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THE GLOBAL FINANCIAL CRISIS AND ITS MACROECONOMIC IMPACT ON THE EUROPEAN UNION²

The financial crisis started in the United States spread over to Europe and, for the first time after 1945, it developed to an overall macroeconomic crisis in the entire developed world. Social and ideological consequences of the deep recession are expected to follow. The article focuses on the impacts of the crisis on the European Union, with special regard to the economic policy answers on nation-state and community levels. It is stressed that the unprecedented challenges represent both a high risk of stopping or fragmenting the integration process and, at the same time, a unique chance to deepen and upgrade the European integration, as a key player of the changing global economic (as well as political and institutional) system. The answers to be given in 2009 will fundamentally shape the future of Europe in general, and that of the European Union, in particular.

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The financial crisis that started to evolve in mid-2007 in the United States has already captured the world financial system in general, and the European Union, in particular. This crisis differs in several points from previous financial turbulences in various parts of the world we could witness in the last decades (mainly in Latin America, in the Far East and in Russia).

First, for the very first time the crisis definitely originates in the most developed country with the most sophisticated (deepest) financial structure of the world. Also its spread to other countries predominantly hit other developed economies, while developing countries generally characterized by a „shallower” financial system became, at least for the time being, less affected by the contagion (excepting stock exchange development that shows very similar features all over the world). Second, the crisis is not a special currency crisis, many times experienced in several, generally less developed countries in the past. In contrast, after a sharp decline, the US dollar representing the US economy and financial systems in serious trouble, started to appreciate against all currencies, particularly against the Euro (with an apparently stronger and healthier economic background). Third, and most importantly, the current crisis is literally a global one, reflecting the outstanding

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global character of international financial transactions.³ In consequence, any turmoil appearing in one country's financial community is likely to spread immediately to other countries. For trust and confidence are basic elements of the financial sector, the loss of these features in one country's financial system rapidly generates the same impact in other countries, irrespective of the „health” of the financial system there. The fact that banks and financial institutions are globally intertwined only underlines the speed of declining confidence not only in the US financial community but from Europe to East Asia, across all major financial centres as well. Either in institutional or in psychological terms, confidence and trust are indivisible in the current global framework.

This paper is structured in four parts. The first section deals with the origins of and lessons from the financial crisis in the United States. The second addresses its spread to Europe and the emergency actions taken both in the US and in the EU. The third section provides an overview over the macroeconomic impacts on the European integration, with likely consequences in the coming period. It concentrates on issues and policy areas that are expected to seriously challenge the current structure of the „European construction”. In addition, some remarks on the new member countries, with special reference to Hungary, will be added. The final section concludes and puts forward some basic questions for the future global economic order.

1. Origins of and lessons from the financial crisis of the USA

The crisis of the financial sector of the USA reveals three features that became manifest within a very short time. First, an asset crisis emerged, once it turned out that the lion's share of the assets of the financial sector do not represent „real assets”. Shortly after the „bubble” became evident, banks started to stop crediting each other. As a result, a supply-side or liquidity crisis developed. Finally, a general institutional and confidence crisis appeared.

The pre-crisis situation was characterized by liquidity abundance and very low interest rates, as a result of a deliberate policy of the Federal Reserve (FED) to revigorate growth in the American economy. Very low interest rates both enabled

³ In the last decades of rapid globalization, all major production factors became part of this process. However, the speed and scope of „getting global” remained rather different. Trade in commodities could be substantially liberalized (in several groups of countries, and in many bilateral relations, free trade became the standard, with its most developed form in the European Union). Also trade in services experienced substantial liberalization, even if some obstacles have still remained (both between developed and developing countries as illustrated by the failure of the Doha Round of trade negotiations, and even within the EU committed to the full implementation of the „four freedoms”). Also technology flows became global, with a rapidly declining part of „non-transferable technology”, due partly to comparative advantages and market domination by mainly large international firms, and partly as a result of international and bilateral agreements on restricting the free transfer of military technology. Much less progress was made in the free flow of labour across national boundaries, both due to factors on the side of the potential labour-exporting countries and to serious administrative restrictions applied by potential host countries. In contrast, capital flows became fully liberalized, without practically any restriction.

banks to lend money at favourable conditions, while abundant liquidity encouraged them to provide large sums of credits. On the other side, and not surprisingly, there was a huge demand for „cheap” money in the US society, since the savings rate, as expressed in GDP, was very low, but steadily increasing stock market indices (where most Americans used to deposit their savings) appeared to provide sufficient guarantee for the repayment of „cheap” credits.

However, the problem is rooted much deeper. It started with the dramatic decoupling between the amount of value produced by the „real economy” and the amount of money traded in the global financial system. Up to a certain degree such a „gap” is even desirable in order to smoothly finance international transactions. But the financial market started to become fully independent of real processes, so that much more money was created than the creditworthy demand would have been able to absorb it. In addition, banks developed a large number of new „financial products” without any clear origin of the money, let alone the amount of bank deposits that could have guaranteed the solvency of the bank in case of non-repayment of the credits. As a result, „bundled credits” became to a large part „toxic assets”. The lack of international regulation encouraged the financial institutions even more to lend rapidly expanding liquidity to clients. In order to get rid of „surplus liquidity” (a large part of which was just „bubble”), not only low-interest credits were massively given. This could still have been understood looking at the very low interest rates established by the FED. What is less clear, is why credits were provided without any documentation (income of the credit taker, collaterals, etc.). Moreover, credits for construction (housing) were available covering the total costs, without requesting any co-financing of the credit taker.⁴

The behaviour on both sides (banks and credit-takers) was dominated by a short-term and short-sighted approach. Banks were confident that the liquidity would remain abundant and they would be able to finance credit-giving activities from the market over a long period, as it happened to work over more than a decade. Their privileged position was further strengthened by the continuous AAA assessment by all-mighty rating agencies. On the other side, credit-takers (consumers) started from two assumptions. First, that interest rates will remain low in the future, and second, that housing prices will keep on rising by 10 to 20 per cent a year, as it could be experienced in the last years. In this case, investment in housing at very low interest rate offers a huge gain when the house will be sold in the future. Thus, demand for money to finance construction was much higher than real physical demand for a new (or a first) house. The housing market became the field of huge speculative investments that made itself largely independent of „real demand”. Constantly increasing stock market prices added to this illusion. All in all, a „psychological bubble” developed and gave birth to an immense and unlimited process of „social infection”.

⁴ Even more, several banks lent money at 120% of the housing costs, so that hundred thousands of citizens and families were able to finance extra holidays or durable consumer goods purchases from the credit taken.

To some extent, also the FED participated in the „bubble game”. Although several experts have been warning financial institutions, investors and consumers that the „heavenly” situation will not be continue for ever, and huge „bubbles” were already in the system that could explode any time, US macroeconomic indicators did not point to such a danger. Liquidity abundance should have resulted much earlier in accelerating inflation, a clear sign of overheating. However, inflation remained low, due to the rapidly increase of US imports from „cheap” countries, mainly China, but also other emerging economies (India, other Far Eastern countries, Latin America). As a result, cheap imports occupied larger and larger portion of the consumer basket and successfully compensated for higher prices of other commodities and services in the same basket.⁵ Moreover, two basic items that could have call attention to relevant inflationary pressure are not included into the calculation of the consumer price index in the USA. Neither the rapid increase of housing prices nor the similarly important rise of shares on the stock market are represented in the consumer inflation index (the housing market is considered but not the price of selling the house but the price of renting, revealing the latter a much slower increase than the former).

The first signs of the looming financial crisis became obvious already in 2007. However, the difficult situation (including insolvency) of one (or some) US banks and financial institutions was considered as a special case, without affecting the whole system and to be managed in the form of „individual treatment”. Unfortunately, these „special cases” could not be separated from the entire system. First, the American (and the global) financial system is fundamentally interdependent that acts against „separate treatments”. Second, as already mentioned, trust and confidence are also global features that cannot be divided between „good” and „bad” banks. Thirdly, and most importantly, rather soon it became clear that it is not going about „special cases”, but just about the top of a huge iceberg that includes the whole global financial system.⁶ In consequence, an unprecedented reaction (both in size and speed) occurred. Banks stopped financing each other and paralyzed inter-bank lending made a large number of banks suddenly bankrupt. Not less dramatic was the impact on credit-takers. As they were unable to pay the monthly instalment of the credit taken (partly due to higher interest rates, partly to the plummeting of stock market prices, and, as an antecedent of a deep crisis, as a result of losing their jobs), banks started to take houses back. However, the massive insolvency of house-keepers led to a collapse of the housing market, and prices were rapidly falling. As a result, the banks only could get back the assets incorporated in houses at a very low price. Moreover, these houses represent today a frozen asset, as they cannot be resold on the market.

⁵ One of the main consequences can be identified in the rapidly deteriorating trade and current account balance of the US, with huge deficits that had to be financed by emitting US bonds that were mainly bought by Japan for a longer time, and by China more recently. On the positive side of the coin, US imports substantially contributed to higher global growth rates. A deeper analysis of these interdependent aspects, however, falls outside the topic of the current paper.

⁶ Practically overnight it turned out that several US banks and financial institutions followed a bookkeeping correctly characterized by the statement of “nothing right to the left, nothing left to the right”.

The process is by far not finished, but some lessons can already be drawn. First: interest rates should not be kept for a long time at a very low level. Second: irresponsible crediting has to be stopped. Third: strict and transparent regulation has to be introduced without jeopardizing the global activities of financial institutions. In this context, both national regulation has to be improved and global rules have to be implemented, including a qualitative upgrading of cooperation among national financial supervisory authorities. Fourth: the re-rating of „omnipotent” international rating agencies cannot be avoided any more.⁷

2. The European Union and the financial crisis: from illusion to emergency policy steps

At the beginning, the European Union reacted with easiness to the unfolding American banking crisis. It was stressed that the crisis is due to the US subprime credits and the special features of the housing market (mortgage), as well as the consequence of low (or even negative) savings of the population with overwhelming reliance on the stock markets. Moreover, potential consequences for the European banking system were ruled out by emphasizing that the EU, very much in contrast to the US, did not accumulate huge current account deficits and enjoys good financial shape and strong macroeconomic growth potential able to keep adequate growth despite the declining US economy. In addition, it was pointed out that Europe’s banks were prudent and had solid financial background. The simultaneously exploding Iceland bank affair was considered as a special case that nothing has to do with the European financial system.⁸ Some weeks later, when the US crisis reached the banking system of the United Kingdom, the self-complacent „splendid isolation” of the continent was even fostered by underlining that British banks are part of the Anglo-Saxon system that is fundamentally different from the structure of continental financial institutions. However, the contagion was already on its way to the Eurozone, not least to its most powerful economy, the German one.

The self-satisfaction of European banks and bankers was based on three erroneous assumptions. First, it was believed that it would be possible to separate „good” and „bad” banks in the period of globalization. European banks became global players in the last two decades, within a closely-knitted network dominated by American,

⁷ In fact, rating agencies, with their highly irresponsible attitude, have substantially contributed to the creation of the „global financial bubble”. The highest-level personal interlocking between rating agencies and financial institutions can also be blamed for the current situation. Interestingly, most analyses of the crisis still do not mention the very negative role of these agencies. (It is another topic, to what extent such „independent” agencies with their biased or fundamentally mistaken „ratings”, have contributed to serious economic problems of individual countries.)

⁸ In order to exploiting unique opportunities of globalization (and ignoring risks), three Icelandic banks started global operations with a total lending of 800 times the GDP of the country at the moment of collapse. Obviously, Iceland is not an EU member, even less belongs it to the Eurozone, but it should not be ignored that these activities were managed from Luxembourg, a central financial place of Europe. Also, interdependences due to the global character of financial markets, including links to the European financial community, should not be ignored.

European, Asian and Arab banks. American banks have been present in the European system at least from the end of World War Two, while European banks started to enhance their operations in the lucrative American market in the last decades. The European banking and financial system became absolutely global and, as such, the flagship of a supranational economic structure, probably one of the deepest chains of economic integration of Europe. Due to the global character of financial cooperation, different layers of intra-European and EU-USA linkages could not be either identified or (could have been) separated from each other. Second, once again the indivisibility of trust and confidence has to be underlined. Even without close American ties of the European banking system, the „psychological contagion” would have necessarily reached Europe. Third, and at a surprise of experts, it became clear that „toxic assets” are not a unique characteristic of the American banking system but can be abundantly found also in the European banking practice.

Thus, the moment of truth arrived in Europe. After some complaints and accusations (mainly by the German chancellor) addressed to the US, as the country that has to take full responsibility for the crisis, emergency measures had to be taken. Similar to the bailing-out of American (and British) banks by the governments (practically re-nationalization of leading banks by pioneering countries of private ownership and „free markets”), also continental European countries had to put together big packages and implement them urgently. Until October 2008, officially announced bailing-out actions amounted to USD 3,000 bn, or 20% more than the German GDP.⁹ In the last weeks, the above sum substantially increased, since it became – finally – evident that it is not only the banks that have to be supported but also key sectors of the economy that started to suffer the chilly winds of serious economic decline (car industry, construction, small- and medium-sized companies).¹⁰

National bail-out attempts were accompanied by international efforts that, at least in the first and very critical period, remained inefficient. In order to revive inter-bank lending, huge amounts of money were pumped into the banking system. However, they landed in the safes of the banks as some kind of „last resort” but could not restore financial confidence. As another step, internationally coordinated reduction of interest rates was announced (excepting the already very low interest rate in Japan, but, for the first time, in cooperation with China that possesses the largest reserves in the world). In fact, international actions were taken in order to get or keep under control the global financial markets, but they did not provide meaningful support. Looking back to the last months, one can only guess whether these actions were too modest as compared to the size of the problem or they were taken too late when the crisis reached another (higher) level.

⁹ The US, after some Congressional opposition, started to implement a USD 700 bn project, while the United Kingdom made available Euro 384 bn, Germany Euro 480 bn, France Euro 460 bn. Also almost all smaller states of the EU had to take recourse to similar steps, from Belgium and the Netherlands over Austria to Switzerland with a financial system that historically had been considered as the strongest and the most prudent, therefore the least vulnerable.

¹⁰ The US prepared a second project amounting to USD 800 bn, while, after some hesitation, also the European Union announced a Euro 200 bn plan of reviving the economy.

More success can be registered with national efforts, a clear contradiction to the global character of the financial crisis. Still, it seems more likely that, as a first step, confidence in the financial system can be attempted to be restored with more promise of success by national actions than by internationally coordinated projects (bottom-up approach). National bailing-out packages consist of three key elements. First, and with utmost urgency, banks in crisis have to be recapitalized with direct government intervention and affecting the national budget. Second, the government assumes full responsibility for managing the „toxic assets” by taking them out of the portfolio of the banks. Third, several countries announced a full-scale guarantee for private savings in (national) banks in order to prevent an atmosphere of panic and to appease citizens not to „storm” banks and take out their savings.¹¹

It has to be underlined that the money financing bail-out actions is not necessarily fully lost or „disappeared”. Obviously, the recapitalization of banks requires real money and its financial consequences will become fully visible in the budget of the given country. However, the loss of taking out „toxic assets” of the bank portfolios cannot yet be determined. The loss will be the difference between the price of bailing-out such assets and the price at which they can be resold on the market after a certain time. Most probably not all toxic assets are dead, however the rate of their depreciation may vary from country to country and even across time. Finally, the guaranteeing of private deposits can be considered more as a psychological appeasement than „real money” behind this element of the package.

Beyond the financial costs, the massive bailing-out initiatives have already had two crucial consequences, one global, and one European. In the global context, the philosophy and practical sustainability of the „neoliberal free market economy” became seriously questioned. Even more, it was discredited once pioneers of this philosophy and practice, as the United States and, shortly after the United Kingdom, decided that direct state interventionism cannot be avoided in order to save key banks of the system. Another implication, without any clear consequences for the time being, affects the European integration. Due to the urgency of the situation but also as a result of lacking community-level mechanisms, banks have been bailed out by interventions of the respective nation-states. Over decades, internationally active European banks were rightly considered as a key pillar of community-level or supranational development processes of the European integration. National governments could not influence the decision-making process of these banks. Now, with renationalization occurred, banks became subject to the economic and financial (or even social) priorities of the given national government. In other words, the national bureaucracy that lost control over the management of internationalized banks in the last two decades, could take revenge on the internationalized (globalized or even „Europenized”) financial community. The consequences may be

¹¹ If such a situation happened, it would immediately turn out that the full guarantee of private deposits is another „bubble”, since no bank and no country would be able to fulfill this promise. Private deposits in Western European banks amount to 5 to 6 times the aggregate GDP of the countries that made such a promise. This, certainly, would be the end of „modern economy”.

far reaching, both within the evolving new power structure of the member states and, not less importantly, concerning the future of European integration.

However, the most relevant challenges originate in a different constellation. The financial crisis can just be considered as the first level of a global crisis. The evolving macroeconomic crisis represents the second level. Two other levels are likely to follow: a social crisis and a mentality and behaviour-related crisis with unknown (but frightening) consequences. In the first year of the financial crisis, practically no view was expressed on its connection with the future of macroeconomic development. Many experts considered it as a „pure” financial issue that would remain within the boundaries of the financial institutions. Only in the last months, policy-makers started to address the very serious macroeconomic implications. We are now at the threshold of a recession that would most hardly hit the developed countries in general, and the European Union, in particular. But this is not the end of the story. With deepening economic crisis, higher level of unemployment, growing uncertainty of entrepreneurship, widening budget deficit it is likely that social problems will be exacerbated. Finally, declining growth and living standard, hardship, social inequality, large-scale uncertainty about the future are a hotbed of demagoguery, populism, nationalism and extremism. Each country, rich or poor, tends to produce populist and extremist politicians who promise big improvements without hard work, „light dreams” or omnipotent patterns of breaking out of the current negative growth spiral. These tendencies have to be strangulated and, as far as possible, eliminated already now, at the beginning of economic recession. Therefore, immediate crisis management and short-term anticyclical economic policies have to embrace social aspects and „ideological” considerations from the very beginning. If we fail to address the latter aspects, they will start their autonomous life and could not be reversed later, not even when economic growth restarts and business outlooks will be improving.¹²

3. Macroeconomic challenges for the European Union: new chances of integration from the crisis?

In its history of more than a half of century, the qualitative development (deepening) of the European integration was usually linked to crisis situations that were able to drive or just forced the member countries to develop new community-level policies by giving up part of their „holy” national sovereignty. The very birth of the integration was due to three pressures, two of them external ones: the threat perceived from the existence and growing influence of the Soviet Union, both in military, ideological, political but also to some extent socio-economic terms, the benign (or sometimes not so benign) pressure of the United States particularly in the first decade following World War Two, and the dramatic personal reminiscences of the war both on the side of the „winners” and of the „losers”. Today, none of them exists any more. Still, external pressure did not stop in most periods of the European integration. However, they were either too mild to break through the status quo

¹² It has to be reminded that economic and social „cycles” do not overlap. In historical experience, social hardship culminates when the economy is already on the path of recovery. An even larger „time gap” exists between economic and „ideological” development cycles.

mentality or the unquestionable achievements of the „autonomous” integration process did not require additional external impacts for „quantitative progress”. In the last years, particularly around and after the historical enlargement of the Union from 15 to 27 member countries, the necessity of fundamental deepening of the EU became increasingly pressing. In fact, a number of factors, including the shifting core of economic growth, globalization and competitiveness, international terrorism, the new economic and security-related geography of Europe, rapidly growing migration waves, serious questions about the future of secure energy supply, environmental concerns, the possibility of channelling positive impacts of enlargement into new community-level policies, etc. started to push member countries and politicians of the integration towards more common actions. However, until most recently, these efforts were not able to substantially restart the engine of deepening of the integration.

Now, the global financial crisis and the emerging deep economic recession with its social (and partly ideological) implications appears to be the most important challenge. The European answers to this challenge will fundamentally shape the future of the integration. Today, returning to (or, better to say, sinking back into) renationalization by fragmenting even the achieved level of integration has at least as much chance as the seizing of the unique opportunity to achieve a qualitative breakthrough and, as a consequence, prepare the EU as a successful global player for tasks, opportunities and challenges of the 21st century.

The immediate answer to the banking crisis was definitely national. One member country after the other took measures in order to save its major banks, even if the latter were already highly globalized and only by names they remembered their „national origin”. More surprisingly, national actions characterized member countries of the Eurozone, having the same common currency. In this context, the birth failure of the Economic and Monetary Union, namely the discrepancy between a common monetary (exchange rate) policy and an unchanged framework of national fiscal policies became evident.

The same discrepancy was aggravated by the first macroeconomic answers to the rapidly worsening growth prospects and the unfolding reality of negative growth in the coming period.¹³ Each country started to announce national plans how to minimize recessionary trends and counteract primarily negative impacts on the labour market. It turned out that the European integration did not dispose of a community-level economic policy in case of serious and across-member-country recession. This fact is best illustrated by the urgently outlined plan of mobilizing Euro 200 bn to reviving the EU economy by the European Commission. Obviously, the EU as integration does not have such an amount of money, for its always hotly debated common annual budget is about Euro 130 bn, or two-thirds of the sum

¹³ International organizations (IMF, World Bank, OECD) and Eurostat started to change their growth forecasts to the worse within some weeks. In the summer of 2008, a downturn, but still with positive growth rates for 2009 and 2010 were predicted. In early autumn the figures were modified to zero growth, and in October to minus. However, most likely this is not yet the final stage. Key EU economies may experience a deep and long recession with negative growth rates of more than 2% in 2009 (and with highly uncertain outlook for the next period).

represented by the „recovery package”. The latter was tried to be sold (and communicated) as a genuine EU project, however, not less than Euro 170 bn are the adding-up of national figures expected to be released from the respective national budgets and not from EU financial sources. Euro 15 bn only is planned to be made available from the reserves of the common budget (non-paid or returned sums coming back from national governments) and another Euro 15 bn in the framework of the European Investment Bank (mainly for financing of small and medium-sized companies in the conditions of global economic storm).

It is another question, to what extent the urgently designed member country rescue (or recovery) plans can be integrated on the EU level. As a secondary step, but a consequence of the lack of adequate crisis management instruments on the community level, Brussels now tries to streamline national efforts in order to identify common priorities that should be financed from the national packages. Some key areas include the development of physical infrastructure, environmental projects (in principle, both expected to absorb part of the rapidly growing mass of unemployed persons), support to small and medium-sized firms, upgrading of selected issues of the Lisbon Strategy. For several reasons, more problematic seems to be the direct support promised to the car manufacturers, a core sector already started to be hit by the recession. On the one hand, it is not easy to differentiate between activities oriented towards future-oriented investments (structural change) and those aimed at just keeping jobs without any innovation. On the other hand, even more problematic is the connection between national state aid and the basic rules of community-level competition policies. The Commission has already raised a number of concerns about the implementation of member country „recovery plans” that seem to violate basic principles of free competition within the internal market, a basic pillar of the functioning of European integration.

Not less clear is the scope of member-country-driven plans on the level of integration. Not all member countries contribute to such a financial package, for about one-third of the members indicate serious budget deficits that constraints their ability to outline and implement recovery plans that would further deteriorate their budgetary situation. If, however, they do not contribute to the „common” package, will they be entitled to participate in the programs to be financed from this source? In addition, will member countries that are inclined to mobilize substantial resources from their national savings (or assuming higher budget deficits) be ready to share part of this sum with other members, or such financial resources will strictly be used to „national recovery”? If the latter happens, Brussels has to be satisfied with a „book-keeping position”, without any real intervention into the distribution of available resources. According to the current rules of the integration, the Commission does not have any right to collect national contributions and (re)distribute them according to community-level priorities. As a result, the danger of renationalization of European integration, and, in consequence, the fragmentation of the not yet fully functioning internal market, can hardly be considered to be prevented at the current stage of developments.

Beyond the accelerating negative growth path, the immediate impact of macroeconomic recession will become manifest in the labour market.

Unemployment will be growing, despite the potential mitigating impact of „recovery plans”. The regulation of labour markets, however, belongs to the competence of member countries. Therefore, even if Brussels were authorized to conceive and implement community-level economic programs, it could not influence national labour market policies in a relevant way. What would be needed is not the creation of a common labour market (although one pillar of the four freedoms, namely the free flow of persons, points into this direction), but the substantial deregulation of national labour markets, as an open method of cooperation stipulated in the renewed edition of the Lisbon Strategy.

However, implications of the recession on the labour market do not end here. First, free circulation of labour between the EU-15 and the ten countries that joined in 2004 should be achieved in 2011, following a maximum seven-year transitional period (the same situation has to be reached by 2014 concerning Bulgaria and Romania that joined in 2007). It can already be predicted that the European labour market will be facing serious challenges just at this period (unemployment may reach its highest level just in 2011). Will, under such conditions, transitional measures be lifted by those countries that, until now, have resisted to open up their national labour markets? And how will those countries behave that liberalized intra-EU labour flows at times of positive growth but may enter an economic recession in the coming months? Second, increasing unemployment is likely to hit employees differently. Most vulnerable are those without strong political and social support, missing the counterbalancing power of trade unions and, in most cases, not having special skills. In this context, employees

in the construction industry, a major victim of recession, are in a particularly difficult situation. It is evident that workers that used to come to work in Western Europe from selected new member countries (mainly Poland, Bulgaria, Romania, but also Slovakia and the Baltics), will represent an above average share of newly unemployed people. Will they return to their home country, with contradictory impacts on the labour market (growing unemployment versus reducing the shortage of skilled workers, a growing problem in the last years in several „sending countries”)? Not less importantly, and irrespective of the fact whether they will stay abroad (hoping for new job opportunities quickly) or whether they opt for returning, as unemployed people, they will not be able to transfer part of their income to the home country. This may not only affect family members that used to rely on remittances but also the macroeconomic balance of some countries. In the last years, remittances started to become one or just the most important revenue item in the current account balance (together with the inflow of foreign direct investments) that provided a large support to finance huge trade deficits and prevent the national economy from rapidly increasing external indebtedness and, finally, from insolvency.

Another impact of the crisis and of the already publicized „recovery plans” can be identified in the future development of national budget balances. The maximum 3% budget deficit defined as one of the key Maastricht criteria of qualifying for membership in the Eurozone is based on the assumption that member countries accumulate budget surplus (or at least have a balanced budget) during high growth

periods. In this case, there is sufficient room for entering a budget deficit period during slow growth or even recession. However, if countries register budget deficit in „good” years, it is likely to be unable to keep the deficit within the Maastricht limit during recession. Excepting some Eurozone countries, budget deficits can be considered as the dominant feature already at the start of the recession. Moreover, the budget deficit criterion did not consider the size of the negative impact of global financial crisis and unprecedented European (and American) recession. Thus, most probably several Eurozone (and EU) member countries will exceed the 3 per cent limit in 2009 and 2010 (or even for a longer period). This would be the result of recession exclusively. The budgetary impact of the bailing out of banks and of the „recovery plans” has to be considered as an additional deficit factor. As a result, some countries may be faced with huge budgetary deficits. Of course, there is a well-known instrument to reduce this deficit by starting to restructure the expenditure side of the budget. In most countries, such an exercise has been overdue for several years but, for obvious political and social reasons, no government dared to touch upon this issue. At least in principle, the current crisis offers a unique opportunity to break this deadlock and launch a coordinated EU-level plan of restructuring key items of the social welfare system(s) in the highly developed member countries. Obviously, budget deficits would drive countries into this direction. However, the decision depends on several factors. On the one hand, the „recovery plans” should be oriented towards future-oriented goals and sustainable competitiveness instead of keeping as much as possible of the status quo (protecting uncompetitive jobs and companies). On the other hand, this new approach would require the support (or at least the lack of open opposition) of the society accommodated to high-level social welfare in the last decade(s). If the EU wants to remain competitive and keep member countries together in a sustainable and successful framework of integration, a fundamental restructuring of the budgetary expenditures cannot be avoided. Of course, such a decision can be still delayed, but the status-quo-preserving approach would substantially delay the start out of the recession, it would prolong the recovery path and, at the end of the day, would force the member countries to similar steps but probably in a more difficult situation and without the „persuading pressure” of the current crisis, as well as the „perception maturity” of the societies.

Not only excessive budget deficits but largely diverging national instruments of „economic recovery” (see the obvious differences between the French and the German approach), as well as similarly different outcomes of the crisis on national level could seriously affect the future of the common currency. It has to be underlined that, until now, the Euro proved to be a solid currency in the first wave of global financial storms. After a period of strong appreciation against the US dollar (well above 1.50) that already threatened the export competitiveness of several Euroland economies, the dollar regained strength and the Euro-USD exchange rate

stabilized at about 1.25-1.28.¹⁴ The next challenge, however, is expected to come from inside of the Eurozone. Not only different and until now largely uncoordinated national „recovery plans”, but also the coming export crunch will test the solidity of the monetary union. Exports, being one of or the main driving force of economic growth in the last decade(s) may seriously suffer from recession in the EU and the dramatic decline of global demand. Eurozone member countries may prove differently competitive in such an environment. In addition, differences in competitiveness had been accumulating over the last decade of the common currency, due to differences in real wage development and inflation rates across member countries. These differences will now become even sharper. Without a rebalancing (countervailing) mechanism that is still missing in the Eurozone (e.g. some kind of compensation to the members with loss of competitiveness but deprived of the instrument of „independent” exchange rate policies), such a critical situation could result in the breaking up of probably the most important achievement of European integration in the last decade.¹⁵ The establishment of an adequate mechanism would, however, need substantial financial resources to be channelled into the common budget and, not as the only but certainly a very powerful factor, it would give the necessary impetus to fundamental changes in the member countries’ approach to the common budget and to essentially redraw the structure of the budget (increasing the national contribution from the current 1 per cent of GNI to a much higher level and changing the priorities of budgetary expenditures).

In addition, a more justified assessment on the future of the monetary union can only be made after the current crisis will be over. The solid behaviour of the Euro until now is a promising sign, but the impact of the economic crisis and further turbulences in the international financial markets (mainly around the US dollar) can still substantially change the current evaluation. It has to be pointed out that despite the strong and solid position of the Euro, global confidence, as measured in the composition of international reserves, mainly remained with the US dollar.¹⁶

As most EU member countries have export-oriented economies, competition for external markets will be growing. The recession in (most) intra-EU markets will further strengthen the drive to extra-EU markets still with substantial growth

¹⁴ The strengthening of the US dollar, despite the US crisis and the huge current account balance of this country, let alone the emerging and similarly huge budget deficit as a result of the bailing-out actions, needs a more detailed analysis. At first glance, it contradicts the basic and negative developments of the US economy. However, international political and economic factors (not least the Chinese attitude to the US debt and banking crisis), as well as psychological elements, a relevant determinant of the development of exchange rates and financial markets, have been, at least until now, able to counterbalance the adverse trends of the real economy in the USA.

¹⁵ The United States, as a monetary union (plus, not less importantly, a political one) has such a mechanism of fiscal redistribution between more and less competitive States.

¹⁶ In the last decade, the share of Euro in international reserves increased from about 20 to 28%. At the same time, the share of the US dollar lost about 6 to 8 percentage points (from near 70 to the current 60% level). Still, the difference between both leading currencies remains obvious.

potential. To be sure, growth will be declining from the previous high levels everywhere (from the new member countries through Russia, Ukraine, the Western Balkans to China and other Asian economies). Still, in most such markets growth rate will remain in the positive field (declines from 6 to 3 and in the case of China, from 11.5 to 8.5% have been anticipated). These markets will be definitely upgraded in the member countries' search for new export opportunities, and the most successful countries may be able to mitigate domestic and intra-EU recession by rapidly growing exports to other markets. Even more, because the difference between intra-EU and extra-EU growth rates will only moderately change, if at all. For instance, the pre-crisis growth difference between the Eurozone average and China was about 10 percentage points (1.5 versus 11.5%). There will be no meaningful change in the crisis period, by comparing minus 1.5 to 2% growth in Europe with plus 8 to 8.5% growth in China.

Of course, one very dangerous development, namely the contagion of trade protectionism, as a result of economic recession and increasing social hardship and claim for protecting national markets and producers cannot be fully ruled out. This would generate additional problems and create a global negative spiral, even if the sustainability of the common trade policy of the EU were not seriously questioned.

More controversial seems to be the correlation between negative growth and continuous efforts to achieve the environmental (climate) goals of the EU set for 2020. At first sight, the priority of environmental goals clashes with the priority of growth. This conflict can be alleviated (even if not fully eliminated) in periods of relatively high growth and sustained global competitiveness (partly supported by rapidly increasing global demand). However, the conflict may be exacerbated in periods of negative growth (and constrained competitiveness). It would be good to believe that this „target conflict” can be solved and the EU (and the member countries) would not be forced to sacrifice, even temporarily, the priority of achieving the common environmental objectives, a key element of a sustainable world in the next decades and centuries. However, the policy and the main instruments leading to this goal in a critical period of serious recession are not yet clear.

Evidently, the current and deepening crisis will not leave unaffected companies, banks, the financial mechanism and credit activities as well as international capital flows, including direct investments. However, based on available statistics and experience, a more detailed analysis of these elements could not miss a large number of speculative considerations. Therefore, they will not be addressed. Similarly, the delayed potential inflationary impacts of the current crisis can only be identified in the next (may be, not too distant) period. However, at the moment the overwhelming fear in Europe is not inflation but recession accompanied by deflation.

Before finishing this chapter on some macroeconomic impacts of the financial crisis, two special remarks on the new member countries have to be made. One is related to their banking sector, the other to the export-oriented industries, both largely owned by foreign, and notably Western European banks and companies.

Transformation of the banking sector through massive participation of foreign banks is one of the most important changes in Central, Eastern and Southeastern Europe. Subsidiaries of foreign, mainly European banks became the dominant actor on the domestic financial market in the last decade. Most of them ranked among the most profitable subsidiaries worldwide. Their lending policy was less risky than in Western Europe, let alone in the United States, because credit-giving required collaterals and financing of apartment construction was accompanied by a substantial financial contribution of the credit-taker. At the same time, the share of consumer credits was rapidly rising, due to favourable conditions, abundant liquidity and the psychological (and partly economic) impact of catching-up of the citizens (sometimes beyond their own burden-taking capacity). With the financial crisis liquidity became short (or non-existent) and credits much less available.¹⁷ The crisis in the headquarters automatically spread to the subsidiaries, irrespective of the structure of their financial products and of their profitability. However, the rescue actions were limited to the headquarters. Money made available to this purpose was strictly linked to domestic banks, and some politicians emphasized that taxpayer's money is not allowed to be used to bail-out subsidiaries. This, according to this view, should be the task of the governments of countries in which the respective subsidiaries have been located. To put it more bluntly: high profits of the subsidiaries could contribute, even if indirectly, to the taxpayers' income in recent years, but it is forbidden to use German, Austrian or any other money to help out, in case of emergency, subsidiaries working abroad. Just the opposite, assets accumulated in profitable subsidiaries should be centralized and be used to improve the financial situation of the parent bank.¹⁸

At present, it is not yet clear how major transnational banks will behave. Their future competitiveness badly needs the profitable activities of their subsidiaries in the new EU member countries. However, the bailing-out of the parent banks that requires not only state support but also the centralization of assets available in their international banking network, may become a higher priority.

To some extent, a similar situation can be expected with the subsidiaries of transnational manufacturing companies, with special reference to the car industry. Declining demand and growing competition forces several companies to dismiss part of the employees and cut production volume. Several Western European car manufacturers have already applied for state subsidies, similar to the banking sector and against the basic competition laws of the European Union. In case they will get financial support, most probably it will be used for the survival of the parent company and for mitigating social problems arising from growing unemployment in the domestic economy. In this case, subsidiaries that in many cases are more

¹⁷ Some experts argue that national financial authorities should have tightened the credit-giving activity of banks much earlier in order to avoid overspending of the population. In fact, the net outstanding debt of Hungary increased by Euro 10 bn in a year (from June 2007 to June 2008), and the increment was exclusively due to enterprise and consumer credits (government and national bank indebtedness did not change at all).

¹⁸ This happened to several banks in Hungary and the sudden selling of Hungarian bonds in order to increase the liquidity of the parent companies was one of the reasons of the financial crisis in the first half of October 2008.

profitable in the new member countries than in the old ones may be burdened with the largest part of the crisis. However, the final result would be the consolidation of (partly) outdated production structures and low level of profitability in the country of the parent company. Thus, after the crisis, these companies will hardly remain competitive. A burden-sharing ignoring competitive advantages within the subsidiary network would backfire and undermine the global competitiveness of the given company. It is not yet clear to what extent this consideration will be taken into account when relevant decisions for the future viability of big companies have to be made.

4. Concluding remarks

The financial crisis started in the United States not only reached Europe but gave rise to the deepest macroeconomic crisis of the developed world after World War Two. We have just entered the downward spiral of economic recession, with largely unknown consequences for the future of the European integration and of the individual member countries.

At the same time, the crisis offers a unique chance for the renewal of European integration and its fundamental deepening. As a result of the crisis, community-level policies should be elaborated and implemented, with special regard to the fiscal side of the economic and monetary union (including the future size and structure of the common budget). Also the decades-long work on the creation of a genuine internal market could be finalized (mainly in the field of financial services and energy). Obviously, the more federal structure of the integration requires substantial institutional reforms (more than contained in the current version of the Lisbon Treaty recently rejected in Ireland). However, the future of the European integration basically depends on the political and economic measures to be taken in the member countries and in Brussels facing the evolving economic crisis as well as its social and ideological repercussions in the next years (from the common migration policy over energy issues to the common foreign and security policy). On this development path, a clear definition of European identity and of the EU's mission in the rapidly changing world of the 21st century cannot be avoided or postponed any more. One can only hope that Europe and its nation-states will be able to cope with unprecedented challenges and Nietzsche's assessment formulated more than a century ago will become obsolete: „The time was ripe for Europe but Europe was not ripe for the time”.

Finally, we should not forget that the current crisis raises some global questions far beyond European developments but requiring the active participation of the EU in the shaping of a post-crisis world.

First, the future of the international economic, and particularly, financial institutions is on the global agenda. Global capital flows need international regulation and supervision, without strangulating the free flow of capital, the most global factor of production. Beyond better regulation also shifts in economic and financial power have to be taken into account when international organizations will be restructured and transformed according to current and future requirements of the evolving new

global order. Most importantly, largest international reserve holders (and savers) have to get an adequate place in the voting mechanism of key financial organizations (mainly China but also the energy-exporting countries).¹⁹

Second, the future role of the State has to be reconsidered. In the current crisis, failures and deficiencies originated in the neoliberal economic practice, had to be remedied in an unprecedented emergency manner by nation-states. Also the deepening of the economic (and later social) crisis may increase the desire and reliance of key economic actors and politicians on the „helping hand of Father State”. Or, following the most important bailing-out activities, will nation-states willingly return to their previous non-interventionist role? Or will they be forced to do so by the more powerful global developments and actors?

Third, and finally, longer periods in economic history were usually characterized by a mainstream approach. Keynes and his economic theory dominated several decades of the 20th century. As a response, neoliberal ideology became the leading economic practice in the last decade. As Keynesianism several decades ago, now neoliberalism is believed to be out of service, as a consequence of the global crisis. But will the crisis produce any new mainstream economic philosophy (and practice), or will we be living for a longer time in a period characterized by a mixture of different and rapidly changing approaches without any clear direction? Can we afford such a future in the century of globalization without catastrophic economic, social and ideological repercussions? The global financial and economic crisis has invalidated some key factors of the neoliberal ideology because it was not able to create the key regulators in and for a globalizing economy. Since, however, globalization will remain with us in all areas of our life, the only acceptable answer is not anti-globalization but better regulation and adequate international institutions accompanied by global dialogue between politicians, economic leaders and societies.

¹⁹ It is more than paradoxical that China's voting share in the IMF is lower than that of the Benelux group.