martin (1995:46-47) set the bar at demonstrating “that institutions are sometimes significant for political outcomes.” Both formulations agree that, in order to matter, an institution must act as an independent variable in determining states’ behavior.

Stephen D. Krasner (1983b) provides an explanation for how this can happen through his notion of “feedback.” He outlines four mechanisms by which institutions can alter member states’ behavior through influencing the basic causal variables behind that behavior. Those mechanisms are defined as institutions changing member states’ (1) calculations of interests, (2) interests, (3) power, and (4) resources and capabilities. The remaining sections of this paper will examine the EU’s responses to the global financial crisis for evidence of Krasner’s four mechanisms in use. Where such evidence is found, it indicates that the EU has independently affected member states’ actions and therefore matters. Where such evidence is not found and the EU’s activities are seen to be solely dependent on national interests such as relative-gains calculations, the natural conclusion is that the EU has not mattered (Mearsheimer 1994/95).

It is worth noting that the body of this paper is focused on searching for *outcomes* not *processes* that show evidence of the EU’s explanatory effects on member state behavior. A compelling argument can be made that, for instance, an “automatic reflex of coordination” (Nuttall 1992 cited in Tonra 2003) – an instinctive desire on the part of member states to seek consensus – demonstrates that the EU is affecting national interest calculations and behavior. The process side of the argument is important but difficult to quantify and will therefore be left to the conclusion.

## **I. Financial Oversight Reform**

The response to calls for enhanced supervision of multinational European banks is perhaps best described as schizophrenic. In the year between the onset of the financial crisis in Europe and the decision by the Commission to postpone handling reform for several months, significant conflicts arose between those who wanted the EU to wrest control of cross-border financial supervision away from member states and those who aimed to keep that power in national hands.

Nicolas Véron, authoring a policy brief for European think tank Bruegel in August of 2007, forecast that if a large-scale banking crisis struck Europe, the authorities would be caught unprepared. Under the so-called Lamfalussy process for dealing with financial legislation, Level 3 Committees such as CEBS hold responsibility for coordinating financial regulations across borders. However, despite the proliferation of large banks operating in countries across the EU, these committees serve in an advisory capacity and do not have the mandate to force national agencies to take action (Véron 2007). Véron warned that because real supervisory power over banks remained at the national level, member states would protect their own citizens at the expense of their neighbors if a pan-European bank's solvency was threatened in a crisis (Véron 2007:5). To mitigate this risk, he called for regulation of pan-European banks to be carried out at the EU level with the aim of minimizing the collective European cost of a crisis (Véron 2007:1). As this would weaken a nation's ability to regulate its own industries, pursuing such a recommendation would represent the EU reducing member states' resources and capabilities – the fourth of Krasner's mechanisms of feedback. Additionally, if states

were willing to accept this loss of resources in the interest of the collective good, that would have constituted Krasner's first mechanism by demonstrating a fundamental change in interest calculations. As the ensuing year proved, this was not to be.

When Northern Rock applied to the Bank of England for emergency liquidity on 13 September 2007 it sparked a bank run and signaled that Europe was indeed going to suffer from the subprime crisis in the US.<sup>2</sup> The Ecofin Council was quick to announce a response, adopting a roadmap of measures to enhance "cooperation and preparedness" at the EU and national levels (Ecofin 2007a:2). This commitment proved more rhetorical than substantive (Lannoo 2008:13). Many, such as Italian Finance Minister Tommaso Padoa-Schioppa called for a radical overhaul of the EU's financial supervisory institutions, pushing for Level 3 Committees to become agencies with the power to make binding decisions. However, in December 2007, the Ecofin Council rejected the notion of a supranational financial market supervisor under pressure from the UK and Germany (Lannoo 2008).<sup>3</sup> Instead, it decided to "strengthen" the Level 3 Committees without "unbalancing the current institutional structure" or "changing their legally non-binding nature" (Ecofin 2007b:17).

The Ecofin Council in May did assign additional tasks to the Level 3 Committees but handed responsibility for cross-border banking supervision to colleges of supervisors drawn from willing supervisory authorities, central banks, and finance ministries (Lannoo 2008: 14). This arrangement was widely criticized as being weak and convoluted, particularly by the European Parliament, which took the lead in pressing for more powerful EU-level oversight (Parliament 2008). On 9 October 2008, the Parliament voted 565 – 74 (with 18 abstentions) to adopt a report calling for the Level 3 Committees to be

given a legal mandate to “break deadlocks and solve conflicts” and for the colleges of supervisors to have streamlined decision-making procedures including qualified majority voting (QMV). The report also stipulated that participation in the colleges of supervisors should be mandatory (Parliament 2008).<sup>4</sup>

Following the Parliament’s vote, the debate reached a stalemate and the Commission handed the issue off to a team of experts headed by former International Monetary Fund (IMF) President Jacques de Larosiere. That high level group is due to present its recommendations in the spring of 2009 (Barroso 2008).

The desire by some at the Commission and especially in the Parliament for supranational financial supervision was stymied by member state opposition in the Council – particularly from the UK and Germany.<sup>5</sup> The UK, which claims three of the most valuable ten pan-European banks (including the largest and second largest) would stand to lose a great deal from increased EU-level control (Véron 2007:3). The stumbling block to coordinated action thus becomes the UK’s relative-gains concerns (see Mearsheimer 1994/95). It is possible that the UK would realize an absolute gain by having better cross-border financial supervision and, therefore, a more financially secure EU. However, because it must give up more than other EU member states to implement such a system, it would *lose* relative to the rest of the EU. Mearsheimer’s point that this is a significant barrier to cooperation is confirmed to be the case. As long as the UK calculates their interests with more emphasis placed on its relative loss than on the whole EU’s absolute gain, it will resist calls for reform. The success of member state blocking efforts means that the EU has not mattered on this subject thus far. Furthermore, the fact that the Parliament has already raised objections to the composition of the high level

group, which includes the former managing director of Lehman Brothers, does not bode well for the supranational side.<sup>6</sup>

## **II. The European Economic Recovery Plan**

In November 2008, anticipating the Commission's forthcoming announcement of a European Recovery Plan, Bruegel produced another policy brief laying out a recommended course of action. It suggested a harmonized stimulus of 1% of GDP to be enacted through VAT cuts and a more coordinated system of economic governance, including a strengthened Excessive Deficit Procedure (EDP) within the Stability and Growth Pact (SGP) (Pisany-Ferry, Sapir, & von Weizsäcker 2008). If enacted, such a program may have constituted a realignment of interest calculations – Krasner's first mechanism – towards an EU rather than national center by putting the economic health of the bloc first. The plan proposed by the Commission on 26 November 2008 fell short of this target and has been watered down by the Council since. There was very little in the Recovery Plan to indicate that the EU mattered.

It is important to note that there was not much the EU could do in terms of direct fiscal action aside from accelerating structural funds payments and prompting further investment by the European Investment Bank (EIB). The EU does not possess the power to raise funds via taxation and the entire EU budget only amounts to around 1% of the EU's GDP (Commission 2008b). The EU's contribution to the crisis would necessarily be one of guiding and coordinating member state action.

Even the most basic aim of the announced plan – coordinating a stimulus of some amount – has not yet been achieved. A cut in the VAT proved to be controversial.

Although the UK did reduce VAT from 17.5% to 15% it did not harmonize the move with other EU countries and France and Germany both rejected VAT cuts outright.<sup>7</sup> The text of the Recovery Plan as released by the Commission eliminated any reference to VAT and simply called for fiscal stimulus of 1.2% of EU GDP to come from member states with an additional 0.3% of EU GDP to be provided at the EU level, coming to a total of €200 billion (Commission 2008a). Ministers then failed to agree on those percentages at the 2 December 2008 meeting of the Ecofin Council; France asserted that there was agreement on a total figure of 1.5% and Germany complained that other countries were “not registering” their 1.25% figure. The Council also opted to omit the €200 billion number altogether.<sup>8</sup>

Much of the problem lies with the accounting of various national stimulus plans. Germany says that its package is worth 1.25% of GDP but others claim that it is merely previously announced plans repackaged as something new and amounts to far less.<sup>9</sup> The Bruegel proposal attempted to circumvent this problem by having financial reforms – both the stimulus and the subsequent plans to restore fiscal stability – submitted to the Commission for an even-handed evaluation. This would be combined with an accelerated EDP to bring deficits back under the 3% of GDP threshold by 2010 rather than by 2012 (Pisany-Ferry, Sapir, & von Weizsäcker 2008). The combination of these two policies echoes the sort of centralized economic governance that France has sought in vain since the crisis began.<sup>10</sup>

However, nearly every effort to coordinate a fiscal response – first a European bank rescue fund, then calls for more EU-level economic governance, and finally an EU-directed stimulus – fell at the relative gains hurdle. For this, Germany bears the most

responsibility.<sup>11</sup> The Germans' lack of structural deficits allows the country more room than most EU governments have to spend on stimulating the economy (Pisany-Ferry, Sapir, & von Weizsäcker 2008). However, Germany has not been aggressive with its efforts and has been criticized for pursuing a passive “beggar-thy-neighbor” approach.<sup>12</sup> While there are absolute gains to be realized by Germany if the EU's economic health improves as a result of a robust stimulus package, Germany would be on the wrong side of the relative gains equation. Instead, by essentially free-riding on other nations' spending, Germany is choosing to maximize relative gains.<sup>13</sup> Through not allowing the EU's communal interests to alter their own, the Germans are showing that the EU has not yet mattered in the stimulus debate.

Bearing in mind the fast-changing nature of the crisis and the tremendous pressure on Germany to take a more active leadership role<sup>14</sup>, it is possible that this will change. If it does, it would have tremendous ramifications for the conclusions of this paper.

### **III. The G20 Summit**

Two features of the 15-16 November 2008 G20 summit are relevant to the question of whether the EU matters –the assertiveness that the EU demonstrated in securing the cooperation of the US and the extra representation that EU member states obtained.

The existence of the summit was a coup for the EU in general and Nicolas Sarkozy in particular. Sarkozy had advocated some kind of summit as far back as his 23 September 2008 speech to the UN General Assembly.<sup>15</sup> Support came quickly from European leaders, with UK Prime Minister Gordon Brown also calling for a “new

Bretton-Woods.”<sup>16</sup> It was clear from the outset that George W. Bush was lukewarm to the idea but Sarkozy was adamant, declaring: “Europe wants this summit before the end of this year. Europe wants it, Europe requests it, Europe will obtain it.”<sup>17</sup> By pressing Bush at an October 18 visit to Camp David by Sarkozy and Commission President José Manuel Barroso, Europe did obtain it (Goldgeier & Kupchan, 2008).<sup>18</sup> The EU’s success in forcing Bush to follow its lead pushed European leaders’ confidence to new heights with Brown proclaiming that he would “send a message to the world” and Sarkozy announcing that the dollar “can no longer claim to be the only currency in the world.”<sup>19</sup>

Would things have unfolded this way without the presence of the EU? Without Barroso and the added heft of the EU, would France alone (or France and the UK together) have been able to bring such pressure to bear on their more powerful ally? My answer to both questions is ‘no.’ The fact that Sarkozy and Barroso were able to leave Washington with a commitment to a summit that the US President didn’t really want demonstrates evidence of Krasner’s third feedback mechanism – that the EU has increased the power of its member states.

The Spanish and Dutch efforts to secure representation are also significant in examining the EU’s value as an independent variable. Despite their respective positions as the 8<sup>th</sup> and 16<sup>th</sup> largest economies in the world neither was allotted a seat at the summit (The World Bank 2008). The US refused to expand the guest list, turning down a direct Polish appeal as well; however, both Spain and the Netherlands were able to attend by working through the EU. France, as an invitee both in their own right and as holders of the EU presidency, had seats to spare, which it did.<sup>20</sup> In a symbolic show of solidarity, the French, Dutch, and Spanish representatives were all seated behind the flag of the

EU.<sup>21</sup> While one could argue that these arrangements were essentially bilateral deals struck between Spain, the Netherlands, and France, the fact remains that France would not have had extra seats to give up if not for the EU. Furthermore, the fact that France would choose to surrender any representation is difficult to explain from a strictly realist perspective (without being privy to any *quid pro quo* that may have gone on behind closed doors). A donation in exchange for nothing would indicate that shared EU membership, through Krasner's first mechanism, led the French to calculate their interests as encompassing their neighbors' interests. At the very least, the EU mattered by enhancing the diplomatic power of both Spain and the Netherlands.

Here, relative gains issues were less relevant than absolute gains. The EU and all members stood to profit in absolute terms by forcing the summit and gaining extra representation. On the other hand, the relative gains issues at stake were fairly limited – France did not lose much to its neighbors by surrendering its extra seats.

## **Conclusions**

In the one external issue examined above – the G20 summit – the absolute gains at stake outweighed the relative gains at stake. The opposite was found to be true in two internal issues – financial market supervision reform and the European Economic Recovery Plan. In these two cases, the relative loss to some members (chiefly the UK and Germany), led them to block action that may have improved the absolute position of the whole. The question of whether the EU matters is intimately linked to the notion of how much weight nations place on absolute versus relative gains. In terms of Krasner's mechanisms, the more emphasis nations place on absolute gains, the more member state

interest calculations (and perhaps even interests) have shifted towards the collective center.

The lesson from the three EU responses considered in this paper, however, is that member states still put more weight in relative-gains considerations. Has the EU mattered within the context of the financial crisis? Yes, but less than concerns over relative gains. Empirical evidence for the EU mattering in the form of a tangible outcome can only be found in the example of the G20 summit where relative-gains considerations were minimal.

Some might stop at this point because the empirical question of the EU's impact has been answered. However, as mentioned earlier, this overlooks the significant question of process. Although the EU does not yet have centralized banking supervision reform or a coordinated fiscal response to the crisis, it is clear that there are powerful forces inside and outside the EU still working to achieve those aims. The fact that the EU has not mattered *enough* to produce an output like Germany sacrificing fiscal responsibility for the good of Latvian manufacturers does not mean that the EU has not mattered *at all*. It should also not be assumed that this state of affairs is static. The fact that member states continue to invest significant time and effort in trying to come to a consensus testifies to the strength of the idea that the EU does and should matter. If, as some argue, these ideas matter (Parsons 2002), then the balance between the EU as a dependent variable and the EU as an independent variable may indeed shift towards the latter over time.

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