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Role of the EU in a New Global Financial System

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The current crisis has turned our attention to the tremendous inequalities in the global financial system.

It has become even more obvious that the *monetary hegemony* of the *US dollar* in the *global economy* is not well suited to the economic realities of the world.[1] The overwhelming American dominance in global markets has justified the dollar's success as the key reserve currency and for a long time it had no real competitor. But when a national currency serves as an international *reserve currency*, there are inevitable conflicts of interest between short-term domestic and long-term international economic objectives (Triffin dilemma). The dollar's exceptional function has played a huge role in distorting the global economy.

A further serious flaw in the current financial world order: the global institutional framework does not recognize the growing role of emerging markets and developing economies. Multilateral economic institutions still mirror a world dominated by developed Western countries.

Since newly emerging economies and the "Great Crisis" are reshaping the financial order, Europe has no choice but to adjust to these new dynamics. How should the EU proceed when integrating itself into the new financial order?

Europe has to cope with its internal problems and the changing external environment at the same time.

As for internal changes: the global economic downturn has had a catastrophic effect on the common European currency and several member states of the eurozone. This has proved that it is practically impossible to further maintain the common currency without fiscal policy coordination at the supranational level. Europe has a monetary union, but no fiscal union.[2] This has been viable as long as circumstances were favourable. Now that some member countries have difficulties and others must finance them, it seems more important than ever to institutionalize fiscal transfers within the eurozone.

Thus the crisis is not only a test, it may also represent an important opportunity: a chance to build a closer union. The sovereign-debt crisis could act as a catalyst to reopen negotiations on tightening fiscal ties between member states.

A sovereignty transfer in the area of fiscal policy would very probably not be accepted under normal circumstances because the determination of fiscal policy is an integral part of national sovereignty. Since most of the eurozone countries are already heavily indebted and need to cut on spending, it is virtually impossible any politician to become popular enough to persuade voters to support a plan of fiscal union. Taxpayers typically do not support both the payment of taxes and the loss of control over where they are spent. But as crises hit eurozone countries one after the other,[3] short-sighted public opinion may begin to realize the urgency of moving forward with fiscal integration.

A fiscal union would not solve all EU problems but would definitely calm markets[4] and clarify European intentions, in particular when journalists are writing more and more frequent articles on the disintegration of the eurozone.

Financial supervision, which became stricter in the Union from the beginning of this year, represents an important step forward.[5] In order to "help prevent future financial crises", several new authorities have started monitoring Member states' micro- and macro-

[1] The primacy of the US dollar is due to several factors that facilitated its emergence after the 1970s: abandoning the peg of the dollar to gold, the denomination of oil in dollars after the oil crisis, and the deregulation of global financial markets resulting in cross-border capital flows.

[2] Interview with Niall Fergusson Harvard professor on CNBC, published : 13 July, 2010, source: http://finance.yahoo.com

[3] The Greek and Irish bailout was followed by Portuguese difficulties while Spain, Italy and Belgium are also facing acute problems

[4] The European Financial Stability Facility (an emergency fund worth *750 billion euros*) was supposed to perform that task but investors simply did not believe it was financially stronger and politically more unified than the eurozone

[5] Commission adopts legislative proposals to strengthen financial supervision in Europe, Brussels, 23 September 2009, http://europa.eu

economic prudence in the framework of the European Systemic Risk Board (ESRB) and the European System of Financial Supervisors (ESFS).[6] Policymakers are trying to build a more solid, robust European economic system that should respond better when placed in jeopardy.

Sanctions must also be introduced: for countries who breach the Stability and Growth Pact, ECOFIN has agreed to suspend voting rights in the European Council. There are several other proposals on the agenda: impose "interest-bearing deposits" on countries that make insufficient progress consolidating their public finances under a favourable external economic climate. On the other hand, Member states that accumulate large surpluses could spend more during crises without having to face excessive deficit procedure. Cohesion Fund payments could also be suspended in countries that repeatedly breach the Stability and Growth Pact.[7]

Another important element of a future fiscal union is the bond market. The most recent proposal is the establishment of a federal eurozone (joint government) bond, or European bond (E-bond) market. A common bond market would have to be centrally coordinated and backed by joint guarantees from the participating euro-area Member states. This would help reduce currently high borrowing costs. Jean-Claude Juncker, Luxembourg's prime minister and chairman of the eurozone finance ministers group, and Giulio Tremonti, Italy's finance minister, proposed the establishment of a European Debt Agency to issue common bonds. Writing in and article published in the Financial Times, the pair stated: "The European Council could move as early as this month (December, 2010/*Zs.B.*) to create such an agency, with a mandate to gradually reach an amount of outstanding paper equivalent to 40 per cent of the gross domestic product of the European Union and of each Member state…We believe this proposal provides a strong, credible and timely response to the ongoing sovereign debt crisis." But the proposal has met with resistance from Germany and several euro area countries with a strong fiscal position. Angela Merkel is not willing to take participate in financing other eurozone members — at least not yet. The German chancellor has also pointed out that the creation of a European bond market could lead to further fiscal negligence among eurozone member countries.

Creating a centrally coordinated joint bond would also have the effect of promoting the euro as a reserve currency. With a deep, complex (liquid and large enough) common bond market, the euro could represent an alternative to the US dollar in world financial markets. Instead of relying exclusively on the US dollar, and thus the US economy, emerging markets exhibit strong interest in a multi-polar world based on more than one currency. China, for example, has already bought bonds from several Eurozone members (Greece, Portugal, Spain). Most likely, China, as well as every country that has huge foreign currency reserves mostly denominated in dollars, would be willing to buy Eurobonds. If Eurobonds were able to supplant U.S. treasuries on the market, the EU could play an active part in reshaping the global financial landscape and help solve imbalances resulting from dollar hegemony.

In addition to the rise of multiple reserve currencies, a multi-polar financial system also requires steps toward a realistic representation of both developed and emerging economies in multilateral organizations. Taking the IMF as an example, if the EU wants to keep pace with recent developments,[8] it must act according to new dynamics. European countries have already agreed to give up two of the eight or nine seats they control and shift 6 percent of their voting rights to dynamic developing economies. Europe could further recognize recent power shifts with a proactive symbolic gesture: renouncing the title of managing director (traditionally a European position) in favour of the developing countries. By fostering changes, Europe could prove its devotion to multipolarity. And in return of giving up the title, it could pave the way for friendly cooperation with the future giants of the world economy.

One thing is sure: the crisis has only accelerated the decade-long power shift in world economy. For the European Union, the crisis has brought to light flaws in the monetary union that were previously less apparent. However, as noted above, this may well turn out to be an opportunity rather than a calamity.

As Ambrose Evans-Pritchard wrote recently in the *Telegraph*, the "architects [of the European Monetary Union] were well aware that a one-size-fits-all monetary policy for vastly disparate nations would create serious tensions over time. They gambled that this would work to their advantage. The EU would be forced to create new machinery to safeguard its investment in the euro. It would be a 'beneficial crisis,' bringing about the great leap forward to full union. We are about to find out if they were right."

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[6] There will be a European Banking Authority (EBA), a European Insurance and Occupational Pensions Authority (EIOPA), and a European Securities and Markets Authority (ESMA).

[7] Brussels tables plans for closer EU economic union, published: 12 May 2010, www.euractiv.com

[8] *E.g.* in the IMF, "BRIC" countries (Brazil, Russia, India and China) will be promoted to the ranks of the Fund's top 10 shareholders, while China's share will rise to the third place from its previous sixth position