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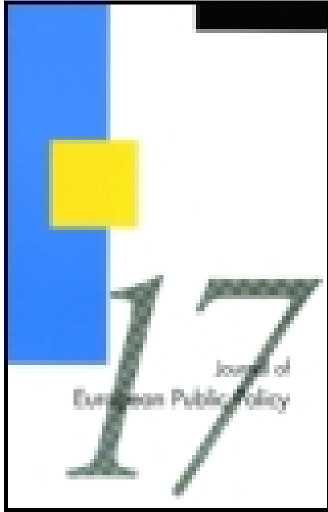

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Still a regulatory state? The European Union and the financial crisis

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Still a regulatory state? The European Union and the financial crisis

James A. Caporaso, Min-hyung Kim, Warren N. Durrett and Richard B. Wesley†

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ABSTRACT The European Union (EU) has been conceptualized as a regulatory state, i.e., an emerging polity that differs from the classic Westphalian state. Unable to engage in redistribution and stabilization, the EU has specialized in a range of regulatory functions related to market creation and management of externalities. We argue that the European financial crisis is pushing the EU to move beyond regulation. We explore the origins of and responses to the crisis, and examine the ways in which the crisis is creating pressures for stabilization and fiscal policy. Indeed, we argue that significant inroads into these areas have already been made and further changes in the direction of stabilization and fiscal policy are likely, though whether such competences are centralized or decentralized is an open question.

KEY WORDS European Union; financial crisis; macroeconomic imbalances; redistribution; regulatory state; stabilization

INTRODUCTION

We initiate our analysis of the financial crisis of the euro area with a model of the European Union (EU) as a regulatory state, using it to ask several questions: what can the financial crisis and the EU's response to it tell us about the limits of the EU as a regulatory state? And to what degree have the three classic governmental functions – regulation, stabilization and distribution – become co-implicated in the crisis and its potential resolution? In short, what are the possibilities that the financial crisis will expand the competences of the EU in the direction of stabilization and redistribution? Since the origins of the crisis have been extensively dealt with in the literature (e.g., De Grauwe 2013; Eichengreen 2012; Hall 2012; Marzinotto *et al.* 2010; Pisani-Ferry 2011), we deal with this subject briefly, moving quickly to focus on the EU's response and the implications for our understanding of the regulatory state.

Our article will be organized as follows. First, we provide a brief outline of the regulatory state as it has developed within the political economy literature. Second, we make the argument that regulation of structural imbalances – particularly trade and capital flows imbalances – were (and continue to be) an important source of disruption in the eurozone. While capital flows

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were important initiating the imbalances (Jones forthcoming; Wolff 2011), we focus on trade relations, since balance of trade problems are a central component of the crisis. Since the causes of these trade imbalances lie, at least partly, at the national level, we introduce data on domestic labor costs and real exchange rates to explain divergences in the current account. Third, we analyze the responses of the EU to these imbalances with an eye toward the shifts in the kinds of functions involved (regulatory, stabilization, fiscal). Fourth, we discuss the implications of the analysis for our understanding of the EU. Our central argument is that an adequate response by the EU requires more than regulatory overhaul, but also implies the development of a capacity for stabilization policy and redistribution. Building on the work of others (Genschel and Jachtenfuchs 2014), we argue that the EU's regulatory state has diversified its functions to include 'core state powers' (*ibid.*: 1) in the areas of stabilization and fiscal policy. We see our contribution as providing a detailed process tracing of the crisis, linking this account to the EU's responses and, finally, drawing out the implications of both crisis and response for the diversification of the EU's institutional capacity, which we think is decidedly 'beyond the regulatory state.' If our interpretation is correct, we should observe that a substantial part of the EU's response lies not only in the extension of regulation to previously uncovered areas, but also to different policy arenas; in short, into the arenas of stabilization and redistribution. In line with our goals, we emphasize these extensions in the fourth and final part of our article.

THE EUROPEAN UNION AS REGULATORY STATE

Modern political economy recognizes at least three forms of intervention in the economy: income redistribution; macro-economic stabilization; and regulation (Majone 1997: 140–1). The regulatory state is an institutional specialization in one of these functions (Caporaso 1996; Thatcher 2002).[1] The main specialization of regulatory policy centers on the control of market failures, including negative externalities, co-ordination failures and the undersupply of public goods (Majone 1997: 141). However, no real political entity can completely avoid some activity in all three areas. Our recognition of these three key functions is not meant to imply that they exist in sealed containers with no interactions or overlap among them. Indeed, we argue that the financial crisis has exerted pressures for the EU to move further beyond regulation.

While Majone's work is the starting point, others have advanced a line of research arguing that the regulatory state is changing in important ways (Genschel and Jachtenfuchs 2010, 2014; Hallerberg 2014; Mabbett and Schelkle 2014; Schelkle 2009, 2012, 2014). Genschel and Jachtenfuchs (2014) have argued that the competences of the EU are migrating from regulation of markets, to regulation of fiscal and stabilization policies, to fiscal policies via stealth. As a point of reference, they first outline what they call the 'standard view' of the EU as a multi-level regulatory polity. They move quickly to challenge this view, arguing that changes in the structure of the

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regulatory polity assume at least two forms. First, there is an extension of the EU's regulatory powers into the area of public finance.[2] EU institutions monitor not only markets for market-based externalities, but also budgets since these too can have external effects. As Hallerberg (2014: 88) points out, poor budgets in Greece and Ireland are likely to have negative effects on borrowing costs in other countries with sounder public finances. Second, they argue that there are changes in 'core state capacities' such as taxation and defense, whereby the EU assumes a greater role in the development of fiscal competence.

How is the financial crisis associated with changes in the regulatory state? We start with the notion that there are strong functional pressures to align the decentralized political structure of the EU with the region-wide market. Yet, there are formidable barriers to this alignment. The most important supply-side restriction lies in the political architecture of the EU itself, particularly in the unanimity constraint of the European Council, where the relevant institutional changes would have to take place. The EU is strongly state-centric insofar as the decision-making rules for redistribution are concerned, and a new rule to change these rules would also require a unanimous vote. Thus, 'unwillingness to pool fiscal resources for stabilization and social insurance' is a major reason the EU is confined to regulation (Schelkle 2014: 106).

Standing against these supply-side restrictions are powerful demand-side pressures. These come mostly in the form of dense interdependencies and the inevitable externalities and collective action failures that accompany them. These externalities take many forms. There are market-based externalities such as financial contagion, cross-country contamination of interest rates between government debt and banks, and capital flight from risky areas to 'safe havens'. There are also policy externalities such as occurred when Ireland guaranteed deposits for all customers or when Germany carried out domestic reforms to keep wages in line, thus creating competitiveness differences with its trade partners. Collective action failures may take the form of co-ordination failures, as when governments do not co-ordinate their monetary policies (some accommodate while others tighten). Taken together, these market and policy failures lead to outcomes less desirable than the member states could produce if they acted together, given the resource constraints under which they operate.

The combination of supply restrictions and demand pressures leads to outcomes that do not overtly create new fiscal capacity but do lead to changes in regulation as well as fiscal policy without visibly fiscal institutions. We advance this line of thought in our article by demonstrating how the financial crisis developed, the responses on the part of the EU to date, and the meaning of these responses for the development of the EU's regulatory polity and beyond. Our article builds on and extends the work of Genschel and Jachtenfuchs (2014) by providing a detailed analysis and process-tracing of the development of the crisis. In addition, our analysis emphasizes that the institutional and policy responses of the EU and member states are informed by a view of market imperfections as well as policy externalities.[3] That is to say, informed by the theory of market failures, markets themselves may create externalities, under-provision of public goods, and other

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'failures' such as monopolies and asymmetric information. We see these imperfections at work in capital markets (which did not accurately price risk – German loans to Denmark at the same rate as to Greece and Portugal) and in the markets for exchange of goods and services (trade).

DEVELOPMENT OF THE CRISIS

Despite differences across countries in terms of the origin and manifestation of the crisis, we present a stylized representation of the crisis dynamics. Our model starts with credit expansion, leading to domestic booms, which in turn lead to wage increases, then to worsening real effective exchange rates (REERs), and finally to a balance of trade crisis.[4] Guntram Wolff (2011: 3) presents data showing that between 1999 and 2007 credit growth was high in Greece, Ireland, Portugal and Spain. The growth of credit was fueled by low interest rates and a greater abundance of capital in the Northern countries. Prospects of stronger growth in the South, even if based on intensification of factor inputs rather than productivity improvements, also played a role. Capital inflows mostly fueled asset booms in real estate and construction rather than investment in manufacturing production. In Figure 1 we present a graph of credit expansion in the countries of the periphery. As we can see, growth of private credit is very rapid overall. Within the overall pattern of accelerated credit expansion, two groups of countries are discernible. The first group includes Ireland, Spain and Portugal. Ireland leads the pack, at least after

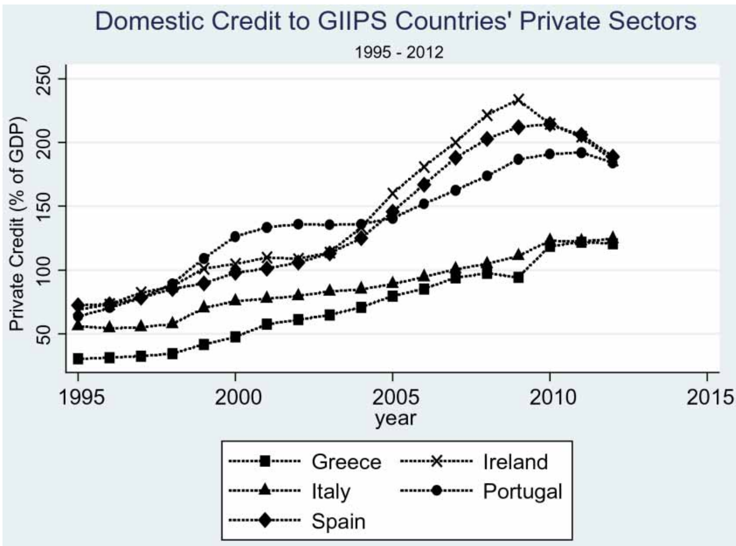

Figure 1 Growth of private credit in periphery
Source: World Bank.

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2004, with credit expansion reaching almost 240 per cent of gross domestic product (GDP) by 2009. Ireland is followed closely by Spain and Portugal. Greece and Italy actually have a lower rate of credit expansion.

The next steps in the growth of imbalances are differential wage increases and deterioration in REERs. Here we use unit labor costs as the basis for wage comparisons. As we see from Figure 2, the data are striking. If we normalize the data so that all countries are fixed at 100 in 2000, we can focus on the changes since then. By 2004–2005 the differences are dramatic.[5] They crest in 2007–2008. All five GIIPS (Greece, Ireland, Italy, Portugal, and Spain) experience rapid growth in unit labor costs (ULCs) with Ireland and Greece in the lead. Ireland's wage growth was probably not in the tradable sector, and as a result Ireland did not suffer as much in its trade with the North. Italy's wage growth is right in the middle of the pack, which is remarkable, since Italy's productivity declined over this same period. Germany actually decreases its unit labor costs from 2003 to 2007, thus contributing further to the growing gap in labor costs.

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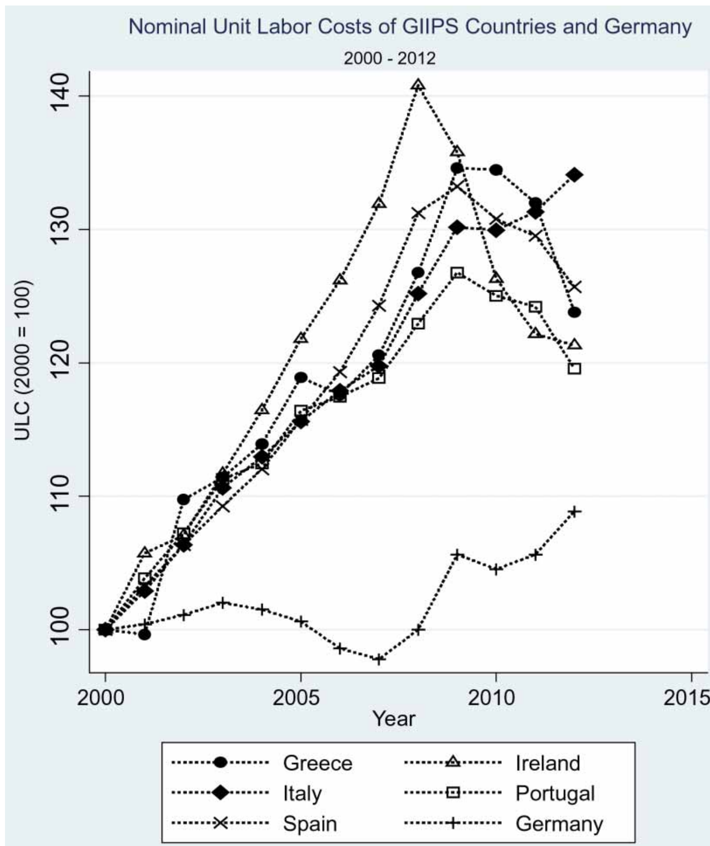

Figure 2 Unit labor costs in GIIPS and Germany
Source: Eurostat.

Labor costs are the primary determinant of the final costs of marketed goods. Thus, if labor costs increase more in one country than another, prices will rise faster in that country, with predictable consequences for its balance of trade account. Since the exchange rate mechanism is no longer present to balance accounts, some other balancing mechanism is needed. To see if this link in the hypothesized chain holds, we examine REERs. REERs are essentially measures of relative prices. They attempt to get at the price of goods as they are traded on international markets. The term 'exchange rate' may be misleading, since the nominal rate of exchange is one to one. However, the prices of traded goods may vary as a function of domestic inflation, tax differences among countries, subsidies and, of course, wages. Figure 3 presents a graph of the time paths of REERs for the GIIPS and Germany. All country prices are set at 100 in 1999. As we can see, Germany's REER declines on average after 1999 so that by 2010 it is below 90. At the same time, the REERs of the five GIIPS are climbing to produce a substantial gap. We expect this pattern of divergence in real exchange rates to produce a growing trade gap.

Do these gaps in competitiveness translate into trade advantages and disadvantages? The simple answer is yes. We can see this most clearly if we look at the trade balances of the GIIPS combined with the rest of the euro area.

The trade account is in balance as of 1996 but in 1997 it becomes negative. These balances continue to plummet until 2007, at which time the turnaround

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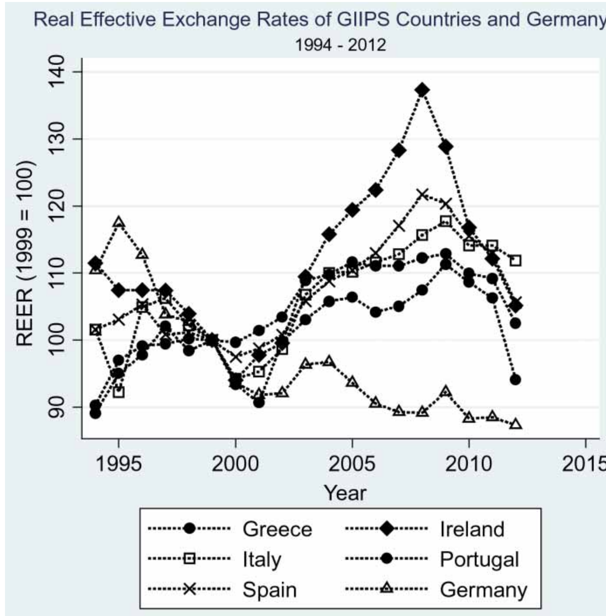

Figure 3 Real exchange rates in GIIPS and Germany
Source: Eurostat.

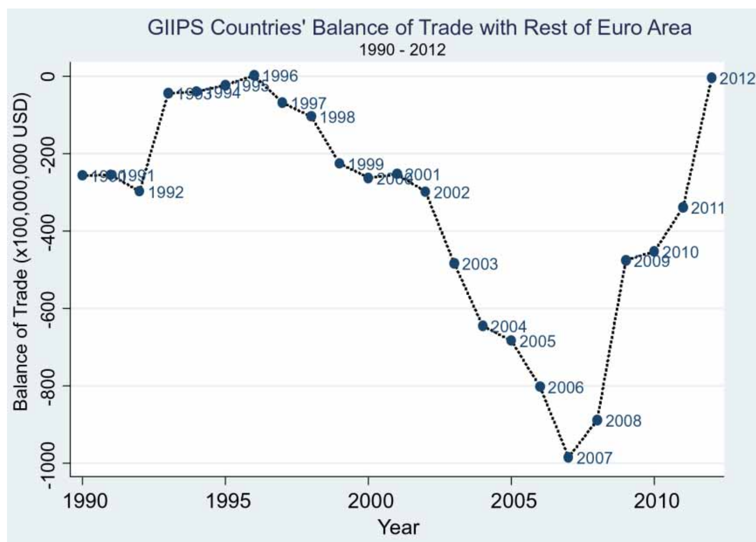

Figure 4 GIIPS trade balances with rest of euro area
Source: IMF Direction of Trade Statistics Database.

occurs (see Figure 4). All of the GIIPS countries except for Ireland share the same basic pattern of accumulation of negative balances. If we next examine trade patterns of the GIIPS countries with Germany, Austria, the Netherlands

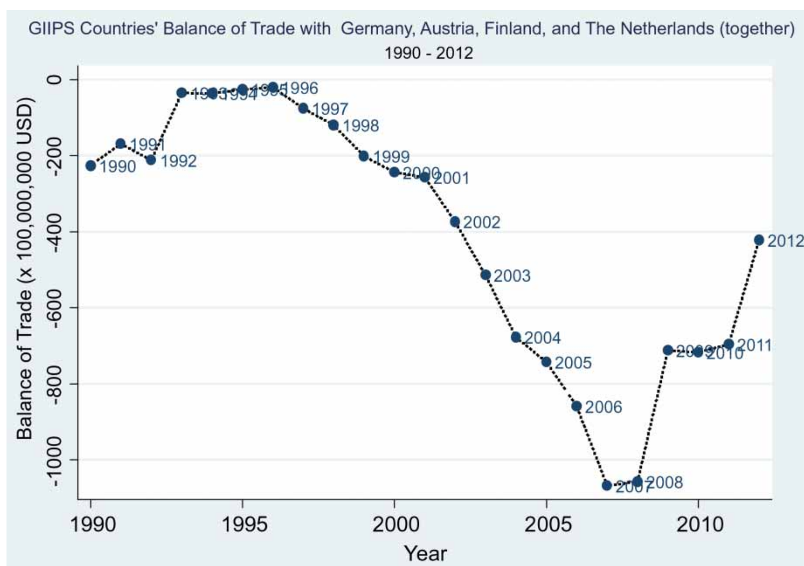

Figure 5 GIIPS trade balances with Germany, Austria, Finland and Netherlands
Source: IMF Direction of Trade Statistics Database.

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and Finland (Figure 5), the patterns look very similar. The buildup of trade deficits starts in 1996 and worsens until it bottoms out in 2007. There are some differences, but they are not substantial, suggesting that most of the trade deficit with the euro area is with Germany, Austria, the Netherlands and Finland. In both cases, the GIIPS are at or close to balance in 1996, their balances deteriorate monotonically until 2007, turn around slightly between 2007 and 2008, and continue to improve until 2012.[6]

In the next section, we examine the responses of the EU to these macroeconomic imbalances.

THE EU'S RESPONSES TO MACROECONOMIC IMBALANCES IN THE ECONOMIC AND MONETARY UNION (EMU)

The European financial crisis has exposed serious shortcomings in the functioning and governance of EMU. In particular, it revealed large gaps in the regulation of macroeconomic imbalances and competitiveness divergence between the north and the south of the eurozone. It is these imbalances, rather than solely fiscal problems, that have caused the financial crisis (European Parliament 2010).

In this section, we analyze the EU's responses to the problems of macroeconomic imbalances and competitiveness divergence in the eurozone. By examining how the EU has tackled such crisis-triggering issues as current account imbalances between the north and the south of the euro area, wage increases in the periphery, worsening REERs, and massive capital inflows to the south (including the local credit expansion that led to domestic booms – e.g., construction booms in Ireland and Spain and consumption booms in Greece and Portugal), our goal here is to set the stage for the next section of the discussion of interrelationships among regulatory, redistributive (fiscal), and stabilization policy in EMU.

First of all, since the European financial crisis illustrated gaps and weaknesses in the framework of the stability and growth pact (SGP) – a rule-based framework for the co-ordination of national fiscal policies in the EU, which was created to facilitate and maintain the stability of EMU – the EU drastically amended the SGP in 2011. The so-called Six Pack[7] introduces (in addition to fiscal surveillance) a new macroeconomic surveillance mechanism under the macroeconomic imbalances procedure (MIP).[8] The MIP's main purpose is to create an alert mechanism to detect the emergence of macroeconomic imbalances at an early stage (i.e., the preventative arm) and have the member state correct them through an effective means of enforcement (i.e., the corrective arm).[9] The alert mechanism is based on an economic reading of a scoreboard with early warning indicators. Beyond public deficit and public debt, these indicators monitor both external and internal imbalances and competitiveness positions in the euro area.[10] For instance, the indicators that are most likely to give an early signal of external imbalances and competitiveness include the current account balance in percent of GDP, the three-year percentage change

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of the REERs, and the five-year percentage change of export market shares. Meanwhile, the indicators that are supposed to monitor internal imbalances closely involve year-on-year changes in the house price index, private sector debt in percent of GDP, general government sector debt in percent of GDP, and private sector credit flow in percent of GDP, among others. The scoreboard particularly stresses external balance variables (e.g., the current account balances, changes in REER, and the net foreign financial asset position) as indicators of a potential crisis (Gros and Roth 2012: 79–80). Despite its merits, an important shortcoming of the new macroeconomic surveillance framework is that the alert mechanism is not well-equipped to effectively deal with credit expansion, which was a central cause of the imbalances of the eurozone. The European Central Bank (ECB) may be able to restrict bank credit and check the emergence of booms and bubbles, but it is left mostly outside the excessive imbalance procedure (EIP).[11] This is a significant deficiency, since credit expansion was the main driver of booms and bubbles in the periphery that led to the crisis (De Grauwe 2011: 16).

Second, the EU has also taken measures to cope with the problems of current account imbalances and competitiveness divergence in the euro area. As a matter of fact, current account imbalances within the eurozone are not just the result of international regulatory factors; they also result from differences in competitiveness among members of the eurozone. The South lost competitiveness through wage increases and inflation, whereas the North (in particular, Germany) kept wages and prices under control (see Figure 2). The link between current account imbalances and competitiveness divergence in the euro area illustrates that in order to prevent a future financial crisis, reducing competitiveness gaps between the North and the South is critical. The EU has responded to this problem, among others, by including two competitiveness indicators in the MIP's scoreboard – i.e., relative unit labor costs and consumer prices reflected in REER. Given the likelihood that differential growth in wages and consumer prices in the South will trigger a balance of payments crisis, the EU aims to prevent it through a close monitoring of country-specific developments in those areas. While the EU's approach to the problems of competitiveness divergence is in the right direction, it is worth noting that the correction of competitiveness imbalances in the euro area, in which excessive wages and price inflation in GIIPS following the introduction of the euro played a significant role, would call for adjustment policies such as 'competitive devaluation' or 'relative disinflation' assisted by market reforms. Those adjustment policies, however, are no longer available for the euro area member states. Hence, a big question that the EU is facing now is who will take care of potential social costs generated by the adjustment process in the crisis-hit eurozone countries (e.g., costs that will be triggered by sudden stops). No common European mechanism to mitigate the social costs exists yet. A fiscal union conceived as a concrete step towards a genuine EMU could work as an effective fiscal backstop, but the proposals for a fiscal union have so far been largely sidelined (Bosch 2014: 19–21).

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Third, the European financial crisis also highlighted the problems of unregulated capital flows and fragmented banking system in the euro area. As Figure 1 shows, massive capital inflows from the North since the launch of the euro provoked the huge expansion of private credit in GIIPS. The expansion of private credit in turn caused an increase in the domestic demand of GIIPS via excessive construction (Ireland and Spain) and consumption booms (Greece and Portugal), leading to the appreciation of their REERs (see Figure 3). The sudden stop of capital inflows, especially with the outbreak of the Greek debt crisis, however, created contagion with other countries of the euro area. In response to this problem of unregulated capital flows, the EU has taken quite extensive measures to strengthen its financial sector. For example, a new European System of Financial Supervision was launched on 1 January 2011, and replaced the former supervisory committees. It is composed of the European Systemic Risk Board (ESRB) and three newly established European supervisory authorities – i.e., the European Banking Authority (EBA) that aims to safeguard the integrity, efficiency and orderly functioning of the banking sector; the European Securities and Markets Authority (ESMA) that seeks to enhance the protection of investors and reinforce stable and well-functioning financial markets in the EU; and the European Insurance and Occupational Pensions Authority (EIOPA) whose core responsibilities are to support the stability of the financial system, enhance the transparency of markets and protect insurance policyholders, pension scheme members and beneficiaries. Under the new architecture, the EBA, in co-operation with the ESRB, conducts EU-wide stress tests in order to assess the resilience of financial institutions to adverse market developments, and to contribute to the overall assessment of systemic risk in the EU financial system. With the aim of creating a sounder and safer financial system, the Commission also adopted a legislative package on 20 July 2011, which is designed to strengthen the regulation of the banking sector. Among others measures, it called for stricter capital requirements and better corporate governance for banks and investment firms. On 8 December 2011, the governing council of the ECB announced additional credit support measures to enhance bank lending and liquidity in the euro area money market.

However, what is most remarkable in the EU's efforts to strengthen its financial sector is the Commission's proposal on 12 September 2012 for an ECB-led single supervisory mechanism (SSM) for banks. Given the widespread tendency of countries to hide information on their troubled banks at the time of the financial crisis, which exacerbates the crisis by postponing corrective action (Carmassi *et al.* 2012), the transfer of supervisory powers to the European level is undoubtedly critical to prevent the spread of crisis and break the so-called doom loop – i.e., the vicious cycle between banks and sovereigns. Therefore, agreeing[12] to an SSM for euro area banks is a first step towards an integrated banking union, which includes other key components such as a single rule book for financial institutions in the single market, a single bank resolution,[13] and a supranational deposit guarantee scheme.[14] On 15 October 2013, the Council adopted regulations on the creation of a SSM. The SSM regulations entered into force on 4

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November 2013. Composed of the ECB and the supervisory authorities of the member states, the SSM, once fully operational in November 2014, will have the ECB directly oversee banks in the euro area and in other member states that decide to join the banking union (Council of the European Union 2013a).

As a second step towards a European banking union, EU leaders in December 2012 also agreed to complement the SSM with a single resolution mechanism (SRM). Since the risk of a bank experiencing a serious liquidity problem can never be completely excluded, even with the reinforced supervisory framework of the SSM, the Commission officially proposed the SRM on 10 July 2013. The SRM's main purpose is to manage bank crises more effectively by breaking the link between sovereign crises and ailing banks in times of crisis. An SSM with a strong central decision-making body (a resolution authority) and a single resolution fund (SRF) would allow resolution decisions across participating member states to be taken quickly, minimizing negative impacts on financial stability, avoiding unco-ordinated action, and limiting the need for financial support from taxpayers. In the case of cross-border failures, a central body of the SRM with expertise on bank resolution is believed to be more efficient than a network of national resolution authorities with more limited resources and experience on which the Directive on Bank Recovery and Resolution (BRRD)[15] relies to resolve banks. According to a provisional agreement reached by the European Parliament and the European Council on 20 March 2014, once operational on 1 January 2015,[16] the SRM will apply to all banks and other financial institutions supervised by the SSM (European Commission 2014). The SRM is deemed necessary, since without it tensions between the ECB (supervisor) and national resolution authorities are likely to emerge over how to deal with insolvent banks.[17] Indeed, as Veron and Wolff (2013: 11) point out, a centralized supervision system may harm the effectiveness and credibility of the supervisor, if there is no centralized resolution mechanism.

While EU's efforts in coping with the problems of capital flows by creating effective surveillance mechanisms and strengthening financial sector regulations are comprehensive, there are several important issues that need to be addressed. First, like the EIP, the main purpose of newly created macro-prudential oversight mechanisms such as the ESRB, the EBA, the ESMA and the EIOPA is to avoid the build-up of future imbalances. Hence, they have limited value for reducing already existing large imbalances, although they still can be helpful in fostering the intra-area adjustment through rebalancing (Gros 2012: 2). Second, given the large stock of existing imbalances between the core and the periphery of the euro area, threats to financial stability are likely to be derived from a limited number of specific countries such as GIIPS. This means that macro-prudential oversight mechanisms like ESRB will have to call for action at the national (as opposed to European) level, taking into account national differences in the application of financial market regulation. Needless to say, this will be in conflict with the goal of establishing a single rule book in the proposed banking union (Gros 2012: 12). Third, once the SSM becomes fully operational, the ECB will have capacity to supervise all

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the banks (in addition to executing its traditional monetary policy) in the euro area. However, the ECB's new task of micro-supervision may sometimes be in conflict with its monetary policy goals. For instance, a central bank supervising a generally weak and undercapitalized banking system could be very hesitant to execute a tight monetary policy for fear of driving some of the banks under its supervision to the edge of insolvency (Carmassi *et al.* 2012: 4). Moreover, evidence shows that countries where the monetary authority and the banking supervision authority are integrated in an institution tend to have higher inflation rates than those where such authorities are set apart (Claeys *et al.* 2014: 11). Hence, an effective handling of this potential problem of institutional set-up within the ECB should be worked out. Fourth, despite some recent progress on the SRM, it is important to point out that the size of the SRF (a total of 55 billion euros that will be raised over the next eight years) is too small for the banking union to effectively manage a future eurozone-wide financial crisis. If the SRF runs out of money, national treasuries of the member states will have to intervene, since without that assurance, banking union that is designed to rescue failing banks with minimum recourse to taxpayers will not be credible. Understandably, there are some countries that are strongly against this idea (most notably, Germany). After all, the absence of a common fiscal backstop in the current banking union framework, which requires national bailouts as the last-resort intervention (Valiante 2014: 15), would reinforce (as opposed to break) the vicious circle between banks and sovereigns, especially for the European banking sector that will remain highly fragmented, with a strong home bias for sovereign debt for the time being (Bosch 2014: 17–19). Furthermore, while the European banking union should also have a common deposit guarantee system (DGS) as a safety net so that it can prevent a bank run and thereby restore market confidence fully, it is not envisioned at the time of writing. This means that though likely, a fully fledged European banking union still has a long way to go. What is worth stressing here is the International Monetary Fund's (IMF) warning that 'a half-baked, piecemeal banking union could be worse than none' (*The Economist*, 14 December 2013).

In sum, the EU's responses to the European financial crisis analyzed in this section illustrate that while the primary objective of EMU in its first decade was fiscal/budgetary discipline, these objectives have expanded with the outbreak of the sovereign debt crisis. Now, the EMU has two more key objectives: the avoidance of macroeconomic imbalances and securing financial stability. Accordingly, macroeconomic surveillance mechanisms have also expanded beyond the fiscal dimension by covering macroeconomic imbalances and financial stability. This development is welcome, given the fact that the European financial crisis is not simply a problem of public fiscal indiscipline, but a result of the combination of such various factors as unregulated capital flows, competitiveness divergence and macroeconomic imbalances. This suggests that a widely held conceptualization of the EU as a regulatory state completely independent of the function of redistribution and stabilization is questionable.

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In order to map out an effective governance of monetary union to prevent a future crisis, therefore, it is essential to understand the interconnectedness among regulatory, fiscal (or redistributive) and stabilization policy in EMU, which is the issue that we will discuss in the next section.

DISCUSSION AND CONCLUSION

While the fiscal sources of the European financial crisis should not be dismissed, we have emphasized a non-fiscal causal path to explain the crisis – macroeconomic imbalances in the euro area. Our research findings show that capital flows, differential wage movement in the core and periphery, and current account imbalances are important drivers of the financial crisis. Recognizing this, the EU has sought to correct these problems via multiple financial as well as fiscal sector reforms. In this last section, we discuss the major implications of the EU's responses to the financial crisis for our understanding of the EU as a regulatory state. We argue that the EU is expanding its regulatory power at the same time that it is developing capacity in stabilization and fiscal policy, and that the key drivers of this transformation are market and policy externalities and the institutional limitations of the EU itself.

Using Majone (1996, 1997) as the starting point, we have argued that the EU is still a regulatory state with the tight budgetary constraints and limited power to tax and spend. Thus, our first conclusion is that regulatory politics is not only alive and well but is also extending its scope (Mabbett and Schelkle 2014). For example, the introduction of a new macroeconomic surveillance mechanism under the MIP, the creation of a new European system of financial supervision, a gradual move to banking union, and the reforms of the SGP are basically measures to promote efficiency, control systemic risk and promote stabilization at the international level.[18] To the extent that responses to the financial crisis extend the scope of the EU's regulation, Majone's argument still holds. The EU continues to be primarily a regulatory state, though one with much more extensive powers.

That said, we stress that the European financial crisis has created pressures for the EU to move into areas besides regulation. While government policies are often categorized as regulation policy, fiscal policy and stabilization policy, these 'pure types' are more interlinked than is often suggested. Good/bad regulations can make the economy more/less stable and regulation can have fiscal implications. Hybrids are not only possible. They proliferate in the EU. The pressure for these hybrids springs from the discrepancy between economic integration and political decentralization in the EU; that is, between monetary integration as single currency and political control in terms of the dominance of member states in the institutions of the EU. As De Grauwe (2013: 2–5) points out, historically the two major stabilizers against the dynamics of booms and busts in capitalist economies since the Great Depression have been the central bank's role as a lender of last resort and the counter-cyclical automatic stabilizers built into government budgets. First, in the absence of a lender of last resort, i.e.,

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someone to lend to banks when they face liquidity problems, even solvent banks may fail. Second, at the national level, automatic budget stabilizers have effectively managed deflationary downturns that may result from the private sector's effort to reduce its debt, Keynes's paradox of thrift (Keynes 1936). As De Grauwe (2013: 5) argues, by being willing to increase its borrowing and spending on the one hand and to take over the debt of the private sector on the other, the government acts as an effective backstop to endangered actors in the private sector.

De Grauwe (2013: 5) argues that although these two stabilizers are institutionalized at the national level, corresponding structures were not created at the EU level. This is what De Grauwe refers to as the two 'design flaws' in EMU. Given this dual institutional vacuum, it became only a matter of time before problems of confidence and trust plagued financial markets in eurozone countries. Countries that had been growing rapidly with the aid of cheap foreign debt now faced a situation where credit was hard to come by. Bond markets demanded higher yields which increased government (and private) indebtedness. In addition, austerity programs cut back on government spending, further worsening deflationary dynamics. The automatic stabilizers that were to operate in a counter-cyclical way at the national level did not exist at the level of the eurozone. Indeed, after the expansionary stimulus of 2008–2009 (European Economic Recovery Plan), the EU turned to austerity and operated on the crisis in a pro-cyclical way (Wolf 2014: 42–43).

With the outbreak of the financial crisis, however, the EU has become more responsible for stabilization. Since most of the asymmetries and imbalances in the eurozone are cross-country rather than intra-country, it follows that stabilization efforts organized at the national level will have limited effect. The imbalances track geographical differences between the north and south of Europe, although significant within-country differences also exist. This simple fact is creating strong pressures for a eurozone-wide counter-cyclical capacity. The efforts on the part of the ECB to provide liquidity in order to prevent a self-fulfilling crisis stemming from doubts about solvency of governments provide a good example of an early attempt at stabilization.

The European financial crisis has created pressures for the EU to move into the domain of redistribution as well. Redistribution is taking several forms: bailouts; liquidity provision; and bond purchases. Pisani-Ferry (2011: 5–7) argues that the EU leaders were slow to realize what was at stake in the creation of monetary union. A true banking union is at bottom a commitment to mutualize the costs of certain events, such as the prevention of large-scale market panic and systemic crises. At Maastricht, the founders of EMU believed that governments could borrow on the market to absorb national shocks. They did not foresee the possibility that credit markets can dry up so quickly that crisis-hit countries are left with few tools for macroeconomic stabilization policy. Hence, neither a federal transfer system nor fiscal risk sharing was considered (Wolff 2012: 5). Yet, as Martin Wolf (2014: 338–9) argues, no one wanted to see the eurozone fail and as a result financial support became available. One type of support did

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not involve the EU legally and depended instead on co-ordination among donor countries and the IMF. The European financial stability facility (EFSF), a special purpose vehicle, was of this type. Another source of aid was less direct and came from the ECB in the form of loans at below market interest rates, and policies such as bond purchases in secondary markets that were on the margins of violating the Treaty.

A third broad source of support is found in the generous liquidity provided by the ECB. The two biggest liquidity injections took place in December 2011 and February 2012. The ECB provided up to three trillion euros to banks at 1 per cent interest rate over a three-year period. Since government bond rates are higher, this means that banks can effectively recapitalize themselves by exploiting the differences. Schelkle calls the long-term refinancing operations (LTROs) a 'quasi-fiscal activity' (2014: 112).

Finally, there are the bond purchasing programs of the ECB. In a famous speech on 26 July 2012, ECB President Mario Draghi said, 'Within our mandate, the ECB is ready to do whatever it takes to preserve the euro.' The ECB shortly thereafter announced that it would buy short-term bonds from governments. This is called the outright monetary transactions (OMT) program. Monetary hawks reacted negatively to this program, since it came, in their opinion, 'perilously close to violating the prohibition of central bank lending to sovereigns' (Pisani-Ferry 2011: 17). While an express fiscal capacity headquartered in Brussels under the direction and control of supranational institutions has not arrived yet, the EU and member states have taken a position to shore up the finances of troubled economies and governments in the eurozone. It is 'fiscal policy by default' (Schelkle 2014) or 'fiscal policy via the back door' (Schelkle 2012).

The European financial crisis has forced the European leaders to recognize not only the design failures of EMU but also the interdependence among regulatory, stabilization and redistributive policy in the euro area. While most of the European policies in the history of European integration have involved regulations to correct market failures, the financial crisis has created pressures for stabilization and fiscal transfers (Vilpisauskas 2013: 362–4). Indeed, the EU, while still a regulatory state, has broadened its regulatory powers and also developed new competencies in the areas of stabilization and fiscal policy. In order to fully grasp the EU today, we have to understand the interconnections among regulatory, fiscal and stabilization that are embodied in its evolving institutions and policies.

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NOTES

1 For additional readings on the regulatory state, see Moran (2002).
2 Mabbett and Schelkle (2014) also make this point.
3 Genschel and Jachtenfuchs (2014) rely heavily on the idea of policy externalities to guide their research. While they are correct to emphasize the external effects of country level policies, we think that markets themselves can create negative externalities that create demand for policies to internalize their effects.
4 We realize that this is not a complete model. We could have started earlier than the credit expansion and asked about the causes of this expansion. Or we could have elaborated the theoretical links between the domestic booms and wage pressures first in non-tradables and how wage increases spread to the tradable sector. This truncated model is largely owing to compromises arising out of data limitations.
5 For a similar analysis, focusing on labor costs in manufacturing and their relationship to current account balances, see Marzinotto *et al.* (2010: 3).
6 The improvement picture is not fully monotonic. We can see a slight reversal of sign for GIIPS with the four Northern countries between 2009 and 2010.
7 Composed of five regulations and one directive, the Six Pack entered into force on 13 December 2011.
8 The two regulations of the MIP in the Six Pack are Regulation 1174/2011, which is about enforcement measures to correct excessive macroeconomic imbalances in the euro area (see http://eurlex.europa.eu/LexUriServ/LexUriServ.do?uri=OJ:L:2011:306:0008:0011:EN:PDF [accessed 10 September 2013]); and Regulation 1176/2011, which covers the prevention and correction of macroeconomic imbalances (see http://eurlex.europa.eu/LexUriServ/LexUriServ.do?uri=OJ:L:2011:306:0025:0032:EN:PDF [accessed 10 September 2013]).
9 The corrective arm of the MIP operates as follows: an interest-bearing deposit can be imposed after one failure to comply with the recommended corrective action; after a second compliance failure, this interest-bearing deposit can be converted into a fine (up to 0.1 per cent of GDP); sanctions can also be imposed for failing twice to submit a sufficient corrective action plan. By making it very difficult for member states to form a blocking majority through the expanded use of 'reversed qualified majority voting' (i.e., Commission recommendations or proposals to the Council are considered adopted unless a qualified majority of member states vote against it) for all the relevant decisions leading up to sanctions, the MIP seeks to strengthen

the enforcement regime. See 'Macroeconomic imbalance procedure', available at http://ec.europa.eu/economy_finance/economic_governance/macroeconomic_imbalance_procedure/index_en.htm (accessed 15 September 2013).

10 For the scoreboard indicators, see European Commission (2012).

11 The EIP makes the MIP's corrective arm operational, which can eventually lead to sanctions for euro area member states if they repeatedly fail to meet their obligations. See, for details, http://ec.europa.eu/economy_finance/economic_governance/macroeconomic_imbalance_procedure/index_en.htm (accessed 2 October 2013).

12 In a vote on 12 September 2013, the European Parliament approved (559 to 62, with 19 abstentions) the SSM that puts about 130 of the euro area's largest banks (which represent about 85 per cent of bank assets in the eurozone) under the direct scrutiny of the ECB (Kanter2013).

13 'Bank resolution refers to specific legal regimes for the orderly restructuring and/or liquidation of certain financial institutions' (Veron and Wolff 2013: 2).

14 For further information, see 'Towards a banking union', available at http://europa.eu/rapid/press-release_MEMO-12-656_en.htm (accessed 5 November 2013).

15 The proposed draft of the BRRD, once adopted, is supposed to 'determine the rules for how EU banks in difficulties were restructured, how vital functions for the real economy were maintained, and how losses and costs were allocated to the bank's shareholders and creditors.' See 'Memo: proposal for a single resolution mechanism for the banking union-frequently asked questions', available at http://europa.eu/rapid/press-release_MEMO-13-675_en.htm?locale=en (accessed 23 January 2014).

16 The SRM regulation will apply only after an intergovernmental agreement on the functioning of the SRF entered into force. The intergovernmental agreement will go into effect once it is ratified by the participating member states of the SSM/SRM that represent at least 80 per cent of contribution to the SRF. See Council of the European Union (2013 b).

17 See the European Commission, 'Memo', 10 July 2013, available at http://europa.eu/rapid/press-release_MEMO-13-679_en.htm?locale=en (accessed 11 November 2013).

18 Efficiency is important, since unco-ordinated monetary policies can interfere with one another. Less of the desired outcome is achieved if member countries pursue unco-ordinated policies. Controlling systemic risk is important, since there can be contagion from one country to the next. Stabilization is important, since there are positive feedback processes which can aggravate processes that otherwise might be stabilized, as evidenced by the so-called 'doom loop' between sovereigns and banks, or when escalating sovereign bond yields make it yet more difficult for governments initially in fiscal danger to pay off debts.

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