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Policy Analysis in a Changing World

EUROPEAN FINANCIAL REGULATION AND EUROPEAN ECONOMIC RECOVERY

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CONFERENCE REPORT

The Director of the Federal Trust, Mr Brendan Donnelly, opened the conference by addressing the focus of this conference, financial regulation and the European economic recovery. This symposium forms part of a series, co-funded by the Representation of the European Commission in London, which examines the new UK liberal-conservative coalition government's positions and policies towards Europe.

The first speaker, **Mr Benjamin Angel,** from the European Commission Directorate General for Economic and Financial affairs, briefly discussed three main issues, namely the roots of the global financial crisis; the EU response in terms of financial regulatory measures; the sovereign debt crisis and the financial safety nets that the EU Member States are in the process of establishing; before finishing with a few reflections on improving European economic governance. Mr Angel pointed to a combination of several macroeconomic and microeconomic failures that lay at the heart of the financial crisis in 2008. Macroeconomic deficiencies included an "abundance of global liquidity"; a spectacular growth in the abundance of credit which fuelled a "real estate bubble in the US, UK and Ireland" and finally dysfunctional national financial supervisory bodies, which remained too "national in focus." Microeconomic deficiencies consisted of excessive securitization, opaqueness of Collateral Debt Obligations,"conflicting interests of credit rating agencies"—which according to Angel were unable to provide accurate ratings for complex securities and provide self-defeating advice to financial institutions on how to improve their credit rankings—"incentives for short term risk taking" and finally the lack of focus of banks on the liquidity of their balance sheets versus their solvency—in which context Mr Angel remarked that Northern Rock had been solvent the day before it collapsed.

Mr Angel then went on to enumerate the actions that the EU has taken to regulate the European financial markets, which have consisted of four main priorities: firstly, to develop a more efficient financial supervisory framework— consisting of macro and micro prudential European supervisory authorities, which will be functional from January 2011; secondly, to increase liquidity in the financial banking system— through coordinated actions in line with new measures agreed at the Basel III Accords that include the introduction of leverage and short term liquidity ratios and new requirements with regards to capital buffers; thirdly to extend the parameters of financial regulation and supervision—which include new proposals on credit rating agencies (separating credit and advising functions), regulating short selling, derivatives,

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and deposit and insurance guarantee schemes—and finally to "ensure financial stability" in terms of improving overall transparency of the financial sector, creating crisis management mechanisms (insolvency and resolution funds), enhancing safeguards for consumers and providing European stress tests for banks.

Mr Angel then discussed the safety nets that the EU has put into place to overcome any future sovereign debt crisis, such as the enhancement of the Balance of Payments Support arrangements and the creation of the European Financial Stability Mechanism and the European Financial Stability Facility. Mr Angel then concluded with remarks on current EU efforts to consolidate gaps in European economic governance—as witnessed by the creation of a European Task force under Herman Van Rompuy to report back to the European Council on a package. It will deal with four main issues to include the establishment of a "European Semester" for policy coordination between member states, the resolving of macroeconomic imbalances [sanctions in case a member state fails to tackle the issue], quicker sanction mechanisms for member states deviating from fiscal targets and the reduction of overall percentages of debt to GDP of Member States, [which have shot up well above the 60% GDP laid out in the EU treaties].

The second speaker **Mr Graham Bishop**, an independent analyst of European financial affairs and founder of grahambishop.com, began by praising the "commendable speed" at which the EU and the USA have embraced financial regulatory reform, before asking whether the De Larosière report [that formed the basis for the EU's Financial Supervisory Package agreed last September] would reach different conclusions today from those it reached nearly two years ago. In particular he raised six issues for debate, namely whether: (1) states could remain the "guarantor" of the financial sector when questions over their own solvency loom and if not, who could bail out the banking sector; (2) the derivatives system should be completely overhauled, given the risks it poses to nation states, as it does constitute a high proportion of their GDP debt exposure; (3) EU member states and their financial systems could survive economically if a catastrophic "non economic event" were to occur—noting that the ESRB would only provide economic, not political, systemic risk warnings (4) a private centralised credit agency authority would be better suited to providing "suitable measures of credit worthiness" [as envisaged by the Financial Stability Board]; (5)"fair value", currently the American approach, is a good accounting mechanism for the financial sector—to judge companies given it may act as a potential disincentive for long term innovation; and finally (6) the banking sector can meet the overall costs of adapting to the new financial regulatory regimes, noting that the banking sector will continue to function under the moral hazard of a "too big to fail" taxpayer bailout issuance policy for at least the next few years.

Mr Bishop then concluded with a brief discussion of the recent European Council conclusions, calling for a treaty change to improve the economic governance of the Eurozone. This treaty change would, he contended, if agreed and implemented, "send a torpedo" through the Basel III accords: central to those accords had been the absolute creditworthiness of national government debt—a concept put in question by the proposed treaty change.

The third speaker Sir Brian Unwin, former president of the European Investment Bank, discussed major EU policy issues that the new UK coalition government [may] face; namely, (1) financial regulation, (2) the 2011 EU Budget and finally (3) economic governance reform of the Eurozone. Sir Brian

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began by underlining that “light touch” regulation lay at the heart of the 2008 “financial debacle” and stressed that there was a need for the regulatory “overhaul” of the financial sector at the trans-national level” as a necessary “precondition for putting the house in order.” He pointed to “the experience of Canada, that enjoyed stringent regulation and whose banks came out relatively unscathed” and dismissed the claims of free-marketeers—such as the Institute for Economic Affairs’ recent claim that “judging by the thousand of paragraphs and pages in the FSA regulatory rulebook, the UK financial sector was over-regulated.” Sir Brian then commended the new UK liberal-conservative coalition government for playing a more cooperative role with its EU partners than he, and many analysts, had feared a new Conservative government might have done had they won outright in the 2010 General Election. He emphasised that securing sufficient European financial regulation is part of “completing the Single Market” and that the UK should participate in this process as a means to contribute to the economic recovery of the Eurozone—even if this process, as Sir Brian noted, is still in its early stages. Sir Brian then highlighted the imperative for the EU Financial regulatory framework to remain in line with the objectives set out in Basel III Accords and the G20 summits. Nonetheless, he noted the potential stalling of US regulatory reforms—due to an “enfeebled president” in the new configuration of a divided Congress after the recent US midterm elections—as a setback for achieving trans- national regulatory reform.

Sir Brian remained sceptical about the new UK government’s confrontational approach to negotiations for the EU 2011 Budget, describing the “negative rhetoric” of the UK government reported in the British media as deeply harmful to British relations with its EU partners. Although Sir Brian praised the Prime Minister’s efforts to “accept a comprise”, [i.e. a freeze equal to a 2.9% increase in the 2011 EU Budget] “and avoid direct confrontation”, Sir Brian lamented that he did not point out to the British public, “so bombarded by misinformation about Brussels bureaucracy and profligate spending, that the principal priorities of the 2011 European Budget, are measures to boost economic recovery, such as research, innovation, technical development, transfer and energy networks —all of which are or should be priorities for the British government itself”. Furthermore, Sir Brian also noted that the “Budget will entail a freeze on nearly all staff recruitment in Brussels” [which should please Conservative backbenchers] and the “Budget provides for a 7% increase in environmental protection”, which Sir Brian wished was the case” in Britain.

Sir Brian concluded by referring to British isolation from the economic governance reforms currently being conducted by Eurozone partners. Noting Britain’s dependence on exports to the Eurozone, Sir Brian commented that Britain’s non-membership of the Eurozone hinders the UK government’s ability to play an active role in re-structuring Eurozone rules to favour Britain.

The final speaker, **John Stevens,** former Conservative MEP laid out the reasons for why the UK government should pay greater attention and be an active participant in the new financial regulatory regime developing at the EU level—given Britain’s pre-eminence as a financial centre in Europe and given Britain remains highly dependent on trade exports to the EU. Mr Stevens observed that the UK’s recent defence pact with France demonstrates how isolated the UK finds itself in most EU policy areas given it is not part of the Eurozone. John Stevens remarked that fears that the Eurozone would fall apart are “now gone” given “Germany’s intent on sustaining

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the Euro" with a strengthened European governance framework. Furthermore, he commented "the more severe the crisis, the greater the development of a "European identity."

Observing that the entire economic fortunes of the UK remain linked to the Eurozone, Mr Stevens noted that it is in the Britain's interest that the Eurozone recover. However, he observed that Britain's status outside the Eurozone means that the UK plays no part in the process of strengthening the governance of the Eurozone. Mr Stevens concluded that if the UK government is keeping any option of joining the euro open, then any measure to reform the European governance of the Eurozone will matter to Britain and thus the UK government needs to clarify its approach to this issue.

On a side note, Mr Stevens indicated that the UK's opting out of the common fund in the Eurozone bailout could lead to an odd situation—and potential "fault line. The bailing out of British banks based abroad could make Britain's semi-detached status from the Eurozone unsustainable. Mr Stevens also warned that the UK, as a country that has benefited enormously from the globalising effects of international trade over the last two decades, could face the risk of an ever increasingly "hostile" environment in what he sees as a global trend towards "regionalism" on the world stage with competing protectionist trade blocks.

In the Q & A session, questions were raised about an exit strategy for Eurozone members to leave the Euro (e.g. Greece) and whether the EU was considering a European equivalent of the Glass Steagall Act. Other questions arose about the Europe 2020 strategy, the 2011 EU Budget, the European External Action Service (EEAS) and the recent British French Defence agreement—in particular as to whether the latter constituted a step towards enhancing British involvement in ESDP.

In concluding remarks the chairman of the Federal Trust, Brendan Donnelly commented on the politics of the 2011 European Budget, the Europe 2020 strategy and the EEAS before thanking the European Commission Representation in London for part-funding this conference.

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Christophe Singh

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