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Published April 2010 - James Koessler

Navigating uncharted waters: The EU's response to the financial crisis (2008-2010)

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In this paper, I shall look at the European Union's response to the current financial crisis and evaluate both how the crisis was addressed and the effectiveness of it's response. I shall mainly argue that, while successful overall, this response was unnecessarily handicapped by the lack of strong economic governance on the EU level in favour of often disappointing inter-governmental cooperation. I shall first focus on the EU's immediate response to mitigate and resolve the crisis (I) before turning to its new regulatory and supervisory proposals (II).

I) Mitigating and resolving the effects of the crisis

A) Supporting the financial sector

Banking sector rescue and restructuring

After a meeting on 14 October 2008, between the Eurogroup, the ECB, the Commission and the UK, it was decided that each state would act independently, providing warranties and refinancing for their worst-off banks[1]. This declaration of intent set out the basis for efforts to bring about a concerted EU response to the financial crisis. This approach has been qualified as 'horizontal' Europeanization[2], with a policy which is pioneered by one country (in this case the UK), and then subsequently adopted by other countries. This means that the entire process takes place as non-binding intergovernmental cooperation between policy-makers, and not inside the EU institutional framework.

Previous efforts for a coordinated approach had quickly foundered as several Member States made unilateral moves to reassure both their savers and the markets.

A good example is the move by Ireland, on 30 September 2008[3], to guarantee all bank deposits. Germany shortly followed suit[4]. This was perfectly legal since EU directives only provide for minimum guarantees on bank savings. As a result of this, Finance Ministers adopted a new increased guarantee floor on 6-7 October 2008[5], to mitigate the effects of

[1] SUMMIT OF EUROZONE COUNTRIES. 12 October 2008. *Declaration on a Concerted European Action Plan*.

[2] QUAGLIA, L. 2009. The 'British Plan' as a Pace-Setter: The Europeanization of Banking Rescue Plans in the EU?. *Journal of Common Market Studies*, **47** (5). p 1082

[3] THE ECONOMIST. 1 October 2008. *A pledge too far?: The government in Ireland guarantees all bank deposits.*

[4] ALLEN, N. 5 October 2008. *Financial Crisis: Germany guarantees all private savings; UK 'must follow'.*

[5] KUBOSOVA, L. 6 October 2008. *Paris summit fails to stop unilateral action by EU states.*

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this coordination failure and prevent any outflows of capital from banks in countries with lower protections.

As noted by Persson[6], national deposit guarantee schemes are a significant area where there has been a failure to address the increasing cross-border movement of capital.

Rescue of cross-border banks

Another example of the shortcomings of national intervention can be seen in the rescue of cross-border banks such as Fortis or Dexia. Fortis ran into liquidity problems, partly as a result of its participation in the takeover of Dutch bank ABN. Authorities in Belgium, Luxembourg and the Netherlands were unable to reach an agreement on a common rescue plan for the bank, and aid was eventually broken up along national lines[7]. While neither Dexia nor Fortis failed, this was at considerable cost for shareholders and national treasuries[8]. In this situation, there is little doubt that EU level intervention, based upon a consolidated fund to which all Member States' would contribute, would have been a more effective solution[9].

State aid and competition as a tool for the EU

Prior to the financial crisis, financial stability was regarded as an exclusive national competence[10]. Had this absolute position been maintained there were several risks: First of all, uncoordinated action by individual states would result in uncertainty and confusion, as was the result of the mini-summits mentioned above. Secondly, any such measures could distort competition and undermine the single market.

The lack of any clear legal powers for the EU to direct a coordinated rescue in this field, meant that all coordination was ad-hoc[11]. The decision whether to use public funds remaining entirely with the Member States. The EU was, however, able to use its exclusive competence[12] on State Aid[13] and competition rules to monitor the implementation of these national actions. The Commission was also able to bypass many of the obstacles of the

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[6] PERSSON, M. 8/9 November 2007. *Achieving financial stability in a world of cross-border institutions*. Speech prepared for a Bundesbank conference at Eltville. Stockholm: Sveriges Riksbank.

[7] MELANDER, I. & MIKA, N. 6 October 2008. *Netherlands nationalises Dutch Fortis units*. REUTERS.

[8] EDMONDS, T & MARSHALL, J. 2009. *European responses to the financial crisis*. p.14

[9] GROS, DANIEL & MICOSSI. 30th October 2008. *A call for a European financial stability fund*. VOX EU.
ALESINA, ALBERTO, et al. 1st October 2008. *Open letter to European leaders on Europe's banking crisis: a call for action*. VOX EU.

[10] PISANI-FERRY, J & SAPIR, A. 2009. *Banking Crisis Management In the EU: An Interim Assessment*. p.20

[11] Ibid.

[12] Treaty on the Functioning of the European Union, Article 3

[13] Treaty Establishing the European Community, Article 87(3)(b); now:
Treaty on the Functioning of the European Union, Article 107 & 107(3)(b)

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cumbersome EU institutional framework by relying on soft-law measures such as Communications and Recommendations [14].
Such soft-law measures included: guidelines as to when the use of state-aid was acceptable for the purpose of restructuring and rescuing banks [15], a framework to prevent 'bank runs' [16], and a framework for the removal of 'toxic assets' from the balance sheets of banks [17]. The overall aim of these measures was to attain fiscal stability and the maintenance of credit flows while ensuring a level playing field, and avoiding harmful subsidy races [18].

The Commission moved swiftly, and has now adopted 81 decisions on cases related to the financial crisis in 2008/9, totaling over 3,5 trillion euros worth of state-aid.[19] The Commission has also issued a Communication [20] providing a framework for assessing aid with a view to restoring the viability of the recipient banks without continued support, thus returning to a competitive single market. The new Competition Commissioner, Joaquin Almunia, has continued the aggressive stance taken by his predecessor in forcing banks back to a competitive equilibrium [21].

On the whole, it appears that the objectives and guidelines, discussed above, have been met. An Internal Assessment[22] by the Commission does, however, express concerns that certain states have made aid conditional on the extending of credit to domestic customers, thus distorting competition.

Beyond this, there are some important limitations to the use of competition rules to regulate bank rescues [23]. The Commission imposes conditions on individual recipients, with

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[14] SENDEN, L. 2004. *Soft law in European Community law*. London: Hart Publishing. (Chapters 1, 7 & 9)

[15] EUROPEAN COMMISSION. 2008. *Communication from the Commission — The recapitalisation of financial institutions (1) in the current financial crisis: limitation of aid to the minimum necessary and safeguards against undue distortions of competition*. Brussels.

[16] EUROPEAN COMMISSION. 2008. *Communication from the Commission — The application of State aid rules to measures taken in relation to financial institutions in the context of the current global financial crisis*. Brussels.

[17] EUROPEAN COMMISSION. 2008. *Communication from the Commission on the Treatment of Impaired Assets in the Community Banking Sector*. Brussels.

[18] KROES, N. 27th November 2009. *Keynote address at conference organised by EStALI*. London: European State Aid Law Institute

[19] DIRECTORATE FOR ECONOMIC AND FINANCIAL AFFAIRS. 2009. *The EU's response to support the real economy during the economic crisis: Member States' recovery measures*.

[20] EUROPEAN COMMISSION. 2009. *Commission Communication: The return to viability and the assessment of restructuring measures in the financial sector in the current crisis under the State aid rules.* Brussels.

[21] EURACTIV. 13th January 2010. *Almunia: Bailed-out banks to pay back in 2010*.
WILSON, H. 16 March 2010. *Clock ticks for RBS to refinance its balance sheet ahead of EU ruling*.

[22] DIRECTORATE GENERAL FOR COMPETITION. 2009. *DG Competition's review of guarantee and recapitalisation schemes in the financial sector in the current crisis*.

[23] *Banking Crisis Management In the EU,* p.65 supra at n.10

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an eye to maintaining competition in a given sector. Yet, in many ways, the firms that were not bailed out have benefited from the crisis by expanding their market share and power. There, therefore, needs to be a more sectoral focus, which also includes the sound banks.

Monetary/liquidity support

Central banks in the EU responded decisively to the turmoil that followed the collapse of Lehman Brothers. The ECB, in a co-ordinated move with the Bank of England and various other EU central banks, lowered their interest rates to 3.75%[24]. Several other interest rate reductions followed over the course of 2008 until the summer of 2009.

The ECB, which is an independent institution[25], followed unconventional policy measures such as allowing banks to use a wider range of collateral while borrowing. It also switched to a fixed rate-tender for its main refinancing facilities, resulting in near-unlimited liquidity at a very low interest. In May 2009, the ECB agreed to purchase euro-denominated bonds for a total of 60 billion euros, with the aim of easing credit conditions, in a move similar to the quantitative easing program introduced by the Bank of England[26].

It has been argued, quite persuasively, that it is precisely the independence of the ECB which allowed both decisive and innovative action in the monetary sphere[27].

B) Macro-economic support/stimulus

European Economic Recovery Plan

The European Economic Recovery Plan[28], a framework to address the economic downturn, called for the main focus of stimulus to be on structural policies, which would support aggregate demand in the short term (thus stimulating employment and household demand), while still conforming to long-term policy objectives such as the Lisbon Strategy, the Single Market, and the move to a low-carbon economy. Its total amounts to 200 billion euros, which corresponds to 1.5 % of European GDP, of which 1.2% is be financed by Member States with 0.3% coming from the EU[29].

It should be noted that the 'European' part of the plan is nearly entirely financed by the European Investment Bank, which is subordinate to national governments, with the remainder coming from unspent cohesion funds. The EERP is, therefore, in essence, a plan

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[24] THE ECONOMIST. 8th October 2008. *Global Finance: Lifelines*.

[25] Treaty on the Functioning of the European Union, Article 130

[26] QUAGLIA, L. 2009, supra at n.2

[27] KENEN, P.B. 2010. Ten years of European Monetary Union: What's gone right and What's gone wrong. *International Journal of Economics and Business Research*, **2** pp. 6-9

[28] EUROPEAN COMMISSION. 2009. *Communication from the Commission to the European Council: European Economic Recovery Plan*. Brussels.

[29] Ibid.

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with national fundings. It is hard to imagine this being any other way given the current institutional framework, which requires the European budget to be balanced, and to be less than 1% of community GDP.

There are a number of issues which arise in the financing of the EERP by Member States. First of all, the (albeit weak) commitment[30] to respect the Stability and Growth Pact[31] (which limits the deficit to 3 % of GDP and debt to 60%) means that certain states will have very little margins of maneuver. Germany for example, with it's stellar credit rating and orderly state finances, will not have any difficulties in increasing it's spending. By contrast, countries such as Greece, which are heavily indebted, and for whom the cost of borrowing is much higher, are not in a position to contribute with the same effectiveness.

A solution to this problem would have been to greatly increase the contribution of the EU[32]. This could have been achieved by the issuance of bonds by the EIB, which benefits from a stellar AAA credit rating, and is thus in a position to raise money on terms similar to Germany.

This brings us on to another limitation, the risk of 'free riders'. Given the high degree of integration of the common market, Member States who contribute very little will be able to benefit from positive externalities due to spillover effects from the stimulus actions of other states.

Support to balance of payments

A number of new Member States, such as Hungary, Latvia and Romania, have experienced difficulties with their balance of payments.

To remedy this situation, the Commission is empowered[33] to recommend the provision of emergency assistance to member states which have not adopted the euro, to help with difficulties in current payments or capital movements.

On 4 November 2008, the Council granted Hungary 6.5 billion euros of loans in conjunction with loans from both the IMF and the World Bank[34]. According to the fourth review conducted by the Commission, Hungary is now well on track to fulfilling its obligations set out in the Memoranda of Understanding accompanying the assistance[35].

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[30] EUROPEAN COMMISSION. 2009. *Communication from the Commission to the European Council: European Economic Recovery Plan*. Brussels. p.9

[31] EUROPEAN COUNCIL. 17th June 1997. *Resolution of the European Council on the Stability and Growth Pact*. Amsterdam.

[32] MONTANI, G. 2009. *Which European Response to the Financial Crisis?* p.51

[33] Treaty on the Functioning of the European Union, Article 143

[34] Council Decision 2009/103/EC of 4 November 2008 granting mutual assistance for Hungary

[35] EUROPEAN COMMISSION. 2010. *Commission concludes fourth review of the EU balance-of-payments assistance for Hungary*. Brussels.

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By providing such assistance, the EU was given an extra legal tool in monitoring the economic situation (in addition to those under the Growth and Stability Pact) and the commitment to market reforms among these emerging economies of Eastern Europe.

II) Reform and prevention of future crisis

A) Regulatory initiatives

The EU moved quickly to address the evident need for regulatory reform through the ECOFIN's 'Roadmap for Regulatory Reform'[36] and the Commission's Communication 'Driving Economic Recovery'[37]. These two plans are both in line with global initiatives such as the G20 regulatory agenda.

The EU has successfully implemented a regulation governing the operation of credit rating agencies[38], introducing requirements as to how these agencies should deal with conflicts of interest, the quality of ratings and transparency towards their clients. According to several academic sources[39], credit rating agencies played a significant role in the financial crisis, this move is, therefore, to be welcomed.

A number of further regulatory proposals are currently before the European Parliament, and are set to be voted on in June 2010[40]. These include directives regulating the operation of hedge funds, credit rating agencies, and a new capital requirements directive.

The relatively slow progress on the regulatory level is to be blamed on the EU law-making process and the limits of its competence. The Commission's use of soft-law, such as in the case of executive compensation[41], is a good example of attempts to bypass these limitations. Indeed, remuneration was not included in the social harmonisation system under Article 137[42]. Furthermore, any attempt to introduce instruments targeting taxation would have encountered an institutional obstacle, the rule of unanimity[43].

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[36] ECOFIN. 2008. *Updated ECOFIN Roadmaps*. Brussels.

[37] EUROPEAN COMMISSION. 2009. *Communication from the Commission to the European Council: Driving European Recovery*. Brussels.

[38] Regulation 1060/2009 on credit rating agencies

[39] PARTNOY, F. 2009. Historical Perspectives on the Financial Crisis: Ivar Krueger, the Credit-Rating Agencies, and Two Theories about the Function, and Dysfunction, of Markets. *Yale Journal on Regulation*, **26**. p.431

[40] EUROPEAN PARLIAMENT. 2009. *Economic reform and stability for a new economy: The European Parliament's work*.

[41] EUROPEAN COMMISSION. 2009. *Commission Recommendation on remuneration policies in the financial services sector*. Brussels.

[42] Treaty on the Functioning of the European Union, Article 137

[43] EUROPOLITICS. 26th May 2008. *Remunerations: Narrow legal path for EU action*.

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B) Supervisory initiatives

In November 2008, the Commission mandated a High-Level Group (Larosière) to recommend new supervisory arrangements for the EU's financial systems.

In its final report, published on the 25 February 2009, the Group proposed a twinned supervisory approach focusing on both macro and micro financial supervision[44]. One of the main focus points of the report was to provide the resulting entities with powers that go beyond providing mere advice. The Commission embraced the main elements of the Group's report in it's 4 March 2009 Communication[45].

This proposal would establish a new European supervisory system which would consist of two foundational elements:

1. A European Systemic Risk Council, which will be a committee of central bankers, who will fully accountable to both the European Parliament and the Council. The ESRC's function will be to monitor the macro-economic outlook and not to get involved in crisis-management.

2. A European System of Financial Advisors which will lead to the creation of several supervisory authorities. These authorities, in cooperation with national supervisors, will oversee the financial health of individual firms. The day-to-day supervision will remain in the hands of national authorities, while the supervision of EU-wide entities (such as credit rating agencies) will be under the purview of these new authorities. Their powers will be wide, including a power of inspection, investigation, and supervisory decision-making.

In addition to this new supervisory framework, the Commission has also proposed a new set of standards that would apply across the EU and be used by all supervisors.

These proposals appear to address the issue of information sharing through both the enhanced powers of the new EBA, and the ESRB's ability to request data from national authorities. It remains to be seen how effective these measures will be once they are implemented, but they do appear to address this critical issue[46], which hindered the EU's ability to coordinate bank rescue plans. I would argue that, for stability to be preserved and promoted, national supervisory bodies should be made subordinate to a pan-European entity[47].

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[44] THE DE LAROSIERE GROUP. 2009. *Report*.

[45] *Driving European Recovery*, supra at n.37

[46] PISANI-FERRY, J & SAPIR, A. 2009. *Banking Crisis Management In the EU: An Interim Assessment*.

[47] SEYAD, M. 2001. A Single Regulator for the EC Financial Market. *Journal of International Banking Law*, **16** pp. 203-212.

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The UK has been the chief objector to these proposals, citing fears of losing "fiscal sovereignty"[48]. An agreement has since been found[49], and these measures are scheduled to be voted on by the European Parliament by June 2010[50].

Conclusions

As we have seen, the EU was institutionally ill-prepared to manage a financial crisis, especially with regards to the assignment of competences between the Union and Member States. The EU was largely successful in coordinating the stabilisation of the banking sector, where it was able to rely on its exclusive competition competences. On the other hand, the EU's coordination and role in macro-economic policies, with the exception of the balance of payments assistance, can only be called lackluster. A similar pattern emerges when one looks at the EU's supervisory proposals which, as a consequence of financial stability being a national competence, represent a fragile balancing act between national and EU interests. More progress has been achieved in the regulatory arena, where the EU has a shared competence, under the purview of the common market. Soft-law instruments have shown their value in areas where the EU lacks competence or is faced with stiff resistance, these are, however, not a solution to the institutional problems facing the EU. Looking back at the EU's response, the limitations of inter-governmental cooperation are clear. As several economists and MEPs have suggested[51], and I would argue, this situation would be best solved by the creation of a European economic government with control over economic and fiscal policy. Ineffective agreements such as the Stability and Growth Pact, are no substitute for real governance. Article 136[52] might be a good starting point for this, but a treaty change in this direction appears to be inevitable in the long term. This argument is now even stronger given the current debt crisis in Greece and its impact on all Eurozone countries.

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[48] HOUSE OF COMMONS TREASURY COMMITTEE. 2009. *The Committee's Opinion on proposals for European financial supervision*.

[49] EURACTIV. 3rd December 2009. *Ministers approve financial watchdogs, giving safeguards to UK*.

[50] *The European Parliament's work*, supra at n.40

[51] Supra at n.9; also see: EUROPEAN PARLIAMENT ECONOMIC AND MONETARY AFFAIRS COMMITTEE. 24 February 2010. *Stronger European economic governance and tougher rules for the Stability Pact needed.*

[52] Treaty on the Functioning of the European Union, Article 136

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