



The EU and the Global Financial Crisis

By the Senior Experts Group

Background

The banking crisis, which began in 2007 on a relatively small scale and which became the largest such crisis since the 1930s in the autumn of 2008, was the prelude (alongside a sharp rise in commodity and food prices) to a downturn in the global economy which will have serious consequences for EU Member States. Although the international institutions most directly concerned with the world's financial systems are the International Monetary Fund and the World Bank, the European Union has had a significant role to play in responding to the financial crisis and will continue to do so as it supports Member States through difficult economic times.

The Events of 2007/08

From the spring of 2007 a number of incidents arose of banks in difficulty. Primarily this was in the UK and the USA and was the result of over-exposure by the banks to unreliable mortgage debts. This problem was extensive within the United States, where so-called "sub-prime" mortgages had grown significantly in number in recent years but whose weakness as assets was exposed by a down-turn in the US economy and the resulting rise in the default rate. Interbank lending is now so widespread that it was hard for institutions to identify the extent of their exposure, compounding doubts about the financial health of banks. Identification was made more difficult because these sub-prime loans were "securitised", i.e. parcelled up together, and widely distributed. Consumer and business confidence was falling by early 2008 in many industrialised countries, although property prices in some remained exceptionally high.

Rising commodity prices in the five years up to 2007 reflected a number of factors but were particularly driven by the overall strength of the global economy and the exceptional year-on-year growth of the Chinese economy. Other emerging economies also performed strongly over this period (notably Brazil and India) and this exceptional economic growth coupled with a rising global population of an additional 70 million people a year, created shortages of commodities that in turn triggered inflationary pressures. The increase in some commodities was wholly exceptional: in the case of metals, prices rose 150 per cent in five years – the largest such increase over the last century for this commodity.¹ Rising oil, gas and food prices were a significant element in the rise in commodity prices, with a spike in oil prices in the period 2006-2007 and the first half of 2008.

Strong domestic demand in many industrialised countries both fuelled the shortages of commodities and the rise in energy prices but also generated potential banking and debt problems because in the UK, Ireland, Spain and the USA particularly, much of the retailing and service sector boom was driven by the ease with which credit could be accessed. Much of this credit was borrowed against property in the form of re-mortgages, exploiting the large rise in property values. The property boom was particularly pronounced in the UK, Ireland, Spain and the USA.

“Most major banking crises in the past 25 years have occurred in the wake of periods of extremely fast credit growth” (as three IMF economists have put it). On this occasion lending institutions were encouraged to do so because the Federal Reserve kept interest rates very low as the housing bubble inflated. Corporate and personal debt increased sharply (in the UK as well as the US). Five years ago the UK had a personal debt mountain of £880 billion (£15,000 for every citizen in the country). Since then it has continued to rise from around 60 per cent of GDP in 1998 to nearly 90 per cent a decade later.² In parallel, the regulatory environment had been weakened in a number of countries.

The chronology in the Annex lists the key events of 2007/08, beginning with the liquidity problems of Countryside Financial in the US in August 2007 and the similar difficulties at Northern Rock in the UK a month later. A detailed analysis of these events is outside the scope of this paper which largely focuses on the response of the EU and its Member States to the crisis that developed.

The Financial Crisis in the EU

The effects of the financial crisis were felt across the EU, even though exposure to poor mortgage assets was not as bad in some Member States as in the UK. The vulnerability of banks in a global financial system was exposed by the crisis; several European banks had acquired US-based assets whose value had to be substantially marked down in 2007 and 2008. The presence of these “toxic assets” contributed to a loss of confidence within the banking system as banks became reluctant to lend to one another, causing a dramatic loss of liquidity and a sharp rise in interbank lending rates.

The main difficulties for financial institutions were in the UK, Germany, the Benelux countries and Ireland. Although the exact nature of each institution’s problems varied, broadly the difficulty was a shortage of liquidity in the banking system. In the UK poor mortgage assets triggered a crisis of confidence in banks and property loan lenders, making it difficult for some institutions to borrow and requiring Government intervention to ease liquidity difficulties.

The sudden loss of confidence in the Irish banks on 29th September 2008, when their shares plummeted in value, generated a new problem over deposit protection schemes. Anxious to protect its banking system, the Irish Government announced that it would guarantee all deposits at the Irish banks - far exceeding the deposit guarantees in other eurozone countries (as well as in the UK) - thus creating an incentive to move funds to Irish banks. This unilateral action offended other eurozone governments and served only

to raise fresh doubts about the stability of banks elsewhere. In response, some other countries gave similar guarantees.

Late September and early October 2008 saw a series of problems with financial institutions. In Germany the Government had to step in to prop up a mortgage lender, Hypo Real Estate, and the Benelux countries had to work together to stabilise the over-extended Fortis Bank. These difficulties, although serious in themselves, were resolved relatively quickly although the Hypo Real Estate problem did contribute to wider fears about the stability of the banking system at a key moment in the crisis.

The problems faced by Hungary were of a different type and on a different scale. The Hungarian Government had been seeking to reduce the level of public debt after many years of high spending but had failed to do so sufficiently. Many Hungarians had borrowed abroad for personal and housing loans because interest rates were lower in the eurozone (for example) than in Hungary, creating a significant foreign currency debt that was now a liability because the previously stable Hungarian forint had fallen substantially in value. Hungary was also burdened by high social security costs and had failed to implement the free market reforms introduced in other former Communist countries in eastern and central Europe. The solvency of the country was at risk.

Financial Problems in the EU Neighbourhood

Several countries in the EU neighbourhood experienced severe problems. One of the most serious was in Iceland where a banking crisis resulted from the inability of a small country to stand by its excessively large banking debt at a time when interbank lending had largely ceased. The difficulties in Iceland were exaggerated by the fragility of its currency in international money markets because of the small size of the country.

Russia too faced major difficulties. On several occasions in September and October 2008 the Russian stock market had to be closed, sometimes for several days, as equity markets experienced a sharp loss of confidence. This reflected the dependence of large Russian businesses on international debt arrangements, uncertainty created by Russia's sometimes confrontational foreign policy and most particularly, the dramatic rise and then equally dramatic fall in oil prices. With the dollar price per barrel of oil falling by more than half between its peak in May 2008 (\$147) to less than \$70 in mid October (and the low to mid \$50s now), Russia found herself brutally exposed by her dependence on energy exports.

In Ukraine falling income from exporting commodities – on which its economy is heavily reliant - and the withdrawal of foreign capital from its property and service sectors contributed to a major financial crisis in autumn of 2008. Foreign lenders were unwilling to provide loans and Ukraine experienced both falling equity markets and a banking liquidity crisis.

The EU Response to the Crisis

The crisis exposed the extent to which the financial services system is now global. Expectations of what the EU could achieve collectively were excessive. Maintaining the stability of the banking system is a matter for Member States although the Maastricht

Treaty - which established it - said that the European Central Bank (ECB) should “contribute to the smooth conduct” of policies pursued by national institutions relating to “the prudential supervision of credit institutions and the stability of the financial system” in the eurozone (Article 105). But the ECB is not a treasury – it does not have the financial resources to bail out institutions in difficulty – and that role remains with Member States whether they are in the euro or not.

The ECB, working with other European central banks, played a relatively effective role in the early stages of the crisis through its major injections of liquidity in the market. But the political response was less decisive and – certainly at the beginning – less effective.

The French Presidency’s decision to call a meeting of the EU countries that are also in the G8 (Germany, Italy and the UK) at the beginning of October 2008, whilst excluding all other Member States, caused bad feeling and contributed to market instability the following week as it looked as if Europe’s political leaders were faltering in the face of the crisis just as America’s had the previous week.

Calls for recapitalisation of the banks in the UK and the decision of Gordon Brown’s Government to adopt that approach helped to turn round the situation. At the eurozone plus the UK summit the following weekend, agreement was reached that Member States should recapitalise their financial institutions, as the British proposed to do. Coupled with a promise to guarantee interbank lending, this provided a way forward that reassured the markets. The full European Council endorsed that approach a few days later and interbank lending rates did fall slightly.

The EU’s endorsement of bank recapitalisation helped to give credibility to the idea and encouraged the US to take the same approach as part of its package of stabilisation measures.

The EU was criticised in some quarters for not acting to bail out banks but it did not have the resources or the mechanism to do such a thing. To have tried to create such a facility in the middle of a major crisis would not have been either practical or probably politically achievable as Member State governments might have found the idea of using their own funds to bail out other countries’ banks hard to sell to their electorates. Pressure for greater regulation and a true single market in financial services will however have been increased by these events. In particular, although financial services regulation has been an area of controversy within the EU, there are likely again to be calls for a single EU financial services regulator

The close relations between EU Member States may have helped to resolve some cross-border banking difficulties, such as those of Fortis, where the relevant governments were able to collectively deal with the problem. This was an example of the informal bonds created by EU membership - rather than its formal institutions - being invaluable in a crisis.

The EU collectively responded positively to problems within its Members, particularly Hungary, which received large-scale financial support from the IMF, the World Bank and the EU in order to stabilise its economy. The European Investment Bank agreed to make €30 billion available to small and medium-sized enterprises.

The European Council was less sympathetic to Iceland, whilst it expressed its “solidarity” with the EEA member it also said that it expected Iceland to “honour its international commitments”.³

The Economic Consequences of the Financial Crisis

Meanwhile, the EU was starting to prepare for the recession that is now inevitable. The Commission was asked by the October 2008 European Council to bring forward proposals to support growth and jobs and “in particular to preserve the international competitiveness of European industry”.

These economic measures will run alongside work to reform the international financial system. Here the EU envisages working with third countries and with the international financial institutions.

G20 Summit

Leaders from 20 of the world’s biggest economies met in Washington on 15 November 2008 to discuss the financial crisis and its aftermath. They broadly endorsed the need for a fiscal stimulus by individual countries in response to the onset of recession. They emphasised the need to avoid protectionism and to achieve a positive outcome to the Doha trade round by the end of 2008. They also agreed that reform of the international financial regulatory system was needed, including the creation of colleges of regulators to ensure co-operation. Finally, they agreed to meet again in the spring of 2009 in order to take forward the work of regulatory reform. That meeting is quite likely to be held in the UK.

Political & Wider Consequences of the Crisis

It is too early to make anything other than a provisional assessment of the consequences of the 2007/08 financial crisis. It is still far from certain that the worst of the credit crunch is over. The imbalances in the world economy remain dangerous, particularly the huge US current account deficit and the consequent borrowing to pay the interest on the money loaned to the US in order to finance it. There are implications in the short and medium-term for the European economy as the US downturn leads to reduced demand and the credit squeeze reduces consumer confidence and economic growth. A period of economic difficulty is unavoidable; the question is how long it will last and what measures the EU can take to keep it as short as possible.

There are questions about eurozone stability, as the criteria for deficits laid down in the Stability and Growth Pact have not been met. Some eurozone countries, for example Greece, have been failing to balance budgets for some time and this is reflected in the poor rating these countries’ government bonds receive in the market place. Failure to resolve these difficulties could put the euro under pressure in international markets.

At the same time, there are also calls in the Nordic countries for their governments to reconsider joining the euro. The Danish Government has said the idea should be considered and even in Sweden, where membership was rejected in a referendum some years ago, support for euro membership has been growing. Pressure in Iceland for it to join the eurozone as a safe-haven has led to increasing demand for it to apply for membership of the EU. The vulnerability of small states' currencies has been exposed by the financial crisis and will make joining the euro a more attractive proposition, but eurozone members may be reluctant to take in new members in present circumstances.

The financial crisis will produce new uncertainties of many kinds. Will Irish attitudes towards the Lisbon Treaty be affected? Will the crisis lead to agreement on further EU-wide financial regulation? Will the Russian Government become more or less cooperative? Will it become easier to complete the Doha Round – or completely impossible? The crisis presents the EU with many challenges. Will it rise to the occasion or lapse into still worse divisions? This paper is only an interim report.

Annex: Chronology of key events in the financial crisis

The problems began in late 2006 in the United States when the rise in the number of mortgage foreclosures began to expose the scale of poor lending decisions to home owners. In 2007 foreclosures increased and a shortage of liquidity developed as the market for mortgage-backed securities in the US banking sector collapsed.

- 16.08.07: US bank Countrywide Financial experiences liquidity problems, leading to a run on the bank; the Federal Reserve intervenes by accepting mortgage-backed securities to aid liquidity; Countrywide sold to Bank of America in January 2008.
- 14.09.07: Northern Rock receives liquidity support from the Bank of England as it is unable to raise funds; run on the bank commences.
- 17.09.08: UK Government guarantees all deposits in Northern Rock and halts run;
- 22.02.08: Northern Rock nationalised after no buyer comes forward.
- 11.03.08: US Treasury introduces a new facility to allow banks to use mortgage-backed securities to be used to obtain Treasury notes worth a total of \$200 billion.
- 14.03.08: Bear Stearns, fourth largest bank in the USA, given loans by JP Morgan Chase and later acquired by them.
- 21.04.08: Bank of England announces it will accept a range of mortgage-backed securities in exchange for liquidity for banks.
- 07.09.08: US Federal Housing Finance Agency takes control of two US mortgage backers, the Federal National Mortgage Association (Fannie Mae) and the Federal Home Loan Mortgage Corporation (Freddie Mac) to prevent their possible collapse.
- 14.09.08: It was announced that Lehman Brothers would file for bankruptcy after US Treasury Secretary Henry Paulson declines to bail it out.

- 15.09.08: Global stock market turbulence, repeated two days later, sees dramatic fall in equity values.
- 16.09.08: Merrill Lynch sold to Bank of America; equity markets fell with Dow having its worst day since September 2001; Bank of England injected £5 billion into the banking system; US insurer AIG asks the Fed for \$45 billion of liquidity.
- 18.09.08: Lloyds TSB announce takeover of HBOS.
- 19.09.08: US Treasury Secretary announces a plan to stabilise the banking system by buying up the most difficult assets of banks using public money. The Troubled Asset Relief Program envisages the purchase of up to \$700 billion of assets. This “bail out” is widely discussed and soon criticised because of the lack of detail provided as to how it would operate in practice.
- 24.09.08: President confirms details of the bail out plan.
- 25.09.08: Congressional leaders meet with the President, Senator Obama and Senator McCain to discuss the bail out package but the meeting breaks up without agreement.
Washington Mutual, the largest savings and loan corporation in the US is taken over by the Federal authorities and most of its assets transferred to JP Morgan Chase.
- 28.09.08: Congressional leaders announce tentative agreement on bail out plan.
- 29.09.08: US House of Representatives unexpectedly rejects the bailout plan. Dow Jones falls by eight per cent, its largest drop in a single day since “Black Monday” in October 1987.
Collapse in the value of bank shares on the Irish stock market.
Bradford & Bingley nationalised and its retail savings arm transferred to Bank Santander.
Icelandic Government announces intention to nationalise Glitnir; this triggers worldwide reports of liquidity problems in the Icelandic banking system.
Governments of Belgium, the Netherlands and Luxembourg purchase 49 per cent of banking and insurance company Fortis and oblige it to sell its stake in Dutch bank ABN.
- 30.09.08: The Irish Government announces that all deposits in Ireland’s main banks and building society are guaranteed for two years.
US stock market drops 777 points in a single day – its largest ever single-day drop.
- 06.10.08: EU ‘big four’ meeting in Paris – leaders of France, Germany, Italy and the UK. German Government rescues major property lender Hypo Real Estate.
- 07.10.08: ECOFIN meeting agrees action plan to deal with financial crisis
Russian Government announces 950 billion rouble loan facility for Russian banks.
European Commission announces that it will shortly publish guidance on bank recapitalisation and state aids/competition issues.
- 08.10.08: Co-ordinated half-point cut in interest rates by several central banks, including those of the US, UK, Sweden, Switzerland, Canada and the ECB.
UK Government announces £50 billion will be available as part of a package of finance to recapitalise the UK banking system. Eight banks and one building society agree to take part in the scheme. The Bank of England announces that a

further £200 billion would be available to banks under its Special Liquidity Scheme.

- 10.10.08: Equity markets plunge as fears of global recession grow; the G7 meeting of finance ministers and central bank governors in Washington issues declaration promising “decisive action” to deal with the financial crisis.
- 11.10.08: G7 meeting Washington DC agrees to take all necessary measures to support the banking system and in particular to ensure that banks are fully capitalised and the secondary mortgage market can function properly.
- 12.10.08: Eurozone Heads of Government meet with the UK Prime Minister and promise to act “in a decisive and comprehensive way” to tackle the banking crisis.
- 12.10.08: Hungary requests assistance from IMF and EU.
- 15.10.08: G8 statement
European Council begins October meeting in Brussels.
- 16.10.08: European Council agrees to establish a co-ordinating group in Brussels (the financial crisis cell) to exchange information and act as an informal warning mechanism to EU institutions and governments. The Council endorsed the decisions of ECOFIN and the eurozone summit the previous weekend.
- 17.10.08: French bank Caisse d'Epargne announced losses of £500 million as a result of trading errors in derivatives the previous week.
- 22.10.08: Belarus and Pakistan request help from IMF.
- 24.10.08: IMF loan package agreed for Iceland.
- 26.10.08: IMF loan package agreed for Ukraine.
- 27.10.08: G7 finance ministers and central bank governors statement on the yen.
- 28.10.08: IMF, EU and World Bank package worth £15.6 billion announced.
- 28.10.08: Dutch Government injects €3 billion into insurance giant Ageon.
- 15.11.08: G20 Summit in Washington DC agrees that countries should pursue fiscal stimuli where they can in order to slow the downturn; agree that reform of international financial institutions is necessary; and that there should be agreement on the Doha trade round by the end of 2008.

¹ *Reserve Bank Bulletin*, Reserve Bank of Australia, April 2007.

² *The Independent*, ‘Credit boom may end in bust for UK housing market’, 05.08.03; and Bank of England *Financial Stability Report*, October 2008, p.7.

³ Presidency Conclusions, European Council, 16.10.08, p.5.