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The Impact of Lax Financial Regulation on the Euro Crisis

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ABSTRACT
A loose financial regulatory framework that was especially susceptible to outside shocks was the root cause of the euro crisis. Despite the establishment of supranational regulators by the European Union following the crisis, institutions encountered issues with overlapping regulatory functions and limited authority. Poor regulation, which ultimately caused the financial system to collapse due to the influx of risk money, is exemplified by the Irish financial crisis. With the implementation of an embedded regulatory system, the creation of a single regulatory mechanism, and other actions to improve the stability of the financial system, the EU has now advanced in the field of financial regulation. To collaboratively create a more resilient and effective financial system in the future, however, it will be essential to improve international collaboration and make clear the roles and responsibilities of regulators.

KEYWORDS
Financial Crisis; Financial Regulation; European Union

1 Introduction

The adoption of the euro in 1999 was a significant turning point in the European monetary union effort, and it resulted in remarkable accomplishments over the following ten years. A severe financial crisis silently swept throughout Europe as its citizens celebrated the euro's tenth anniversary[4]. The crisis exposed the weakness of the global monetary system in addition to impeding the euro's long-term stability and profitability.

The European economy exhibited a rising tendency for a considerable amount of time following the creation of the euro, and affluence and economic expansion became the norm. In light of this, European regulators progressively loosened their oversight of the financial markets, maintaining the idea of a "free market and free financial system." As a result, the market environment in Europe is comparatively permissive. But there were also possible drawbacks to this loose strategy, which made Europe more susceptible to outside shocks. In particular, Europe's lack of an efficient early warning system and regulatory mechanism caused it to fail to take prompt countermeasures when the financial crisis broke out in the United States, which exacerbated the crisis's spread.

While there are other factors that contribute to a country's crises, the example of Ireland offers a sobering reminder. Lax regulation in Ireland allowed a lot of risk capital to enter the nation, which fueled a fictitious boom in the financial and real estate industries. But there is a serious risk associated with this affluence. The entire financial system may collapse as a result of a chain reaction that starts when market volatility occurs.

In post-crisis Europe, amid growing skepticism towards the euro and a macroeconomic downturn, policymakers and stakeholders engaged in a thorough reassessment of previous regulatory shortcomings and recognized the critical importance of reinforcing financial regulation. The EU's financial leadership promptly prioritized financial regulation and stability in policy formulation, with member states responding proactively by initiating reforms to their financial systems. However, due to historical, cultural, and economic disparities among countries, their regulatory frameworks exhibit significant variations. These differences not only complicate regulatory harmonisation but also present substantial challenges in addressing cross-border financial risks.

Clearly, loose financial regulation is one of the main reasons for the outbreak of the eurozone crisis. Therefore, after the crisis erupted, research on financial regulation has become a focus for academics and policymakers. This paper aims to explore this area in depth and is divided into three parts: firstly, it analyzes the obstacles and challenges encountered by the EU in financial regulation; secondly, it takes Ireland as an example to explore the severe consequences of lax regulation; and lastly, it identifies the problems in the current EU regulatory system and offers suggestions for improvement, providing useful references and lessons for future financial regulatory reform.

2 Why is regulation difficult for the EU?

A recurring point of discussion and consensus among scholars is that EU regulators have long faced a lack of political power when formulating regulatory policies or carrying out regulatory functions. Savevska (2020) emphasizes in his study that to respond more effectively to financial risks and maintain financial stability, the scope of macro-regulatory powers should be appropriately broadened to ensure the effective implementation of regulatory measures[9]. This recommendation reflects a deep understanding of the insufficient powers of the current regulatory system.

In the aftermath of the financial crisis, the EU learned profound lessons and actively sought solutions. In 2011, it decisively established three new regulatory bodies: the European Banking Authority (EBA), the European Securities and Markets Authority (ESMA), and the European Insurance and Occupational Pensions Authority (EIOPA). These institutions are responsible for the regulation and supervision of the European financial sector. Michel, the President of the European Commission, affirmed at the time that this initiative was a significant turning point in the EU's financial history and at the heart of financial reforms, highlighting the key role of these institutions in rebuilding financial trust and restoring market dynamism.

However, while the creation of these supranational regulators was seen as an important step for financial stability, in practice, they continue to face constraints on their powers. Van der Veer (2018) points out that the enforcement power of these institutions is constrained by the reluctance of member states to relinquish and share sovereignty over financial regulation[10]. As a result, regulatory policies often encounter obstacles in the implementation process, making it difficult to achieve the desired outcomes. At the same time, the process of European economic integration has been closely accompanied by the advancement of financial liberalization, which has overemphasized the importance of free markets and free finance as the real drivers of economic growth and financial development, as well as the ability to reduce regulatory costs.

Such supranational regulators have hindered national democratic processes and, in some cases, have been seen as an expression of "authoritarianism"[3]. The centralization and expansion of regulatory power raise concerns and questions about democratic principles. The inclusion of political elements in the Economic and Monetary Union (EMU) is seen as a potential solution to ensure the effectiveness of regulatory policy. However, coercive political action would undoubtedly touch the sovereignty and democratic bottom line of member states, thus raising a series of complex political and legal issues. Finding a balance between safeguarding the sovereignty of member states and promoting the effectiveness of financial regulation has become a major challenge for the EU.

The second notable obstacle to financial regulation is the complexity of the regulatory system and the overlapping of regulatory functions, which has undoubtedly become a key factor in undermining the efficiency of regulation. Historically, the hard lessons of the financial crisis have been a wake-up call for the European Union (EU), revealing the inadequacy of existing regulation and emphasizing the importance of creating supranational regulators, in addition to the European Central Bank (ECB), to bridge the gap between the financial markets and the regulators[8]. However, the gap between the ideal and reality lies in the complexity of the EU system, not only in the intricate political games and intertwining of interests among member states but also in the complex interactions between the European Banking Authority (EBA) and regulators within member states, resulting in overlapping regulatory functions.

Specifically, the EBA was initially established to enhance the supervision of multinational banks by granting it independent powers and resources through law, thereby increasing interstate banking supervision activities. However, this mechanism has encountered challenges in practice, especially when the ECB was designated as the primary regulator of all banks in the euro area in 2014. This change directly undermined the original regulatory authority of the EBA, and the overlapping of regulatory roles and potential power struggles between the two have further blurred the boundaries of regulatory responsibility.

In addition, the complexity of the regulatory system is also reflected in member states' preference for regulators. Some member states, such as Germany, tend to have a higher level of trust in the domestic regulatory system due to their more stringent regulatory frameworks and long-established, more specialized regulators, and prefer to rely on home-grown regulatory forces compared to supranational bodies such as the EBA or ECB. Therefore, although the new supranational regulators are formally recognized by the EU at the legal level, in practice, they still need to overcome the limitations of their powers and the lack of regulatory experience to win the trust of all member states.

Another financial regulatory obstacle that cannot be ignored is the influence of financial lobbying activities. In the financial sector, lobbying is often seen as an active force in the legislative process, especially when regulatory policies need to be developed or adjusted. Financial lobbyists, as experts in the financial sector, have a better understanding of firm operations and market dynamics than political elites. This expertise enables them to provide professional insights in policy formulation, enhancing the professionalism of regulatory policies.

However, when the motives of financial lobbying deviate from the public interest to serve the selfish desires of specific interest groups, it is labeled "legal corruption." To preserve high-risk, high-reward trading patterns and protect vested interests, some financial lobbies use their expertise and extensive contacts to engage in secretive and complex negotiations with the EU and its commissions. Their goal is often to seek a relaxation of regulatory policies in favor of the interests of specific financial groups rather than those of the wider public. Such lobbying behavior not only defeats the original purpose of democratic decision-making but also exacerbates social doubts about the fairness of financial regulation.

Joseph Stiglitz, winner of the Nobel Prize in Economics, has pointedly noted that it was these financial lobbyists who directly or indirectly contributed to the outbreak of the financial crisis by misleading the government into adopting erroneous lax regulatory measures. Nonetheless, we cannot completely dismiss the value of lobbying in democratic decision-making. In the aftermath of the euro crisis, financial regulation has become the focus of general attention of the international community, and the negative influence of financial lobbying groups in the legislative process has diminished. In the face of the real needs of global financial stability, the EU and its member governments have begun to pay attention to the scientific and fair nature of regulatory policies and have become more cautious about the demands of financial lobbying groups.

3 The disadvantages of lax regulation, with Ireland as a case study

While lax financial regulation cannot fully explain the causes of financial crises in various countries (e.g., Italy was at the center of the crisis but had a strict regulatory system), the financial crisis in Ireland clearly reveals the severe consequences of inadequate regulation. In the 1990s, the Irish government aggressively pursued expansionary fiscal policy and lax financial regulation to boost the economy, a policy that facilitated an influx of risk capital[7]. However, the good times did not last long, as the once booming property and financial sectors quickly fell into a tight market as the global economic environment changed. The balance of assets and liabilities of domestic banks was severely impacted by the entry of risk capital, with bank share prices plummeting by nearly 90% and even bank failures occurring.

Against this backdrop, regulation became a social consensus. However, libertarians remain wary of regulation, arguing that it is costly and may have negative consequences. They advocate loose regulation not only to maintain the operational efficiency of banks but also to reduce the cost of business operations and customer transaction costs. Additionally, they affirm that simplifying the regulatory process can help drive new business and open up new revenue streams for financial institutions[7]. However, reality provides a harsh answer.

In Ireland, for example, the International Financial Services Centre (IFSC) was established in 1987 with the aim of strengthening the regulation of the financial sector. However, around 2000, it was noted that the relationship between the agency and property firms was too close, and it was even "lobbied" by firms. In this lax and quid pro quo environment, Irish banks purchased real estate-related credit products in pursuit of higher profitability. The Central Bank of Ireland, on the eve of the crisis, remained optimistic about the capital position of the banks, believing that Ireland would be able to withstand shocks from the outside. Unfortunately, between 2007 and 2009, Ireland's GDP fell by 7.25% as house prices plummeted and capital shrank. This chain reaction eventually led to a surge in bad bank loans, bankruptcies, an unprecedented blow to the real economy, and the repossession of countless families' homes due to financial difficulties[6].

In addition to being economically hard-hit, Ireland's financial crisis has triggered changes in the social fabric. In the aftermath of the recession, there has been a clear class divide in the labor market. The number of people working in science and technology (high-end industries) has grown significantly in terms of numbers and wages, while this trend has increased income disparities across the country. As the effects of the crisis continued, in 2011, Ireland had to apply for €22.5 billion in aid funding from the International Monetary Fund and received donations at the EU level and from other countries. In response to the crisis, Ireland restructured its banks, but this move led to a further rise in unemployment.

In summary, deficiencies in the regulatory system are one of the main reasons for Ireland's chronic deficits. Therefore, stronger regulation and reforms are imperative. Thankfully, Ireland has also found new opportunities for development during the crisis. Today, Ireland has become a tax-friendly investment center for other capitalist countries, a transformation that has not only led to positive economic opportunities for the country, particularly in terms of creating a large number of jobs, but has also provided a new way of life for countless unemployed and bankrupt families. This experience has not only been a profound rethinking of Ireland's financial regulatory system but has also provided valuable lessons and insights for other countries.

4 The developing regulatory system

While the weaknesses mentioned above do exist and may pose a challenge to the EU's response to the financial crisis, they do not negate the positive changes and significant progress made by the EU in the aftermath of the financial crisis. Compared to the relatively weak regulatory framework that existed before the 2008 global financial crisis, the EU has made a qualitative leap forward in the area of financial regulation. This transformation is reflected in a complete overhaul of the regulatory system, the strengthening of regulatory bodies, and closer coordination between political and economic policies. Although the shadow of the crisis has not yet faded and its impact on the European economy is still far-reaching, these positive developments in the EU are a strong signal that member states are committed to building a more robust financial market system that better protects and enhances the economic well-being of EU citizens.

Firstly, the introduction of the embedded regulatory system marks a major innovation in the field of financial regulation, bringing regulation closer to market realities—the actual needs of banks and firms—as well as increasing the speed of response to changes in financial market dynamics. This cooperation is premised on the establishment of regulatory rules that are acceptable to both parties and strictly enforced. The process of achieving this is challenging, requiring regulators to invest significant resources in building trust while increasing the participation of citizens and experts to ensure that regulatory decision-making is professional and democratic. Although these goals are quite difficult to achieve, the EU is gradually working in this direction.

In addition, embedded regulation promotes greater sensitivity of firms to market information and ensures a balance between regulatory rules and firms' behavior. Instead of being a one-way communication of instructions, regulatory rules become a bridge for information exchange between firms and regulators. On the one hand, enterprises need to keep abreast of new trends in regulatory policies; on the other hand, regulators need to rely on accurate market information to formulate more practical regulatory measures. This stable cooperation mechanism not only achieves a win-win situation for both parties but also enhances regulatory efficiency.

In terms of regulators' accountability and democratic processes, the financial crisis prompted the EU to establish a series of new institutions (both at the national and supranational levels), whose responsibilities are subject to strict public and governmental scrutiny. Accountability, both vertically (i.e., between the government and the public) and horizontally (i.e., between peers and national experts), has become an important tool for assessing and contributing to democratic processes in the EU[2].

Vertical accountability ensures people's right to participation, while horizontal accountability strengthens inter-institutional cooperation and achieves EU-wide policy coherence. For regulators, timely disclosure of information, reduction of information asymmetry, avoidance of bureaucracy, maintenance of supervision, and harmonization with other countries' policies are all responsibilities that they have to face[1]. This accountability mechanism is not only a wake-up call for the institution but also an incentive for continuous improvement.

It is worth noting that with globalization, transnational accountability and coordination have become increasingly important. However, given the complexity of the relationship between the EU system and the state, current regulators are still mainly accountable to governments and other intra-regional institutions, and international cooperation and coordination have not yet become dominant. Therefore, strengthening cross-border regulatory cooperation and accountability mechanisms has become an important direction for future financial regulatory reform in the EU. By enhancing international information sharing and mutual learning, the EU will be able to further improve the effectiveness and adaptability of its financial regulatory system, providing protection for the sustainable and healthy development of the EU economy.

5 Recommendation

Traditionally, policy responses to financial crises have tended to focus on optimizing the allocation of market resources and achieving stability through the self-regulation of market mechanisms. However, such a strategy appears inadequate in the context of the euro crisis, as it fails to provide a deep insight into the nature of the euro crisis. The roots of the euro crisis lie in the intertwining of multiple and complex factors such as differences in economic structure among member states, limited independence of fiscal policy, and uniform implementation of monetary policy[4]. In contrast, the multiplicity of policy frameworks focuses more on how the interactions between different regimes affect the crisis and provides a more comprehensive and in-depth analytical perspective.

In light of this realization, the European Central Bank (ECB) has put forward a proposal to coordinate national policies to jointly respond to transnational crises. This proposal aims to address the crisis more effectively by compensating for the shortcomings of a single country's response capacity through policy coordination within the region. However, the dominance of the banking sector in the European economic system and the significant differences between countries pose challenges to this process.

To address these challenges, scholars have suggested that the European Central Bank could delegate some of its supervisory powers to another independent supervisory body, such as the European Banking Authority, and initiate synergies with national supervisory bodies. Such an arrangement would avoid regulatory overlap while ensuring policy consistency and effectiveness. The European Banking Authority and national supervisors would coordinate their supervisory actions by cooperating with and obtaining supervisory authorizations from the central bank.

This proposal is also accompanied by potential risks. Firstly, the concentration of power in the central bank may lead to an expansion of its size and complexity of its structure, which in turn may increase bureaucratic tendencies. Such a tendency could undermine market dynamism and innovation and even raise concerns about excessive central bank intervention in the market for private gain. Second, a harmonized regulatory system, while contributing to the maintenance of financial stability at the EU level, may also pose constraints on financial policies at the national level, limiting the ability of member states to develop flexible policies according to their own circumstances[5].

To effectively regulate the financial system and prevent the recurrence of crises, greater transparency of financial information is essential. This requires financial firms to disclose information about their assets and to establish a minimum standard reporting system to ensure that firms are able to report regularly and accurately on their financial position. Such disclosure of information not only helps regulators to identify potential risks in a timely manner but also enhances public trust and support for the financial system. Moreover, the process of supporting information disclosure and democratic regulation is an important part of the democratic process. Broad participation by experts and the public can lead to more accountable behavior by firms and governments and reduce the incidence of corruption and misconduct. In particular, popular regulation and condemnation would be a powerful check on lobby groups that wield strong influence in the financial sector.

The financial crisis has also exposed the inadequacy of EU capital markets in terms of risk warning mechanisms. The EU failed to recognize and respond to the build-up of global financial risks in a timely manner, as investors were too concentrated within the eurozone and neglected to pay attention to external markets such as the US. Therefore, investment diversification has become an important way to improve risk resilience. At the same time, for countries like Ireland, where the banking sector dominates the financial system, it is not enough to rely solely on the banking system to maintain financial stability and promote real economic development. Ireland needs to make efforts to diversify its financial sector in the future. For example, it should promote the innovation of financial technology, develop non-bank financial institutions, strengthen the construction of the capital market, and provide enterprises with a variety of financial assistance groups.

In the aftermath of the crisis, there are limits to the ability of the banking system and public finance alone to respond to the crisis. A bank-led system is difficult to change in a short period of time, so strengthening regulation is a feasible and effective way. In recent years, the EU has made a number of improvements in regulatory policy, such as the introduction of the Single Supervisory Manual and the strengthening of the functions of the European Central Bank Authority. These measures aim to enhance the stability of the financial system through structural adjustment.

6 Conclusion

The full-blown euro crisis has undoubtedly been a wake-up call for people across Europe and around the globe, making people deeply aware of the fatal flaws hidden in the financial regulatory system under the liberal structure. The crisis has not only revealed that the free market is not omnipotent but also emphasized the importance of government regulation in the integration process.

Particularly with regard to the financial regulatory system, the outbreak of the euro crisis has made it clearer that the intricate relationship between the state, enterprises, and financial institutions, as well as the overlapping of their functions, are often an important source of regulatory failure. In the past, this lax regulatory environment allowed risk capital to be drawn into the country in large quantities without warning, which in turn triggered a sharp rise in the number of non-performing loans in the country, causing a serious impact on the real economy and a spike in unemployment. This series of chain reactions not only exacerbated socio-economic instability but also seriously impeded the economic recovery and development of the EU as a whole.

To effectively address this challenge, we need to strengthen the scope and powers of macro-regulation. At the same time, it is particularly crucial to strengthen international cooperation, especially cross-border cooperation. After all, the essence of the euro crisis is a transnational crisis, which reminds us that in today's globalization, no single country can do it alone, and that it is only through international cooperation and coordination that we can work together to deal with financial risks and maintain financial stability.

In addition, to further improve the financial regulatory system, we also need to clarify the division of functions among regulatory bodies, including their respective duties and powers, so as to ensure the effective implementation of regulatory work. It is also crucial to encourage democratic participation in the regulatory process, which will help enhance the democratic nature of regulatory decision-making, thereby strengthening the credibility and enforcement of the regulatory system. Although financial regulation is still largely dominated by individual countries and lacks sufficient coordination and cooperation, the trend of cooperation and coordination is gradually on the rise as the integration process develops. We have reason to believe that the EU will further push forward the reform and restructuring of the financial regulatory system, and in this process, close cooperation among countries is needed to jointly build a more robust, efficient, and competitive financial system.

This paper focuses on the deficiencies of financial regulation while exploring the causes of the euro crisis in the non-banking sector. In fact, the outbreak of the euro crisis is the result of a combination of factors, including economic structural imbalances, sovereign debt crisis, inappropriate monetary policy, and many other factors in addition to financial regulation. Therefore, when we seek solutions, we should also think and explore from a broader perspective.

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