

“No, they can't!”
The potential and limitations of the EU (as a supranational state in the making) to reform finance and overcome the crisis.

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1. Modest ambition from the beginning

After the financial crisis had fully broken out in 2008 there were strong statements about the need for reforms from some fractions of the elites. In the Pittsburgh G20 Summit declaration one can read sentences such as:

“We are confronted with the greatest challenge to the world economy in our generation. [...] We want growth without cycles of boom and bust and markets that foster responsibility not recklessness. [...] We will not allow a return to banking as usual” (G20, 2009).

However the official EU statements kept a lower profile from the beginning. This had several reasons. A trivial one was that the EU had been the frontrunner of financial liberalisation and deregulation in Europe before the crisis. A typical representative of the European mainstream at the time was the Commissioner for Internal Market and Services (the most important department for the financial sector), Charlie McCreevy, an Irish market fundamentalist.¹ Even after the Lehman Brothers crash McCreevy was trying to prevent “too much regulation”. For instance he opposed at the end of September 2008, two weeks after the Lehman crash, proposals by the European Parliament to regulate Hedge Funds

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¹ After McCreevy had left the Commission he started to work for the British investment bank NBNK. This is why, for the first time in history, the so-called Ethical Commission of the EU forced him to stand down from his new position. No objections came from the Ethical Commission for McCreevy's other job at Ryanair.

with the argument: “One thing I believe we can agree on is that they were not the cause of the current turmoil” (McCreevy, 2008a). And some weeks later he still thought it was the time to say, “that self-regulation has its benefits” (McCreevy, 2008b).

More important was the fact that the EU did not dispose of the legal, political and financial instruments to intervene in the crisis management, which was in the hands of the nation states. The national governments each adopted rescue packages for banks on their own and also decided on stimulus programs each according to their respective situation. In the peak period of crisis management the EU was marginalised. Also the supervisory bodies, which had been in place at EU level – the Committee of European Banking Supervisors (CEBS), the Committee of European Insurance and Occupational Pensions Committee (CEIOPS) and the Committee of European Securities Regulators (CESR) – had been a total failure. It would have made no difference if they would not have existed.

In this situation the EU established an expert group under the leadership of de Larosière² that prepared a report which was published in February 2009 and that served as a roadmap for the reform process (de Larosière, 2009). The EU should be enabled to be a player to be taken seriously in regulating the financial system.

But the approach of de Larosière was modest from the beginning: “a pragmatic, sensible European cooperation for the benefit of all o preserve an open world economy.” (de Larosière, 2009, p. 4). Although the report identified some real areas of concern, such as the need “to reduce risk and improve risk management; to improve systemic shock absorbers; to weaken pro-cyclical amplifiers”, as well as transparency, improvement of supervision, the further course of European crisis has shown that the report, in its analysis did not understand adequately the depth and range of the crisis. Consequently, the proposals were too moderate to cope with the radicalness of the problems. They maintained a lot of confidence in the capability of markets to regulate themselves. And what would be left over was delegated to supervision, i.e. the capability of the state to con-

² Jacques de Larosière was president of the IMF from 1978 to 1987, head of the French Central Bank (1987-93) and president of the European Bank for Reconstruction and Development (1993-98).

trol finance, in which de Larosière believed. Concerns like: “Overregulation should be avoided. [...] Furthermore, the enforcement of existing regulation, when adequate (or improving it where necessary), and a better supervision, can be as important as creating new regulation” (de Larosière, 2009, pp. 13-14) are symptomatic of the spirit of the report.

After all it was an approach that wanted to repair the system that had collapsed in 2008. The fundamental questions such as what finance system would be needed, what would be its purpose and its role towards the real economy and society as a whole, were even not asked. The necessity of shrinking the overgrown sector, its players, which were too big to fail, and of breaking its dominance over the real economy is beyond the horizon of the de Larosière report. The rational behind the report could be characterised as follows: the casino should be made safer, but should continue to operate.

1.1. Some adjustment in the EU position

It is therefore not surprising, that when in the second half of 2009 financial markets were a bit calmer the illusion emerged that the crisis would soon be over. Only when the Greek disaster became visible in spring 2010 was there growing understanding that the crisis might somehow be more serious than had been assumed until then. The pressure of reality forced the adjustment of the perception of the crisis to a certain extent.

A change in personnel at the European Commission contributed to the shift. McCreevy was replaced by Michel Barnier in February 2010. Nominated by the former French president Sarkozy, Barnier represents the classical type of conservative French civil servant, which had always been sceptical towards neo-liberalism, and who therefore stands for a strong role of the state in the economy.³ Barnier's statements clearly differ from those of his predecessors. His credo is: “Financial markets need to be at the service of the real economy, and not the other way round” (EU Commission Internal Mar-

³ In order to shift the balance of power among the lobby groups in Brussels, Barnier's department had even encouraged the establishment of “Finance Watch”, a progressive and civil society inspired lobby organisation on financial regulation, which was set up in 2011. Barnier's department is even supporting the project with a 1 million euro grant.

ket and Services, 2010, p. 3), which means implicitly, that the system in place was not serving this purpose. Under Barnier a new reform programme was set up, which now included issues that had been blank spots in the de Larosière road map (EU Commission Internal Market and Services, 2010). The political will to reform at EU-level was strengthened. What were the results of this shift towards stricter regulation?

2. State of the art of financial reforms in the EU

All in all there are some 70 directives and regulations of finance in the EU. Most of them have been adopted before the crisis and were inspired by the basic idea of creating a ‘level playing field’ for financial actors in the EU. In other words they imposed harmonisation, in general towards a lower degree of regulation. De facto they were rules of liberalisation and deregulation, based on the Financial Services Action Plan (FSAP) adopted in 1999. The FSAP was an important tool in the neo-liberal transformation of the EU in the last decade. The commission itself said in 2003: “The FSAP is one of the driving forces behind profound changes in the European financial landscape” (EU Commission Internal Market and Services, 2003, p. 1).

Most of the old rules are still in force, but the reform process tries to amend them and to give them a different spin in some cases. A typical example is the MIFID (Markets in Financial Instruments Directive) from 2004. Initially this directive liberalised cross border investments and the trade of all kinds of assets. In the present reform debate, the EU tries to implement the regulation of derivatives (see also paragraph 2.5). The co-existence of old and new rules with sometimes contradictory intentions makes the whole regulatory landscape even more complicated.

But before entering into the individual reform projects it is useful to remind ourselves of some institutional and procedural specific characteristics of the EU, which differ from those which one is used to in a ‘normal’ nation state. This exercise will already highlight to a certain extent the guiding question of this conference: the relationship between financial reform and the state.

2.1. *The unfinished supra-national state*

The EU is a unique phenomenon with its complex mixture of supra-national and national structures and procedures. The institutional arrangements between Council, Commission, European Parliament and all the national institutions involved in decision making – governments, parliaments, national central banks, supervisory bodies etc. including the juridical ones such as the German Supreme Court, which is applying the brakes on or blocking from time to time certain decisions.

The process of financial reform is, of course, also marked by this complexity. This is among others reflected in two types of European laws: the first one is called a *directive* and is a kind of common framework that can be modified to a certain extent by national legislation. This means, that even if there is a common directive, in the end there can be a lot of national modifications of the same directive. The second type is called a *regulation* and is directly binding at national level (in order to differentiate between the general notion of regulation and the EU-law, the latter is reproduced here as *Regulation* henceforth).

These two basic types of EU-legislation are accompanied by other tools, which have no legally binding status, in particular *Recommendations* and *Communications*. For instance the Commission has issued recommendations concerning executive remuneration (bonuses). It is up to member states whether they convert them into national legislation. Communications are a kind of detailed announcement, which prepare a future draft law. These tools are not mentioned here for the sake of encyclopaedic inclusiveness, but in the PR work of the Commission they boost the balance of what has been done, and might give the impression that much more has been achieved than is in fact the case.

The interplay between the national and the supra-national level is not the only source of complexity. Particularly relevant to the issue at hand are the differences in geographical scope of a regulation such as between Euro-zone and non Euro-zone. From 27 EU members, ten do not belong to the Euro. This means that all in all there are eleven currencies in the EU. Out of these ten the UK is a special case as it has an internationally

important currency and the City of London is the biggest financial centre of the EU. As we shall see later this has far reaching consequences.

But the difference between Euro and non-Euro is not always clear-cut, and here a third dimension comes into play: a kind of grey zone between the Euro-zone and the non-Euro zone for specific projects. This means that agreements that are adopted by the Euro-zone members can also be accepted by others outside the Euro. The so-called “Six Pack” or the “Fiscal Compact” are examples of this.

And finally a new, important level has emerged during the crisis that has far reaching consequences not only for European financial governance, but the future of the EU in general: there are now arrangements such as the European Financial Stability Facility (EFSF) and its successor, the European Stability Mechanism (ESM), which are completely outside European legislation. They are just intergovernmental agreements as they could be adopted also outside the EU. Nevertheless the European Central Bank (ECB), which is based on EU legislation, will synchronize its crisis management with these mechanisms. This category of agreements is amplifying the already existing centrifugal trends.

Looking behind this background at the multi-level and highly complex governance system in terms of ‘state’ it is difficult to classify this partially supra-national structure in the making as a state in the usual sense. On the other hand there are also characteristics of statehood. But compared to the typical nation state the EU is something very special. When comparing it with the US or other countries, it is operating in a category of its own.

It is from this perspective that the individual reform projects will be looked at. The primary interest here is not to present and discuss the technical details of the proposals, but how they are related to the political aspects, in particular with regard to the questions as to what role the EU as a very special manifestation of statehood plays in the reform process.

2.2. The case of Supervision

Following the logic of the de Larosière report, the EU put much emphasis on supervision, and one of the first projects was a new supervisory structure, which came into effect in January 2011. The old system which

had failed in such a spectacular manner, has been replaced by four new bodies:

- a European Banking Authority (EBA), based in London (EU, 2010a);
- a European Insurance and Occupational Pensions Authority (EIOP), based in Frankfurt (EU, 2010b);
- a European Securities and Markets Authority (ESMA), based in Paris (EU, 2010c);
- a European Systemic Risk Board (ESRB), attached to the ECB (EU, 2010d).

They have the status of a *Regulation*, i.e. they are immediate law for the member states and cannot be modified at national level.

Whereas the previous institutions were just consultative bodies between national supervisors without any competencies of their own, the new system has been given some supranational competencies. However, there are strict conditions for supra-national intervention, which can only take place if there:

- is a violation of the standards;
- occur conflicts between national supervisors;
- in case of a financial crisis.

But even then, European supervisors have to stick to a certain procedure: they first have to address their decision to the respective national supervisor(s). If these do not implement the decision, the European authority has the right to directly intervene at national level.

However, this right is again restricted in the case of a crisis through four additional criteria:

- a. there must be an “essential violation” of European laws;
- b. the repair has to be urgent;
- c. the definition of what is a crisis remains in the hands of the ECOFIN after consultation and hence of the national states;
- d. in crises and in case of conflicts of national supervisors, member states can contradict a decision of the European authorities, if the sovereignty of a national parliament over the budget is affected; in other words if a decision incurs costs which have to be agreed upon by the parliament.

Such rules cannot overcome the traditional asymmetry between the financial industry and its supervision; on the contrary they only serve to

exacerbate it. One year after its establishment, the staff of EBA consisted of 50 supervisors for the 8,300 banks operating in the EU.

2.2.1. The failure of the new banking supervision

All this is a typical EU compromise: there is a step, which gives the impression of strengthening the supra-national dimension; but the red line, at which national sovereignty would really be overcome is not crossed. In particular the British had strongly insisted that the final and definitive power would remain under national sovereignty. In a paper of the treasury committee of the House of Commons one can read:

“[...] we believe it is wrong for an ESA to be given power to override the decision of a national regulator and to direct individual institutions. [...] Treasury Committee sees it appropriate for the UK to use veto”

if the British interests are not taken into consideration (UK Treasury Committee, 2010, p. 5-6).

It is therefore not surprising that the new bodies were not efficient. EBA organised two stress tests, but they did neither foresee the imminent bankruptcy of Bankia in Spain, which needs support of over 12 billion Euro (*Financial Times Deutschland*, 24/5/2012, p. 17), nor did they realise the criminal manipulation of the LIBOR by banks in several European countries. In view of the failure of EBA the Spanish government has charged two private consultancy firms with the task of looking into the real situation of the major Spanish banks (*ibid.*).

2.2.2. One year after EBA, an even newer supervisory body

In the meantime, most national governments have realised that the new supervisory structure was a flop. Under the impression of the Euro crisis and the crucial role of the private banks in it, the EU summit in June 2012 decided to establish a new supervisory structure, this time under the roof of the ECB. It was the German chancellor who was insisting on this as a precondition for the bailout mechanism through the ESM.

According to the summit declaration⁴, any bail out would be conditioned according to the judgement of the new ECB body. The Commission is mandated to work out a respective proposal. Commissioner Barnier announced a respective draft for mid September 2012. The intention is to supervise directly all 6,000 European banks in the Euro-zone through the ECB by mid 2013.⁵

The new scheme gives a new role to the ECB and would require a change in the statutes. Not only the Euro-zone member states would have to agree but the entire EU-27. While the ECB statutes have the highest degree of independence from politics and democratic control among all big central banks worldwide, the function of supervision, which is a direct effect of state regulation, would require a completely different type of activity inside the ECB. Will this be compatible with the monetary mandate of the ECB? Will the ECB have the right to close banks? What happens, if the ECB in its capacity as supervisor would have to close a bank that is indebted to the ECB, which then would have to incur losses? Does the transfer of supervisory competencies not require further regulation at EU or Euro-zone level, such as a resolution mechanism and a common deposit insurance scheme? And if this would be true, would the member states be ready to make such a far-reaching step forward in the integration process?

A respective change of the statutes requires unanimity in the EU-27. The UK has already declared that they would not accept a European supervision under the ECB. Prime Minister Cameron declared one day after the summit: “We won’t stand behind Greek or Portuguese banks, and our banks will be regulated by the Bank of England, not the ECB”.⁶ As a consequence, a legal trick would have to be found to establish the new supervision, which can be agreed upon by the UK (and probably also others such as Sweden, Poland and other Eastern European members) without applying to them. As a side effect, the distance between the Euro-zone and the non Euro-zone would grow again.

⁴ http://www.consilium.europa.eu/uedocs/cms_data/docs/pressdata/en/ec/131388.pdf

⁵ Interview with Barnier, in *Süddeutsche Zeitung*, 31.8.2012, p. 2.

⁶ <http://www.telegraph.co.uk/news/politics/david-cameron/9367479/David-Cameron-We-need-to-be-clear-about-the-best-way-of-getting-what-is-best-for-Britain.html>

As the bailout of banks is tied to the new supervisory system, it is in the interest of the private sector to agree. This is why the lobby of the big banks might be interested in a smooth implementation. On the other side there are sectors, such as the savings banks, which in some countries (Austria, Germany, Italy, France and the Nordic countries) hold important market shares in non-speculative business. They protest against centralised supervision because they fear that there is less understanding for their business models and that they might be obliged to pay for a European deposit insurance scheme which also covers the risks of speculative investment banking. German finance minister Schäuble has already declared that he wants an exemption for the German savings banks (*Süddeutsche Zeitung*, 1/9/2012, p. 1).

Anyhow we are at the beginning of a new debate on supervision and it would be very surprising if all the open questions would be settled in such a short time that speculative attacks against Spanish banks and Spain will have no occasion to strike.

2.2.3. General problems underlying the regulation of supervision

- As a reminder for general conclusions further below, the underlying general features of EU regulation of supervision should be recorded here:
- the practice of compromises at the lowest common denominator, with as consequence that regulatory measures do not meet the requirements of adequate problem solving,
- the inefficiency and powerlessness of the supra-national vis-à-vis the national level,
- the institutionalising of conflicts of interests, in this case between Germany and its allies (Netherlands, Finland) and the others, when regulation is linked to bail-outs and other measures, which might incur a transfer of financial resources to the crisis countries,
- the procrustean bed of European rules, with on the other side increasing attempts to break with them as in the case of the ECB statutes,
- the special role of the UK government as defender of the interests of the City of London,
- the contradictions and rivalries between different sectors of the finance industry, in this case between public savings banks and private investment banks,

- the pressure of influential constituencies and their lobby on governments,
- the negative side-effects of ‘pragmatic’ and piecemeal strategies, in this case the deepening of the fragmentation between Euro-zone and non Euro-zone,
- the role of the time factor, i.e. the difference in speed between rule making by political bodies in a complex governance structure and the dynamics of still very free financial markets.

2.3. Regulation of Hedge Funds

The regulation of Hedge Funds and other “alternative investment mechanisms” as the EU calls non-bank financial institutions had been decided, secondary to the regulation of supervision, rather quickly. It is a directive, which means that it has to be converted – with the option of modifications – into national law in each member state by July 2013.

The official name of the project is Directive on Alternative Investment Fund Managers (AIFM). It refers to the regulation of Hedge Funds, Private Equity Funds, real estate funds (REITS – Real Estate Investment Trust Funds) commodity funds and infrastructure funds (EU, 2009).

Although the EU had some realistic insights into the highly speculative and – from a macro-economic point of view – detrimental nature of these institutional investors the regulation left the substance of their business model – high-risk speculation and leverage – untouched. The finance lobby and its political supporters, in this case the UK government under labour Prime Minister Gordon Brown had succeeded in heavily watering down the proposal.⁷ The London based lobby organisation of Hedge Funds, AIMA, was finally satisfied, as “the consequences are much less serious, as if the initial draft would have been adopted” (*Financial Times Deutschland*, 20/10/2010, p. 15).

However, since the EU came to the realisation that Hedge Funds were a driving force in speculation against the crisis countries, the AIFM directive is out-dated. Under the heading ‘Shadow Banking’, a new regulation has been announced which is supposed to be stricter than the AIFM.

⁷ For a critical analysis of the directive see Wahl (2010, p. 22 ff).

What is interesting as a general lesson from this case is:

- the strong pressure that the finance lobby is still capable of exerting on European decision making,
- again the influence of the UK in defending the interests of the City of London, and
- the failure of the regulation in the face of the impact of the ongoing crisis.

2.4. Rating Agencies

Rating agencies have contributed to the crash of 2008 through false and/or procyclical ratings. In the Euro crisis their role is also very negative. They are part of a kind of tacit ping-pong together with institutional speculators. The speculators start an attack, for instance by buying or selling CDS for bonds of a crisis country. As this is taken as a symptom of weakening credit worthiness, the rating agencies announce the downgrading of the respective country. Now the interest rates of the bonds rise even faster. A dangerous downward spiral is set in motion.

The EU adopted in 2009 a first Regulation (i.e. not a directive; see 2.1) on the regulation of rating agencies (EU, 2009b). However, this law does not address the basic problem of the present rating system. It is confined to issues of transparency – for instance the agencies have to disclose the algorithms of their computer programs⁸ – and to conflicts of interest. This means that agencies cannot any more advise financial institutions on products and at the same time rate them.

Of course, it is not wrong to have transparency of the methodology and the algorithms of the agency's computer programmes as well as to prevent conflicts of interest. But the *Regulation* is missing the decisive point: the pro-cyclical effect of ratings.

Under the impression of the negative impact of the ratings on the Euro crisis, the first regulation is in the process of being amended (EU, 2011). The most interesting point of the amendment is to define ratings

⁸ Which of course will be nothing more than the mathematical expression of some basic rules for speculators, such as 'the trend is your friend'. But in their mathematical guise, which only few people understand, they will give the impression of being something extraordinarily intelligent.

no longer as the expression of an opinion, covered by the basic right of freedom of speech, but as a product. A similar rule has been anchored in the Dodd-Frank Act.

In this case the ratings could be treated as products and would fall under the liability rules of products. The amendments are still under discussion and there are strong attempts to water down the regulation. Interestingly, the finance lobby is also influencing the process through the European Parliament (EP), where some parts of the conservative and liberal fraction are playing the game of the rating agencies. This shows that the EP is not automatically a palladium of the popular interests, as it is sometimes assumed (European Parliament, 2011). The final outcome of the amendments is yet to be seen, and is expected some time in 2013.

During the debate there was also the proposal to set-up a European agency in order to break the oligarchic dominance of the three big US Agencies Standard and Poor's, Moody's and Fitch. There were two variants: a private agency and a public institution. The attempt of the German consultancy firm Roland Berger to set up a private agency has already failed due to the lack of financial and political support. The European Parliament has asked the Commission to study the possibilities of a public agency. But nothing tangible is as yet in sight.

In this situation Commissioner Barnier has proposed as a kind of emergency measure to ban, at least temporarily, the rating of countries under stress. But he has been blocked by some of his colleagues in the Commission.

On the other hand, the EU has taken over Basle II in CRD III (Capital Requirements Directive), which grants the rating agencies an important role in risk management. This came into force in January 2008. This part of Basle II will probably not be changed in Basle III and the respective European directive CRD IV, which is still in the law making process.

2.5. Derivatives: a step forward

In September 2009 the Commission had submitted a draft for the regulation of OTC-derivatives, the European Market Infrastructure Regulation – EMIR (EU, 2012b). The project is a *Regulation*, i.e. is directly

binding in the member states. The negotiations took almost two years. But in August 2012 a consensus was reached and the implementation is supposed to take place in January 2013.

The core of the law makes the trading of derivatives through clearinghouses mandatory. Furthermore, all derivatives have to be registered in a trade repository. As the OTC trade is a major source of systemic risk and instability the *Regulation* is a real step forward.

Of course, the main objective of EMIR is transparency. There are exemptions and toxic papers as such are still allowed to be traded. Also the trade volume might be reduced only slightly. Hence the serious structural problems of derivatives trading are not tackled. The effect of the regulation will also depend on the capacity of the supervisors to recognise risks and to intervene in time. In light of what has been said above (2.2) on supervision this might be an additional point of weakness.

All in all EMIR is a moderate reform, in comparison with what would be necessary, but at least it has come through.

2.6. Capital requirements

The increase of capital requirements is the core of the G20 reform proposals. It is worked out in the Basle III agreement and the EU is taking it over in a directive: Capital Requirements Directive – CRD IV⁹ (for an overview see Finance Watch, 2012).

The negotiations over CRD IV are less controversial than for the other projects. The reason is trivial: the proposals are coming from the Basle Committee where all major European financial markets are already represented.¹⁰ The conflicts have been settled there and therefore there is not very much autonomy allowed the EU and its member states to push for changes. Most problems have been solved elsewhere. Nevertheless, there is one point where no consensus had been reached by now: the UK wants flexibility with regard to the quota of Basle III. On the other side, the Commission and other member states (France, Germany) want a

⁹ The IV means that it is the fourth edition of the directive.

¹⁰ Belgium, France, Germany, Italy, Luxemburg, Netherlands, Spain, Sweden and the UK.

common ‘level playing field’ because otherwise they expect regulatory arbitrage (*Financial Times Deutschland*, 30/4/2012, p. 16).

At the present stage of the process the directive is expected to come into force in the first half of 2013. As it is a directive, it has to be transferred into national legislation in the member states, which might take at least another year.

Compared to Basle II and CRD III, the new regulation is progress, of a kind. On the other hand it still carries on the basic weaknesses of Basle II, such as the focus on the micro-level, high complexity and too much influence for the rating agencies. Also the long transition period (2019) is under critique and many economists, among them Eichengreen, de Grauwe and Bofinger doubt whether the quota for capital requirements is high enough (*Financial Times Deutschland*, 17/9/2010, p. 16). Also unresolved for the time being remains the issue of Systemically Important Financial Institutions (SIFIs) and international SIFIs. The G20 has put the issue on its agenda since the Seoul summit in November 2010. Until now, no agreement could be reached. The EU has remained passive on this issue.

2.7. MIFID 2

Among the new regulations and the overhauling of old ones, the Markets in Financial Instruments Directive – MIFID (and an attached *Regulation*: MIFIR) has a certain prominence (EU, 2011c). When it was adopted in 2004 it was a major tool for liberalisation and deregulation and has very much contributed to the growing of the shadow sector (WEED, 2012). The 2004 version has a broad approach aimed at brokerage, dealing, portfolio management, underwriting, consulting etc. and facilitates the trading and handling of all instruments from shares via bonds to derivatives.

As a remedy, the core idea of the new proposal is the establishment of an *Organised Trade System*. The concept of *Organised Trade System* sounds very impressive. In reality it is a set of rules, which require more transparency and information for all financial instruments and the surveillance of products and positions. The basics of MIFID 1 are not called into

question, i.e. to further the integration, competitiveness and efficiency of EU financial markets.

New in MIFID is a provision to regulate high-frequency trading and commodity derivatives. The latter has become quite a hot issue. The increasing shortage of raw materials with increased competition on the world markets, first and foremost oil, and the risk of food crisis as a result of shortages of agricultural commodities, have created a strong motivation to do something in this area. As the EU has few raw materials of its own, there is a strong strategic interest to be not too much dependent on the price volatility induced through speculation.

At the same time there is an increasing financialisation of commodity markets and speculation, which boost price volatility and contribute to price bubbles. But the proposals under discussion are limited to transparency requirements and position limits. This will not stop the trend towards financialisation. Nevertheless, the lobby of the finance industry and of big commodity traders are very active in their quest to water down even these modest proposals.

Very similar is the situation for high-frequency trading. The basic idea here is to fix a ceiling for orders. A well-designed transaction tax would have more effect (see the next chapter).

2.8. A special case: the FTT

An interesting special case is the Financial Transaction Tax (FTT). This tax has been promoted by civil society and the UN since the second half of the nineties (at that time under the moniker ‘Tobin Tax’, which gave it some public prominence).

Although the FTT is not a panacea to solve all problems of the financial system, its regulatory potential is on the other hand often underestimated. The FTT cannot be reduced to an instrument to raise money, although its potential in this respect is considerable. But if well designed, the tax can have a strong regulatory effect, in particular on high-frequency trading (HFT). HFT means, that tens of thousands of transactions per day are executed, computer based and fully automatic. This business model has grown very quickly in recent years. It is completely

detached from the real economy and purely speculative and thus threatening to systemic stability. As it is completely computer based there are also specific technical risks, as documented by the so called flash crash in May 2010 at the New York Stock exchange, where the Dow Jones lost 9% in a matter of minutes. HFT is using small margins of a few basic points at every corner in the world 24 hours a day. If the FTT were to tax each of these transactions, the bulk of the business will probably collapse. If the FTT would meet the regulatory expectations, it would be a substantial contribution towards shrinking the trading volume.

The restriction on HFT is explicitly mentioned in the draft directive that the Commission submitted:

“Automated Trading in financial markets could be affected by a tax-induced increase in transaction costs, so that these costs would significantly erode the marginal profit, thereby affecting the business model of high-frequency trading, which can create systemic risks which may potentially be large as the recent crisis has revealed.” (EU, 2011b, p. 4).

But what makes the FTT an interesting case in our context is:

- the Commission has taken a U-turn in its position. During ten years all attempts to put the tax on the agenda were shot down. Even in spring 2011, Commissioner for Taxation, Algirdas Semeta, was speaking out against the FTT. In September he presented a draft (EU, 2011b), which was very close to the proposals made by heterodox economists and civil society (Details see: Wahl, 2011)
- civil society, in particular in the EU, has launched a massive campaign in favour of the FTT, which lead in several countries to strong media attention and a political debate.

An opinion poll by the official EU opinion research centre from Summer 2011 showed that 61% of citizens in the EU-27 were in favour of the FTT. In the Euro zone the figure was 63%. In several countries the support was even stronger: Germany 71%, France 69%, and even in the UK where the government was strictly opposing the tax, but where the civil society campaign was very strong, 65% of the people were in favour.

The Commission admitted that the strong support of the populace was an important factor in their change of heart. Nevertheless, the further

process still reflects several of the structural problems already mentioned in previous chapters:

- the lobby of the financial industry mobilised against the project, and used its influence over media and politics to stop it,
- the UK blocked the project together with some other countries (Sweden, Czech Republic) in the respective EU bodies.

As tax issues need unanimity, the Council had to officially declare that the FTT could not be implemented in the EU. Nevertheless, the efforts will continue in different framework, the so-called 'Enhanced Cooperation'. This is a procedure, in which a 'coalition of the willing' – at least nine countries have to participate – can implement a project in the legal framework of the EU. The German government has taken the lead to bring the coalition together and started the complicated procedure. It is worthwhile to take a glance at the procedure, because it is an instructive example of overly complex governance procedures:

- the nine (or more) partners have to agree on a common letter to be sent officially to the Commission. In some countries the national parliament has to be involved before the procedure can be started, in others not;
- in the next step, the European Parliament has to agree, that the procedure can be started;
- then the Council has to decide by qualified majority. This means:
 - a majority of 255 votes out of a possible 345 (= 73,9%) is necessary. As a reminder: the big countries (UK, D, F and I) have 29 votes each, Spain and Poland 27, Belgium 12 and so on until the smallest with 3 votes for Malta.
 - 62% of the population have to be represented in the majority.
 - If these criteria are not met, the proposal fails;
- if the vote in the Council is successful, the Commission gets directly involved and makes a proposal;
- then the countries that participate in the Enhanced Cooperation start to negotiate the details until they reach a consensus.

Another project on the basis of Enhanced Cooperation, which dealt with family rights, was negotiated over five years. The same procedure on patent rights took ten years. Nevertheless, the German government is optimistic and has put revenues from FTT in its draft budget for 2014.

As general findings to be drawn from this case, we can note that:

- civil society pressure and public opinion can have an impact on the reform process,
- the complexity of procedures to overcome the veto power of single governments is almost prohibitive,
- from the perspective of a state, the EU has many rules that are self-binding.

2.9. *MAD, naked short selling and some announcements*

Finally, there are some other projects underway or announced. *MAD* is the *Market Abuse Directive* (EU, 2011d). As the name already indicates, it deals with activities that are already defined as being openly criminal, such as insider trading, market manipulation and other fraudulent practices. Among others, the LIBOR scandal has underlined that this is not a marginal phenomenon. Most big international investment banks are presently involved in such practices and there is a torrent of lawsuits, most of them filed in the US. Of course, such a regulation is useful and should be endorsed.

There is also one specialised regulation on short selling. After the Lehman crash several European governments had temporarily banned naked short selling for some products. In 2010 the Commission also submitted a *Regulation* that banned naked short selling for all instruments. In addition, there are transparency requirements for covered short selling of CDS. In case of crisis supervisors should furthermore be authorised to also interrupt covered short selling of CDS and other instruments. The *Regulation* came into force in July 2012.

What is interesting about this measure is that bans in the financial sector had been generally considered in the years before to be “radical”, “old fashioned” or “Stalinist”. So far, the measure, although very specific, indicates a change of mind regarding such prohibition.

Some important areas for which no proposals have yet been presented, are the crucial issues of shadow banking and the problems of ‘too big to fail’ and resolution mechanisms.

As for shadow banking the Commission released a *Green Paper* on the issue in March 2012 (EU, 2012), in which a general analysis of shad-

ow banking is presented and a regulation announced. As the Financial Stability Board has also announced they will publish proposals on shadow banking by autumn 2012, the Commission is waiting for this document before a directive is drafted.

The same goes for a resolution mechanism, together with a European bank levy and a European resolution fund,¹¹ which had been announced by Barnier. The issue is, however, closely connected to the further measures in the context of the Euro crisis. If a new supervision system should be established (see section 2.2.2) these questions will come up. As they are linked with issues of distribution among member countries, the debate will be highly conflictive and the outcome is uncertain.

3. The glass is not half full, but it is a barrel

At first glance the list of reform projects is impressive, even if many of the projects are not yet implemented. From the point of view of a pragmatic politician, one could argue that things are on the right track and in the end, in perhaps five or ten years a new financial architecture will be in place. The financial industry is even speaking of a “Tsunami of Regulation” (Kirby, 2011). Of course, this is the coloured perception, seen through a lens of vested interests.

But it is true that something is better than nothing, and the law making machinery is working at full-speed. Nevertheless, the reforms are still too modest from the outset; they are too slow and come too late. In other cases they are so inefficient that even their architects are to soon replace them with new ones. In so far as we can tell there is no Tsunami of regulation, but a slight swell lapping at the beach of Finance capitalism.

But what are the reasons for this poor performance. Is it the inability of policy makers? Is it the strength of the financial industry and its lobby? Or something else?

¹¹ There are already national bank levies and funds in several countries, among others in Germany.

3.1. Structural incapability to master deep and multiple crises

The expectation that the EU will adequately regulate the financial system in the foreseeable future seems to be unjustified for several reasons:

- a. A first reason is the underestimation of the crisis and a biased analysis by the elites. Although there has been a more realistic approach since 2010 and a visible change of heart among some people, this alone is not enough to turn the tide. The hegemony of neo-liberalism is questioned, but not finished. There are still too many that believe the old system could be restored and stabilised. Barnier's slogan, that finance has to serve the real economy is right and a good soundbite, but its implementation requires far more consequences than the authors of the present reform programme imagine.
- b. The governance structures and procedures of the EU are of unique complexity. To deal with the tension between the supra-national level and 27 nation states leads to a general *modus operandi* of policy making, where change is only possible through slow incremental processes – at least if it should not be completely undemocratic. National interests, economic and political ones and also collective identities of populations are still such a strong factor that consensus becomes impossible when these interests are infringed substantially. Such a system cannot by its nature be flexible enough to react to extraordinary challenges. The EU is too complex to manage major crises.
- c. Further, it is not only a problem of 27 different countries. One of the most fundamental principles according to which the EU is designed is economic competition between the member states. According to neo-liberal belief, competition is the best way to growth, social welfare and general progress.¹² There is a special Commissioner for Competition. The competition laws are highly developed and unlike in other areas such as social or environmental, they are hard law, reinforced by sanctions. The European Supreme Court in Luxembourg has passed several sentences in recent years against labour and trade unions in the name of competition. If in the construction of the EU the contradiction between

¹² The EU has translated the principle of competition at micro-level, i.e. between enterprises, where it is useful in many respects, to the entire economy and, it could be said, even to society as a whole. Hence the social security systems, public services, public infrastructure etc. are pulled into a competitive marketplace, with disastrous consequences for the quality of life of the citizens.

integration and competition is built-in, one should not be surprised that at times when unity or even solidarity are necessary, this does not work. The neo-liberals are caught in their own trap.

- d. There are approximately 700 lobbyists active on behalf of the financial industry in Brussels.¹³ They dispose of considerable resources both in terms of money and highly specialised know-how. Potential countervailing forces, which could constitute a system of checks and balances, are very small in number. Of course, the EU is not the only place where lobbying is endemic, but the specificity of the EU governance with few and/or opaque mechanisms of control give wider scope for lobbying than in a democratic nation state.
- e. It is a feature of big crises that the time factor is of utmost importance to their effective management. If certain measures are not taken in time, the crisis gets worse. For instance, behind the background of a permanent and increasing pressure of speculative operations against Greece, Spain etc. it would be crucial to urgently implement the regulation of rating agencies and shadow-banking in order to put a stop to speculative attacks and the pro-cyclical effects of credit ratings. But given the present pace of reform, the situation is deteriorating daily and may reach a point of no return before appropriate regulation is put in place. The same goes for most other important areas of reform. If a house is burning, and the firemen start to discuss in length what they should do...

3.2. *The role of the Euro crisis*

However, the single most important factor to explain the meagre results of financial reforms is probably that there is not only a crisis in the financial system, but at the same time also the sovereign debt crisis. Both crises are inseparably interwoven with each other. The debt crisis puts the sheer existence of the Euro and the currency union into question with consequences that reach far beyond Europe. This is not the place to go in to the details of the Euro crisis and its links to the financial crisis. But the same contradictions that hamper a proper resolution of the financial crisis also dominate the management of the Euro crisis. And, of course, there is a strong absorption effect.

¹³ Figure from Lobby Control, *Wirtschaftswoche*, 31/10/2011: <http://www.wiwo.de/unternehmen/banken/bankenregulierung-finanzlobby-holt-zum-gegenschlag-aus/5782176.html>

Not only are the governmental bureaucracies of major countries at the limit of their capacity to deal with the crises, but more importantly, the attentions of the media, the public, opposition forces and also civil society are more and more captured by the drama of the Euro crisis. Therefore, public pressure for financial reform is weaker than three years ago.

3.3. What to expect?

The EU is a peculiar gathering of nation states that have reached a degree of supra-national integration on a (almost) completely voluntary basis that is historically unique. But the project is in the middle of its making. The integration has in some areas and to a certain extent gone beyond the nation state. Elements of supra-national governance have been established, but there is no fully-fledged system of governance in place that could equal the governance capacities of a nation state. In parallel, the nation state is still very strong, and so are national interests. These are even instigated through the neo-liberal principle of competition, which penetrates all pores of economic and civic life.

To use a metaphor, the EU could be said to be like a house under construction. The cellar, parts of the first floor and a garden house are already built and can be used provisionally. The second and third floor and the roof are still missing and there is no connection to the water supply or sewage system yet. The architect promotes competition between the different groups of workers to make them work faster. As long as the weather is nice, there is no problem. But if a storm (such as the financial crisis) should come along, things become more difficult and serious damage will be done to the unfinished building.

What does this mean for the near future? There is no fast and simple solution to the crisis, not one that is politically feasible and democratic anyway. The structural problems of the European governance system do not allow for any *modus operandi* other than slow and incremental change. This is not only a matter of individual capacities of elites, of their mentality as politicians or as representatives of vested interests, although these elements all play a role.

The existing structures and procedures have created a strong path dependency. This does not mean that there is no alternative. But it takes time to implement change and it is very difficult to make it real – at least as long as one does not want to give up democracy. This is why the crisis management in place is confined to muddling through.

The end is difficult to predict. It cannot be excluded that the Euro collapses, or that another wave of financial turmoil hits amid other dramatic events that may soon be played out on the European stage such as violent social clashes, a military coup and similar developments. In a game of chess a situation often arises where you think at first that you still have three or four options for your next move. But, then you realise: whichever move you choose, they all end in checkmate!

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