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FACING THE TEST OF GLOBAL FINANCIAL AND ECONOMIC CRISIS:

WILL THE EU RISE TO THE CHALLENGE AND DEEPEN INTEGRATION?

Research project 2009 of the Foundation for European Progressive Studies

General Report

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Brussels, January 2011

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INTRODUCTION

The current financial and economic crisis constitutes a unique challenge to the economic-financial governance of the European Union. On the one hand, economic and fiscal policies remain national competencies of the Member States. On the other, they exercise them within an EU system of non-discrimination, solidarity and mutual co-ordination, with fifteen of the Member States sharing a common currency and common monetary policy. These central elements of the EU's economic and financial governance are all challenged by the deep crisis of large parts of the financial system, by economic recession and unemployment, and by exploding public debt in the Member states. The scale of this crisis forced national political leaders to concentrate primarily on battling their economies' slide into depression, and only in the second place on complying with the EU's economic governance. They seek to benefit from the level playing field, solidarity and co-ordination provided by the EU, rather than to preserve and strengthen integration.

How does one prevent domestic crisis-management from damaging European integration? How do we assess the added value of EU integration and take advantage of it in anti-crisis policy? Can the crisis favour new advances in European Union building? These are questions which FEPS considers to have a crucial importance of their own. They concern the basic political structures which the socialist and progressive forces in Europe have contributed to build, and which will permit them to address the economic and social consequences of the crisis, with the co-operative and solidarity-minded methods which are their hallmark, rather than the narrow and conflict-prone approaches of the past. In spring 2009, FEPS started to address these issues through a new research group, by organising a cycle of topical seminars which already started in the month of June 2009.

In the last years before the onset of the financial and economic crisis, the desire for further deepening of integration in the field of financial and economic policy in the European Union had descended to very low levels. An unmistakable sign of the stalemate in this field was the relegation since the year 2000 of further Europeanisation efforts to the less binding integration method of so-called open coordination, another one the absence of any significant advance of economic policy integration in the Lisbon treaty. Since 2008, the development of the US subprime crisis into a full-blown world-wide financial crisis with grave consequences for EU economies has created a new set of pressures and incentives for all concerned actors. They highlight the shortcomings of the existing institutional architecture in Europe and could loosen this stalemate.

It is true that the first waves of policy reactions in the EU in fall 2008 and January 2009, being marked by discord about common approaches and by member states' preference for differentiated national strategies, the pessimism about further integration perspectives in the EMU field appears confirmed. But as we said, these were the first waves of policy reactions. In all of the EU member states' economies and worldwide, the crisis is expected to continue and produce grave consequences, during 2009 and up into 2010, both in the real economy field and in the field of public and private finance. The pressures and incentives resulting out of these developments, for the further development of integration, have certainly not yet become fully visible, nor played themselves out.

Contradictory expectations dominated the public debate. There were voices that warned against the disintegrative dynamic which might result, and endanger the cohesion of the single market and even the survival of today's Monetary Union. The euro-sceptics' vision of the nineteen-nineties came back to mind, which saw –in a monetary union without the resource transfers of true

fiscal federalism— the rigor of a common stability-oriented monetary policy provoking social and political unrest in the less competitive euro-countries, which would in the end drive them out of the Euro. But other voices maintain that today’s integration levels in the EU cannot be put into real jeopardy anymore and that a further deepening of economic/financial policy integration is in the end much more likely to result out of the test of financial crisis.

How has FEPS proceeded? Keeping the contrasting scenarios for EU economic governance in mind, as the grand reference frame for answering the question asked in this project’s title, the inquiry has nonetheless been conducted at a more technical level. First, this project of FEPS has concentrated on the banks, and especially on cross-border banks, in the European Union space. In Europe there are around 5,000 banks (8.000 in the US). Of that number, the great majority are small and medium-sized domestic - frequently regional - institutions. They are confronted by around forty cross-border groups representing almost 70% of the European market. Those groups have seen dramatic asset growth: in excess of 50% between 2001 and 2005 (de Larosière in a recent speech to the Belgian Financial Forum 220110).

Secondly, FEPS has looked at a number of distinct activities which the EU governments and institutions have undertaken at the financial and economic policy level, to counteract the detrimental effects of the financial and economic crisis and prevent its repetition. We took inspiration from Nobel prize-winner Paul Krugman, in an approach shared by many of his colleagues. They point to *three* necessary and consecutive steps, addressing three distinct, but differently urgent, aspects of the crisis. Governments and EU institutions should:

- End the quasi-freeze of the global credit system and get credit (especially inter-bank credit) flowing again by bailing out banks;
- Contain the global slump. “The remedy is good old Keynesian fiscal stimulus”;
- Reform the weaknesses of the financial system regulation, which made this crisis possible, this project limiting itself to the supervision, regulation and re-structuring of banks, especially cross-border banks, in Europe.

Given that our project deals with the challenge which the financial crisis poses to *European Integration*, a fourth aspect concerns the effects on its monetary centrepiece, the Euro system.

- Governments and ESCB must deal with the threat of debt crisis or even a state insolvency in one of the Euro-states. How to react, given the stability-obligation of ESCB-monetary policy and the no-bailout rule of the treaty? This scenario was the fourth aspect of the crisis which we dealt with.

Accordingly, over the years 2009-2010, FEPS has organized a number of high-level expert seminars on *these four aspects of the crisis* and the countervailing measures that the EU MS governments, the EU institutions and their external partners undertake, in more or less co-ordinated manner.

FEPS has opted for restricted high-level expert seminars. Decision-makers from the public and the private sphere, together with top level analysts from academic and other backgrounds presented their views and interrogated each other, trying to find common ground or to identify their differences. Contributions paid explicit attention not only to the difficult technical issues at hand in the evolving policies of Member States and the Union, but also to the effects which they are liable to have for the future balance between national and European policies, the changes necessary within the EU-rules and –institutions.

In the end, an effort is made to sum up the results, in coming back to the question of our overall project. European integration challenged by the global financial crisis: will its reaction be to loosen up, or will it advance and deepen?

In examining the causes and effects of the financial and economic crises, this report will not attempt an analysis of the kind proposed by economic and financial research institutions. Its principal aim is to *analyse policy reactions to these crises at national and EU level and to evaluate their contribution to the EU's evolution on the continuum between less and more integration*. As to causes and effects, it only aims to understand policy reactions well enough to be able to grasp and to appraise the functional reasoning behind the different measures of financial and economic policies, and their meaning in terms of integration.

This report is organised according to the topics of our seminars. We start out with the banks, their supervision at the national and the EU level, and continue with the efforts to keep them afloat and to restructure them.

In the next stage we look at national and EU level efforts in 2008-9-10, at fiscal stimulation of the flagging national economies, and at the upcoming efforts of 2011 and following years to exit from these stimuli before they create either an inflationary wave or pull public finances into a crisis of confidence of the kind which has already played itself out with the Greek debt crisis of 2010.

The final part of the report turns to the Euro system and the challenge which excessive borrowing and indebtedness of a number of Member States have posed to it. For this, the Greek debt crisis and the Euro group's reaction to it are the paradigmatic case. But this case has also focussed attention on the problems which other states have with mastering the financial difficulties created by large-scale debt-financed public bail-outs of banks or by stimulation. Dealing with these challenges has given additional impetus and urgency to the issue of stimulus-wind-down, and in a more general sense to the issue of public debt reduction and fiscal sustainability.

Table: The five topical expert seminars for the project

0	Project Presentation and Debate
1	Reforming European Banking Supervision
2	The Spectre of State Insolvency in the EMU
3	Restructuring Banks and the Internal Market
4	Fiscal growth stimuli in EU Member states
5	Summing up

SUMMARY

At the beginning, a short glance at the principal actors is in order. Who were and are these actors?

- Member States (especially Euro MS) assembled in the Council and in the European Council;
- European Parliament;
- European Commission;
- European Central Bank.

At the end of this summary we will briefly return to these actors and try to present the essential points of their record during the crisis. This is all the more important because first the ensuing policy chapters have no explicit focus on actors, and second because roles and relative influence of actors have actually changed during the battle with the crisis.

The overarching question of this project concerned the challenge posed to European integration tested by the global financial crisis and especially in the Banking Sector: will its reaction be to loosen up, will it preserve its acquis, or will it advance and deepen?

In January 2011, we can confirm our first general answer to this question, given on the occasion of this project's conclusion in June 2010. In sum it is positive:

In the process of reacting to the crisis, EU integration tends to preserve its most central acquis, its institutions and procedures tend to advance in integration, rather than to loosen up. This is the provisional and overarching result. Nevertheless the European strategies for a number of important issues are still not far enough advanced to permit a definite answer to our question.

First Phase of the Member States' and EU's Reactions to the Crisis

After the full outbreak of the crisis with the Lehman Brothers insolvency in fall 2008, Member governments assembled in the Council, and the European Commission, had started the debate about the adequate common reaction only after a first series of divergent national measures had already been taken, mainly in the field of bank rescue. The Council and the Commission started with a disappointing absence, of common approaches for the governments, and of a unifying vision for the Commission.

In fact, the Euro Member State governments took the initiative in a series of Council sessions from September 2008. On October 12 2008 they met for the first time ever at European Council level, whereas they normally meet at Ecofin ministers' level only. They were the most active and constructive actors of this early moment, especially the French government which held the Council presidency in fall 2008.

The Rescue of Distressed Banks and the Stimulation of the Economy

The most urgent concerns for crisis-stricken economies were the rescue of distressed banks, and the stimulation of activity. The start of national programs in these policy fields was thus marked by a pre-eminence of national governments, by the many differences between the national approaches, and by the relative absence of the European Commission.

Strengthening Supervision

Insufficient supervision had quickly been identified as an important Achilles heel of the European financial system. This lacuna concerned especially the macro level. No dedicated institutions existed,

able to give timely alert to financial market authorities, about the emergence of systemically relevant risks to financial market stability (for instance concerning the growth of ‘market bubbles’). Supervision existed at the micro level, as for the business practice of cross-border banks, but with many lacunae. Existing rules functioned insufficiently, and the more important the stakes were for the different host states, the less effectively did they cooperate.

Confronting Sovereign Debt Crisis

The first appearance ever, of an open sovereign debt crisis in the EU and in the Euro area (Greece in the first three months 2009), showed the complete absence of any institutional provisions for that kind of case, at EU level. In a first phase this crisis only provoked a far flung and already divisive debate about the different approaches vis-à-vis affected EU member states, between more or less explicit, and Europeanised, solidarity. The option of sovereign “Insolvency” was not yet mentioned officially.

Preserving the Level Playing Field on the Internal Market

On the other hand, the toolbox of EU rules on competition, or the control and authorisation of state aid stood ready, where national strategies for the rescue of distressed banks and the stimulation of the economic activity did not respect the EU rules for the Internal Market. The Commission quickly started to apply these rules. But soon it had to acquiesce in a rare degree of Member States’ participation, pressuring it to establish the ‘stability of the financial system’ as a first key criterion of its intervention, beside the objective of the level playing field of the Internal Market.

Improving the Accessibility of Credit

At the level of common monetary policy, and of EU sponsored investment credit, the European Central Bank and the European Investment Bank intervened with massive liquidity injections and a dramatic increase of credit levels.

This distribution of Member States’ and of the Union’s first reactions to the crisis does not surprise. In fact, it reflects exactly the distribution of competences at this moment, as fixed by the Treaty of the EC, version of Nice.¹

1. For monetary policy in the Euro area, full EU level competence exists, with the European System of Central Banks. For investment credit at EU-level, the European Investment Bank stood ready.
2. For preserving the level playing field in the Internal Market, it is the EU Commission which is vested with a set of established EU level competences, for protecting competition and preventing or authorising state aid. The Directorate General Competition (DG Competition) wields these instruments with authority and effectiveness.
3. An institutional supervision of banks’ activity, as to systemic risk at the Euro area level, did not exist. In contrast, it does for the compliance with a number of micro-level EU-directives implementing an internal financial market with freedom of establishment for banks. In principle the Member States implement these directives, with the Commission supervising adequate implementation. In one of its first strategic actions, in fall 2008, the EU Commission

¹ This version remained valid until 30 November 2009. From December 1, it was replaced by the version of Lisbon (the former constitutional treaty for the EU). Since that date EU competences conform to the Lisbon Treaty.

acknowledged the insufficiency of the system and commissioned a report on the future of European financial regulation and supervisions, from a group headed by Jacques de Larosière.

4. Concerning public debt crises or the insolvency of Euro Member States, the EU Treaty does not mention them expressly. But it does accept the possibility, by explicitly forbidding the bail-out of sovereign debtors in the Euro-area by Member States and central banks.
5. For aiding or rescuing distressed banks, on the other hand, the respective home country governments were (and still are) responsible, following different national legislation. EU rules only set a frame, controlling for compliance with EU competition and state aid rules. The ECB did its part with drastically lowered interest rates and quantitative easing measures. A minimal set of common criteria was set up by the Council decisions of October 2008.
6. Finally, the stimulation of national economies by *fiscal policy* measures remains in full national competence, with the treaty only setting minimal limits to this autonomy with a demand for non-binding participation in a loose co-ordination effort.² In fall 2008, the Council could only establish a minimum of additional rules, with its short list of criteria to respect. One EU actor exists for EU sponsored investment credit, with the European Investment Bank.

In contrast the instruments of *monetary policy* stimulation are fully Europeanised, concentrated in the European Central Bank. The ECB could and did act early on with lowering interest rates and with expanding its refinancing operations, according to its appreciation of the situation, and its perceived obligations and competences under the Treaty.

Second Phase of Member States' and EU Reactions

In the second stage of Member States' and EU reactions to the crisis, strategies can be divided into three types, oriented either towards a preservation of the existing integration level, towards an adaptation of rules and institutions in the sense of making them more effective, or towards the creation of new rules and institutions to extend the scope of EU integration over not yet covered financial policy aspects.

1. Concerning *monetary policy* in the Euro area, the ECB's status was preserved and confirmed and its instruments and their scope further developed.
2. For the competition and state aid control, directed by the Commission's DG Competition, the powerful status of the latter has been confirmed as well. Even so, important qualifications for its role in this crisis had already been demanded by the Council in October 2008. The Commission quickly introduced them in its practice. In sum the GD has to take a broader approach to its cases, and take issues of financial stability and Member States' economic situations and interests more explicitly into consideration.
3. The supervision of banks at EU level is substantially strengthened, together with the role of the European Central Bank and the Commission. Both play an important part in the construction of innovative institutions, ESRB and ESA, erected for a first-ever EU-level supervision at the macro-level, and for a more effective supervision at the micro-level of banks and other financial market actors.

² This is organised around a commonly decided set of "broad guidelines of the economic policies of the Member States and of the Union" according to Art. 99 TEC (Art.121 Lisbon Treaty TFEU).

4. The first-time threat of sovereign default of Euro Member States (€-MS) has provoked the biggest advance of all, towards the uncharted waters of binding fiscal policy intervention vis-à-vis over-indebted Euro member states, flanked by the introduction of a gigantic bailout mechanism financed by the EU, the MS and the IMF. The Greek and the Irish bail-outs are the first life-size experiments for this new structure. As yet, these innovations are conceived only as 3-year emergency regimes for resolving the affected Euro-member states' public debt crises, to be supplemented by a more robust framework for (sovereign debt-)crisis resolution, attached to the existing SGP. But they may well permanently re-structure the whole set of rules and institutions governing the fiscal policy co-ordination between Euro member states.

In the context of this change, the European Central Bank has assumed a role as lender and bailer-out of last resort –even though indirectly– for illiquid €-MS governments, effectively dumping the no-bailout rule also from its side. Market pressure against over-indebted governments is to be contained by these new EU-level institutions.

5. The Commission is trying to extend EU competence in banking legislation, especially by creating an ex-ante rule book for aiding or rescuing distressed banks, especially cross-border banks. But in the best case scenario, only limited progress is foreseeable for EU-level procedures or institutions, consisting of further rapprochement and co-ordination of national legislations and of national banking emergency tools. Integration will advance only in small steps. Relative to the market-breakup in 2008-9 these steps may well be too small to re-establish the pre-crisis freedom of movement and establishment of banks in the single market. Its most important symbol, the 'single passport', may not survive.

6. Finally, the direction of economic policy formally remains in national competence. Even so, collectively the Member States have delivered a very voluminous fiscal policy stimulus. And they have divided it up according to their respective ability, and not according to their GDP shares, a step of further increased de-facto intra EU solidarity – as suggested by the common criteria of fall 2008.

Concerning the European Investment Bank, there is all the same a drastic expansion of its credit volume of almost 60% in 2008-9, a volume which may in large part remain in place after the crisis situation, and strengthen the EU's funding power.

In 2010 stimuli wind-down moves to the fore, and here the established Euro-system Stability and Growth Pact competences for correcting excessive deficit and debt do give formal co-ordination powers to EU-level institutions and procedures – but as yet no 'bite'. Even so, these competences are being utilised since early spring 2010.

Concerning monetary policy stimulation, competence is concentrated in the ESCB, at EU level. The ECB has meanwhile engaged to start with the withdrawal of liquidity as required by the coming stimulus 'wind-down'.

Thus, the degree of European integration or co-operation, of monetary, financial and economic policy reactions to the crisis, has overall remained high and has even clearly advanced in important areas, since the full onset of the crisis. That is the good news.

Remaining Questions

Even so, important question marks remain. On the one hand, concerning policies in the competence of the Union already before 2008: Here, the common denominator of many of the advances, and even of the preservation, of the established level of European co-operation and integration has been

that supranational institutions were bound more closely into a strategy defined and directed by intergovernmental decision-making at Council level. The specific rule-sets designed to safeguard supranational institutions' autonomy, and their specific role, in the execution of the tasks at hand, appear to have been partly sidelined in this process.

Secondly, concerning the policies in the competence of the Member States, before 2008: Here, important advances of policy cooperation or co-ordination are being made, but in trying to avoid all transfer of competences from the national to the Community level, and to conserve the mutual distribution of powers. The Member States circumvent those institutions and decision-making methods specific to community type integration and in the process renounce to the advantages it can confer for effectiveness and speed of common action. Advancing in that manner can for instance entail sidelining the European Commission or limiting it to a secretarial role, or having to find original new ways of having Member States co-operate to reach a given common objective.

This experience could be a singular one, with a quick return to the institutional and procedural status quo ante. But current EU policy does not seem to run in that direction.

For the case that the unorthodox co-operation of community and of intergovernmental methods were preserved, together with the reduction of institutional 'inhibitions' on the supranational side, there are two contradictory scenarios to expect: First, this could be considered a sign of increasing maturity of integration and the changes could be considered an important step forward with a longer-term pro-integrationist perspective. But the second interpretation would be that underlying interest divergences continue to prevent Member States from converging toward consensus in an un-constrained co-operation with the supranational institutions. Even for the most important issue of them all, the enhancement and 'hardening' of fiscal policy co-ordination under the Stability and Growth Pact, the two sides would remain unable to find a consensual and effective solution. Then, the devaluation of rules, criteria and status in the system could lead to a serious longer-term impairment of integration.

In another interpretation, the intergovernmental solutions pre-empt crucially important fields of functional co-operation which are eminently suitable for further integration by competence transfer to the EU. In a pessimistic and static vision they thus close them to further Europeanisation; in a more dynamic view, it would at least take additional time before Member States would come around to switching a given coordination scheme from the intergovernmental to the community method.

The EU's Actors in Crisis Policy

Summing up the actors' record in crisis policy at this point is all the more important because first the ensuing policy chapters have no explicit focus on actors, and second because roles and relative influence of actors have indeed evolved during the battle with the crisis. As the crisis is not yet over, neither have these changes ended. In fact, the extension of the crisis to sovereign debt is affecting actors in different but not less serious manner, and has caused the creation of new EU institutions in its turn.

The relative distribution of powers between the different EU institutions and the principles guiding their work, viz the supranational and the intergovernmental ones, has remained formally unchanged.

But the fact was that new policy co-ordination became urgently necessary in fields which had remained under national competence such as bank rescue and insolvency law, fiscal stimulation and public borrowing. Here, initiatives and first co-ordination steps necessitated a strong investment of Member State initiative at the intergovernmental level.

This gave a larger share of the EU-level policy initiative and policy direction to the European Council, and to the Council of the EU. Insofar as these new policies were specific to the Euro area –as for instance the protracted debates about saving the insolvency-threatened Euro-member states’ public debt–, a strong incentive arose to treat them only in a Euro group formation of the European Council. Thus not only did the crisis strengthen the share of the European Council in EU policy making. It also gave the occasion, more and more routinely since fall 2008, to assemble a restricted Euro-formation of the European Council, the constitution of which had always been opposed before, by many governments such as the German one.

This change of actors’ relative influence being largely due to the relative weight of intergovernmental, and of community type policies in the EU’s handling of the crisis, the push for a larger or a smaller role for community type policies is also a push to increase, or to reduce the supranational institutions’ and especially the Commission’s weight in this crucial domain. But this is not just an issue to be judged in terms of effectiveness and institutional merit. It is also an issue of basic orientation for the EU’s future integration logic.

This combination of institutional jostling, effectiveness considerations and basic structural choices is nowhere more evident than in the EU’s search for how best to reform the EU Member states’ fiscal and economic governance within the EMU.

Judging by the decisions of 2010 and beginning of 2011, a few preliminary conclusions can be drawn on the outcomes

1. As to the forum for formulating the proposals, the Member states put themselves into control, in creating the Van Rompuy task force composed mainly of national ministers of finance, with the Commission and the ECB only entitled to ‘inputs’, alongside of the Member states. Even between the members of this restricted group, there is a massive difference of influence to the advantage of certain large MS (France and Germany).
2. As to the respective roles of the actors, clear differences would result depending on the weight of two mechanisms:
 - (1) Enhancing the SGP: On the one hand, the governments assembled in the Councils and especially the European Council (full and Euro group members) have further strengthened their innovative role even in the EMU domain, vis-à-vis Commission and ECB, confirming previous developments.

This also showed in the negotiations about the reformed SGP. On the other hand, in implementing the reformed SGP (according to the present drafts), the Commission would gain considerable additional power by making more –and more consequential– assessments, and recommendations, on the rule-conformity of Member states’ fiscal policies, and on sanctioning their non-compliance.
 - (2) Creating an orderly debt restructuring: In case that the orderly debt restructuring became a credible instrument of EU’s fiscal-economic governance, the whole procedure of the sharpened SGP with its enhanced Commission competences could lose much of its importance. Governments could well pay more attention to sovereign bond yields than to the preventive and the corrective arm of the SGP.

Depending on the relative success of these two components of new financial and economic governance of the Eurozone, either of the two might lose importance relative to the other. The integration advance resulting out of this governance reform might indeed take very different paths in the future.

A short and anticipatory look at the other policy domains shows the Member States in the driver's seat also elsewhere, for EU-wide innovations in common economic and financial policy making also where it involves the supranational institutions.

In its stride, the Council strove to determine the direction and the guidelines of EU action down to the point of defining the place which the Commission or the ECB should assume in it. The letter and the spirit of the treaty rules defining the two institutions' role vis-à-vis the Member States sometimes took second rank. It is true that in sum this tended to re-define the division of powers between EU institutions, in financial and economic policies, to the advantage of Council and Member States. This process has not ended by January 2011.

The most significant evolution has taken place at the level of the European Council, first for its increasing measure of leadership, and second concerning the emergence of a Euro group formation of the European Council. This originally French proposal has long been successfully opposed by the German government. The repeated need for high-level emergency decisions at Euro group level has finally prevailed over this opposition. Member states come out of the crisis with a stronger role in EMU than they had before, and this is as true vis-à-vis the Commission as vis-à-vis the ECB.

The Commission went through a dip in influence from which it only re-emerged in 2010. The EU, and itself, having little other direct competence, it had its first and by far its strongest operational and immediately effective role in supervising and defending the level playing field of the Internal financial Market, by applying the Union's existing financial market legislation, and –especially– its competition and state-aid policies. It also must preserve the integrity of these policies and competences itself.

But it has also had quick success with new conceptual work for improving financial supervision. For the other construction sites it appeared absent from the debates, returning only from the end of 2009, with new concepts especially in the field of bank regulation (resolution regime, CRD, and neighbouring issues like rating agencies) which only start to bear fruit at the end of 2010.

Given the Member States' inability to advance EU preparation of an emergency and resolution regime for bank crisis, cooperation in the issue of emergency legislation for important field of banking regulation, the Commission's state aid control was not only a 'negative' integration measure of acquis preservation, but contributed also 'positively' to the emergence of a new de facto EU regime for handling future banking crises.

The European Parliament became involved once the innovations took the form of legal proposals, especially since 2010. New supervision legislation is a case in point. In sum, the Parliament does not up to now appear affected in its role and power, by EU crisis politics.

The European Central Bank finally has at once proved itself an adept operator of its monetary policy competences, but also a dramatic innovator. It has gone up to and for many beyond, the limits of what the EU Treaty permits it, assuming the role of the Euro area's lender of last resort and even of Member States' bailer-out. These unquestionable advances in the 'Europeanisation' of Euro-member states' sovereign risk certainly also constitute advances of European integration. But they also appear

to endanger the strong institutional and financial position of the European Central Bank which allows it its dominant monetary policy role in the first place. At the end of 2010 the ECB has appeared to look for an exit from its excessive bail-out engagements.

Here, as for the Commission, a definite assessment of the changes is not yet possible.

Presentation of the Results

The presentation of the detailed results for the four topics of our seminars is organised in a common manner, around the notion of “advance in integration”. The preceding summary interpretation of the results has already shown that ‘advances in integration’ are not to be understood in a narrow and exclusive manner, with the transfer to the community method as the sole criterion. All advances of policy co-ordination and co-operation among EU Member States which contain the promise of consolidation and consensus, and thus also hold out the solidifying and colimited, in this report.

For each of the four policy fields, and according to the case also for the sub-topics, the results and arguments are grouped and presented under four headings, leading up to a statement on what we consider **the probability of integration advance**, as deductible from an analysis of positive and negative forces acting on the leaders. Accordingly

1. we start with a general appreciation of whether the functional and institutional logic suggests a **Potential of integration advance**,
2. ensuite checking recent developments for concrete indicators for such integration advance: **pro integration advance**,
3. next asking from the other end, for indicators pushing in the opposite direction: **contra integration advance**,
4. and ending with a kind of synthesis: the statement on the **probability of integration advance**.

As to the topics, we start out with the banks, their supervision at the national and the EU level, and continue with the efforts to keep them afloat and to restructure them.

In the next stage we look at national and EU level efforts in 2008-9-10, at fiscal stimulation of the flagging national economies, and at the upcoming efforts of 2010 and following years to exit from these stimuli before they create either an inflationary wave or pull public finances into a crisis of confidence of the kind which has already played itself out with the Greek debt crisis of 2010.

The final part of the report turns to the Euro system and the challenge which excessive borrowing and indebtedness of a number of Member States have posed to it.

FOUR KEY POLICY FIELDS OF DEALING WITH THE FINANCIAL CRISIS IN THE EU



REFORM OF EU BANKING SUPERVISION

Supervision is an important objective of financial market reform in the European Union on its own account. Its institutional setup and the definition of its official mission go a long way in determining the effectiveness of its function. This is what will be analysed in this present chapter.

But it also stands at the crossroads of Bank Restructuring and of Bank Resolution, two other urgent fields of financial market reform, closely linked to the improvement of supervision.

On the one hand, the principal norm of *bank restructuring* in the EU will be the reformed *capital requirements directive CRD*. Banks' compliance with the requirements of this directive for their day-to-day business is enforced by intervention powers of banking supervisors vis-à-vis non-complying banks. Insofar as effective supervision constitutes a passive element of the legal frame for a more sustainable business routine of restructured banks.

On the other hand, once a bank fails to comply with the requirements, the directive provides 'trigger' criteria for supervisory authorities to become active and utilise their powers for *early intervention* to remedy problems before they become too severe. A further shift in gears takes place once a bank is on the point of failure or has become insolvent. Bank law or insolvency legislation then provides supervisors the *tools of resolution*. Here the supervisory authorities become the principal actors which direct and organise the wind-down, the takeover, or the re-capitalisation of this bank, such as to ensure the continuity of essential services and to manage the failure in an orderly way (or prevent it altogether).

Bank restructuring and reform of bank resolution, together with the contributions they will make to the ongoing reform of supervision, will be dealt with in the two following chapters.

But the more explicit part of the new rule-book which *supervisors* apply in evaluating banks' business behaviour, or which authorise their interventions into banks' management, and the challenges posed by transnational banks branches or subsidiaries as to interventions and as to eventual burden sharing, all that is taken up in the present chapter, under the heading of Supervision.

Potential of Integration Advance

The financial crisis has revealed, more urgently than the years before, the crying insufficiencies in national, but especially in Europe-wide financial supervision, be it at the macro-level, of *aggregate excess credit*, or at the micro-level, in measuring the *individual banks' contribution* to this excess credit and to the systemic risk. European supervisors stumbled into the crisis half-blind, especially for the systemic risk accumulation created at the EU macro-level, by banks which had rapidly expanded in recent years as to their business volume, its variety and complexity, and its international reach. Governments had been free not to listen to supervisors, and disregard their signals. Political actors and experts are of one opinion: this has to change. Supervision has to be improved, and to be set into an institutional frame where its voice will be better heard by the governments. And tools have to be put in place, to control/restrict the macro-risk of excess credit and leverage.

Pro Integration Advance

An important result of this consensus had been the creation of the de Larosière committee in fall 2008, which formulated the central objectives of the reform.³ Following these objectives, the European Commission submitted its Communication of 27.05.2009 (Communication from the Commission. European financial supervision, Brussels COM (2009)252). We will briefly outline both the macro- and the micro-prudential related proposals which the Commission made:

- At the **macro-level** the Banking Supervision Committee of the ECB, will be replaced in 2010 by the European Systemic Risk Board (ESRB), set to begin this year (first reading in the EP and single vote being planned for June 15/16 2010). This board, responsible for macro-prudential oversight of the EU financial system and for issuing risk warnings and recommendations is to be composed of the 27 EU national central bank governors, the ECB President and Vice-President, a Commission member and the three chairs of the new European Supervisory Authorities. In addition, a representative from the national supervisory authority of each EU country and the President of the Economic and Financial Committee may attend meetings of the ESRB, but may not vote.

At the **micro-level** the Level Three Committees are replaced by three European Supervisory Authorities (ESA), organised in a European System of Financial Supervisors ESFS. (Currently there are still three financial services committees for micro-financial supervision: (supervision of individual financial institutions) at EU level, with advisory powers only: the Committee of European Banking Supervisors (CEBS), Committee of European Insurance and Occupational Pensions Committee (CEIOPS) and the Committee of European Securities Regulators (CESR)).

- A very strong role given to the ECB in the ESRB, and to the Commission, in both ESRB and ESFS, together with national central bankers and the old level-3 committees,
- A strengthened 'soft' power for alerting EU institutions on emerging macro-risks identified by the ESRB, a 'hardening' EU power for the ESFS vis-à-vis recalcitrant national supervisors.

Contra Integration Advance

Many aspects of these proposals have given rise to dissensions between Member States, but also between European institutions. We discuss them under the headings of "Procedural and Political", "Regulatory", "Institutional", before we sum up.

Procedural and Political

TIMING: The UK critique of the Commission, that its proposal appears to put the new supervisory institutions first, and wants to follow up with new regulation, whereas the UK preferred the new rules to be there first. The new institutions should be put in place only once the regulations are there which they will apply, and not the other way around.

LEGAL BASE: Considerations of *status* are one key aspect - The ESRB is established on the basis of Article 95 of the EC Treaty as a body without legal personality. A 95 is general legislation, with a strong place for Commission and QMV, it permits to create the ESRB as a separate legal entity, explicitly beside the ECB. The ECB had favoured a solution via A.105.6, a specific passerelle for EMU and for explicitly strengthening the ECB in financial supervision and putting the ESRB in a tributary

³ See a virulent attack on the group, accusing it as lobby group for banking interests in the EU, unable to give a new and impartial approach to the supervision issue. Cf. <http://archive.corporateeurope.org/docs/would-youbank-on-them.pdf>

position. Its consensus obligation, while difficult to attain, could help to protect the independent status of the ECB. The solution, still unsatisfactory to the ECB, has been to limit the ESRB to the status of a 'consultative body'.

Regulatory

Regulatory issues in supervision of banks crosscut with regulatory issues in banking per se. Whereas the supervision aspect is largely in national competence, with the EU co-ordinating aspects for cross-border banks, bank regulation as such is the result of an international norm-setting effort in the Basel Committee, the result of which is then integrated into Internal Market legislation for the financial market. This is taken up in the next chapter.

For financial supervision MS have very different legal frameworks and find harmonisation very difficult. This is an issue especially in the micro-prudential field, whereas the rule-set for macro-prudential supervision is smaller and simpler, and more consensual. The cause is not only autonomous national legislation. One of the paradoxes of Europe is also that, even in the fields of Internal-Market-wide harmonised legislation, Member States have frequently ended up with regulations which vary widely from one to another. This is due to the use of "national exceptions" which have proliferated and resulted in very diverse ways of transposing Community legislation into national law, encouraging regulatory arbitrage (de Larosière in a recent speech to the Belgian Financial Forum 220110).

At the official EU level, in the Commission's proposals, there is up to now very little new regulatory text. On the other hand, the Commission's concept already attributes a competence of hard executive intervention in support of EU level regulations, to the institutions-to-be.

In the same way as the de Larosière report, the UK expresses a clear priority for pan-European harmonisation of financial regulation, i.e. a removal of the differences between the existing ones in the MS, leading to unequivocal and equitably implemented texts. Good information, it insists, should be assured for MS-supervisors everywhere. In addition, the implementation of supervision norms all over the EU should also be harmonised. Supervisors should follow common technical standards and guidelines, and common reporting formats. Flexibility, discretion and derogations vis-à-vis different Member States, as were practised by the EU Commission in the past, should be banned.

If the Member States can agree among each other with many of these requests, they diverge on one capital point,

- namely whether they should be satisfied with a harmonisation of important parts of financial regulation, and with rules which would insure this regulation's equitable application all over the EU, by closely and trustfully cooperating supervisors who remain national and independent,
- or whether they should go further, first as to *the regulations themselves*: harmonising down to the level of the banks' 'rule books', and secondly as to *their application*.

Institutional

Whereas London insists on advances in the body of regulations, the only official EU proposals by June 2009 concerned new EU-level supervision *institutions*; this has not changed at the end of November. We already mentioned the planned new institutions ESRB and ESFS with their respective macro- and micro-prudential mission. While there is a measure of consensus building up around accepting these two missions, controversy brews over the exact form of the institutions and over the extent of their power vis-à-vis existing national supervisory systems.

Two or one, and how large? The most obvious controversy concerned the question whether there should be two new institutional pillars of supervision, or just one. For one group of countries and the Commission, there ought to be one for the macro-, and another one for the micro-level. For the other group, led by London, one small and independent institution suffices, looking after macro-prudential foresight, but mainly responsible for dealing with the excessive divergence in banking regulation which was mentioned further up. It would look after European harmonisation and upgrading of existing national regulation and implementation. The micro-level operational tasks would be fully left with the existing national supervisors.

For both sides there is an important material concern, namely the numbers of additional staff needed to make the new EU-level institutions function in a satisfactory manner, especially the ESFS three micro-level authorities. In the Commission's vision, they will not only have to start diagnosing their respective sectors of the financial market, and overseeing national supervisors on the one hand, but in addition to develop binding new standards and regulation and invent, together with the Commission the extremely complex new legal framework within which they can act in future. Experts count with the need of very considerable additional staffing, i.e. hundreds of well versed experts. Already now the under-staffing of existing national supervisory authorities is a big problem. This indicates the size of the challenge which must be taken up and solved in a very short lapse of time, as the Council would like the new structures to be already in place before the end of 2010. Whoever wants to stymie the new institutions' effectiveness, can still do so in limiting their funding.

EU-level competencies: *But the hardest controversy concerned the status which the two new institutions –and their decisions! – should occupy, vis-à-vis national supervisory structures. In this the UK is joined by other powerful players.*

- Concerning the right of ESRB to micro-prudential supervisory information from the national level, the Ecofin Council (090609) has not wanted to support it outright, as demanded by the deLarosiere group (recommendation 16). The draft regulation gives the right to the ESRB to receive such information from a number of national institutions, but always with a qualification that this must be “needed for the fulfilment of its tasks”, which opens the possibility of refusal.
- Concerning 'hard' competencies for the ESFS vis-à-vis national supervisors, as proposed by the Commission:
 - o power to make –in situations of persisting divergence between national supervisors– binding decisions over the proper enforcement of EU legislation on the financial system;
 - o responsibility for the authorisation and supervision of certain specific entities with pan-European reach, e.g. credit rating agencies and EU central counterparty clearing houses;
 - o In crisis situations, the power to adopt specific emergency decisions, as e.g. short selling restrictions, which should be defined in Community legislation.

As for the ESRB, but even more urgently, the issue of *full mutual information* is of highest importance for effective work especially of multinational supervisory colleges of cross-border banks. At present, the exchange of information remains too often constrained by the supervisors' fear of revealing confidential data of bank subsidiaries under their national responsibility, thereby losing some of their freedom of action in cases of crisis. The challenge –not yet resolved– is therefore to find a method for sharing the maximum of mutual information, all in protecting confidentiality and the common rather than the national interest.

As to the first two 'hard' competencies for the ESFS vis-à-vis national supervisors, these were rejected by a certain group of MS, including the UK, and the Germans, because they could force MS into costly national public bail-out or rescue measures ("would impinge on member states' fiscal responsibilities") under national law, in consequence of European decisions. These countries demand solutions which would have no national fiscal consequences. This position was once more confirmed by the Council's "general approach" concerning the Commission's proposals of 031209, providing that decisions taken by the ESAs would not impinge in any way on the fiscal responsibilities of the member states. Any binding decision taken by the ESAs would be subject to review by the EU courts.

This fiscal responsibilities dilemma is taken up again in the debate of a cross-border bank resolution regime, further down. In this debate, the Commission has explicitly proposed, on May 29 2010, to introduce a requirement for Member States to establish national funds according to common rules into which banks are required to pay a levy, plus more common and detailed criteria for burden sharing to finance cross-border crisis resolution efforts. The funds would not be used for bailing out or rescuing banks, but only to ensure that a bank's failure is managed in an orderly way and does not destabilise the financial system.

Probability of Integration Advance

In January 2011, the four central elements of the new European System of Financial Supervision (ESFS) –the European Systemic Risk Board (ESRB) plus the three sectoral European Supervisory Authorities (ESA) – have been put into place by regulations established in November and December 2010. The ESA take over all existing and ongoing tasks and responsibilities from the preceding CEBS, CEIOPS and CESR.

In the words of the regulations which established these bodies, "The main objective of the ESFS shall be to ensure that the rules applicable to the financial sector are adequately implemented to preserve financial stability and to ensure confidence in the financial system as a whole and sufficient protection for the customers of financial services".

The ESFS shall comprise the following:

- (a) the European Systemic Risk Board (ESRB), for the purposes of the tasks as specified in Regulation (EU) No 1092/2010 and this Regulation;
- (b) the European Supervisory Authority (European Banking Authority) established by Regulation (EU) No 1093/2010 of the European Parliament and of the Council;
- (c) the European Supervisory Authority (European Insurance and Occupational Pensions Authority) established by Regulation (EU) No 1094/2010 of the European Parliament and of the Council;
- (d) the European Supervisory Authority (European Securities and Markets Authority) established by Regulation (EU) No 1095/2010 of the European Parliament and of the Council;
- (e) the Joint Committee of the European Supervisory Authorities (Joint Committee) for the purposes of carrying out the tasks as specified in Articles 54 to 57 of this Regulation, of Regulation (EU) No 1094/2010 and of Regulation (EU) No 1095/2010;

(f) the competent or supervisory authorities in the Member States as specified in the Union acts referred to in Article 1(2) of this Regulation, of Regulation (EU) No 1094/2010 and of Regulation (EU) No 1095/2010”.

The new European Supervisory Authorities will co-ordinate the regulation of the banking and insurance sectors and the securities markets, with the old, plus the important new competences. Day-to-day supervision of individual institutions remains with national regulators.

The probability of integration advance in the supervision is confirmed by the results of the July 2010 stress test of banks in the Eurozone. As Karel Lannoo, renowned expert on EU bank supervision, explained in a very recent CEPS Commentary (The bank stress tests: a work in progress, 30 July 2010), “National supervisory authorities in the EU demonstrated, probably for the first time in EU history, that they can work together effectively, under tight deadlines, and jointly analyse the soundness of the European financial system. The coordination by the Committee of European Banking Supervisors (CEBS) has set a standard for what the new European Banking Authority (EBA) should become, in close cooperation with the ECB and the European Commission. The priority now should be to make this a permanent and even more European initiative, to further harmonise the standards and coverage, and refine the findings.”

The supervision of banks at EU level will likely be substantially strengthened, together with the role of the European Central Bank and the Commission. Both play an important part in the construction of innovative institutions, ESRB and ESFS, erected for more effective EU-level supervision at the macro- and the micro-level of banks and other financial market actors.

BANK RESTRUCTURING

Introduction

Directly linked to Banking Supervision Reform, **Banking Restructuring** constitutes the second aspect of EU-Member states' answer to the Financial and Economic Crisis.

Bank restructuring, in the words of the Competition Commissioner Ms. Neelie Kroes, “means tackling the problem of impaired assets, the problem of insufficient capitalisation and the problem of banks' business models, risk management and governance in general.” (09/06/09 - [State aid: Commissioner Kroes briefs June 9 Council of Economics and Finance Ministers on restructuring of banks and their return to viability](#))

These elements of bank restructuring are being dealt with in the **first part** of this chapter on bank restructuring. All countries with sophisticated banking systems pursue similar objectives in the field of banking restructuring. Nevertheless, differences do exist between Member States, as to the institutional framework, both in the structure of banking systems and the organisation of controls.

The new elements have to be fit for implementation within specific national systems of banking legislation and surveillance. And for EU Member states, they must also conform to the minimum of common rules which permit the free movements of capital, and of banks, between them, as stipulated by the Treaty.

Bank restructuring is decided on, and implemented, in co-operation with other governments, requiring decisions about:

- the place which reformed Basel Committee norms, and new common EU or G-20 norms are going to have in defining new legal parameters to which banks are supposed to conform within member states' own jurisdiction,
- the place for consensual norm creation (by supervisory institutions, for instance) by participating in the reform effort at the Basel committee or at the EU level,
- member States' degree of co-ordination with on-going EU-legislation, and compliance with it,
- The remaining differences accepted or desired, between national and EU-wide norms and their eventual effects on EU-wide financial market norms integration.

In fact, notwithstanding the differences in the purposes/objectives of reformed banking legislations, between taking account of national specificities on the one, and of EU rules on the other, the prudential rules used are increasingly analogous, due to the growing trend towards international harmonisation within the framework of the European Union and of the Basel Committee. This concerns the participation in the international fora of EU, Basel Committee and Financial Stability Board (G20), as much as the transposition of their results to the national level of EU Member states.

Today, we remark a large and increasing amount of cross-border banking inside the EU. More than 20 percent of bank assets in the EU are under the control of foreign banks, with percentages higher especially in Central European countries, but also in certain banking sectors. This comforts the EU's objective to have banks to be able to compete and realize economies of scale across the EU, choosing freely whether to do so through cross-border transactions, branches, or subsidiaries, in the interest of deepening and widening the financial market, rendering it more resilient and better able to satisfy the capital needs of the 'real economy' in every part of the EU.

One of the great EU achievements to support this process has been the creation of the ‘single banking passport’—introducing the freedom for banks legally established within an EU Member State to operate across EU borders without needing additional authorisation. This achievement of the free movement of capital and services in the Internal Market has been challenged by the financial crisis and the measures which Member States took for the restructuring of their banks, driving wedges into the financial market. In the aftermath of the crisis strong efforts are being made to mend the damage done and strengthen the structures.

There are two principal construction sites which count in EU bank restructuring:

- Review of the Capital Requirements Directive (CRD);
 - Creation of a new EU emergency regime for future cross border banking crises.
- As Čihák and Nier write, robust financial frameworks require strong regulation and supervision and adequate deposit insurance arrangements. For the overall framework to be effective, these tools need to be complemented by dedicated resolution regimes to stabilize and control the systemic impact of a failing financial institution. (Martin Čihák and Erlend Nier, IMF WP 2009, p.3)

Since the onset of the crisis the lacking scope and effectiveness of financial market regulation, supervision and insurance, and of appropriate resolution regimes has been confirmed globally, including within and at the level of the European Union (EU). The insufficiencies of supervision at national and at EU level have been discussed further up. The manifest lacunae of insufficiently coordinated and diverse national emergency measures for stabilising the banks are discussed further down, in this chapter.

The initiatives for more common regulation and insurance at EU level are addressed in the following pages. Here again, national approaches have shown their inadequacy in confronting the crisis, at the national levels but also as to their aptitude for effective co-ordination at the Eurozone-level. In the absence of robust resolution regimes, the fiscal cost of supporting individual banks has surged and bail-out expectations increased, with attendant costs for the longer-term stability of the financial system.

Review of the Capital Requirements Directive (CRD)

Potential of Integration advance

The *crisis-motivated* new and additional integration deepening potential of bank re-structuring reform is substantial. Even so, its exact dimensions are hard to size up. This is because the development inside the EU is only part, even if it is a substantial one, of a larger worldwide banking reform process, in which the EU Member states plus a number of other powerful national and multinational actors participate. To measure the development of EU-integration in the field of bank-restructuring-policy, we would need to know what exactly is the contribution of EU institutions and procedures to the ongoing reforms of banking inside the EU, as well as in the implementation of these reforms inside the EU banking system.

- (1) A first regard concerns the 'volume' of the crisis-motivated adaptation as compared to the pre-existing body of rules which are applied by all developed economies worldwide. In fact, even this pre-existing framework of regulations under the name of Basel II, hardly finalised and adopted in 2006, has already been attacked by many critics, who attribute some of the blame for governments' and supervisors' inability to prevent the financial crisis, to exactly this framework. There is considerable potential for improvement.
- (2) A second regard concerns the integrated EU system's contribution to the drafting of these amendments: Only the contribution which common EU-proposals have succeeded to make to such amendments, will be counted.

Deepening potential is present insofar as EU member states could, in acting together, exercise more influence to introduce their preferences onto the agenda of FSB and G-20, and into the Basel Committee negotiations.

- (3) As to the implementation of these amendments' content, clear deepening potential is evident as well. Integration advances will only be considered to be embodied by those parts of it which would not have been implemented by EU MS, if they existed outside the EU. This takes account of the fact that all member states of FSB, G-20 and the Basel Committee, in fact all developed economies, implement the amendments to Basel II to a higher or lower degree. If EU member states did just this but not more, it could hardly be called integration, much less would it be an indicator of integration deepening.

There is clear deepening potential insofar as an effective reaction to the crisis with its direct challenge to the single financial market in the EU necessitates a speedy and coordinated implementation of these amendments in all EU MS.

- (4) Again, there is high integration deepening potential as concerns the effectiveness and the uniformity of EU member states' compliance with these amendments. It will only be considered insofar, as it implies an added degree of *commitment in their transposition*, and of *institutionalisation in the legal-procedural setup assuring compliance*, for EU MS as compared to other European adherents of the Basel regulations.

Will there be integration deepening in this special policy field? Already now the answer is a clear Yes. It is especially marked in the field of supervision, the advances of which are presented in the preceding chapter of this report. But in banking regulation, the potential is also there.

Pro Integration Advance

- (1) As concerns the 'weight' of the crisis-motivated adaptation: Since the full onset of the financial crisis in fall 2008, already two sets of amendments have passed, a first one concerning securitisation, large exposures, supervisory amendments, hybrids, liquidity risk, and the second one on the trading book, re-securitisation, and remuneration. The first already passed into legislation by the Council and the EP, the other has been adopted by the Commission. These amendments do constitute very important changes. In December 2009, the Basel Committee on Banking Supervision issued a set of new capital adequacy proposals – “Basel III” – which has become the centrepiece of the Group of 20's financial reform efforts. They concern dynamic provisioning, options and discretions, tighter definitions of capital, liquidity standards, an overall leverage ratio, counterparty credit risk, countercyclical capital buffers and short-term liquidity buffers to cover temporary cash shortfalls.
These supplementary amendment projects contain also the intention to achieve a truly 'single rulebook' from 2012 onwards, by drastically reducing the number of remaining 'national options' and 'discretions'. Depending on the amount of further harmonisation actually reached, this could constitute a substantial step of further integration for banking legislation inside the EU. Reactions to the crisis have thus certainly intensified and accelerated a still ongoing process of Europeanisation in banking legislation.
- (2) As concerns the integrated EU system's contribution to the drafting: The EU has a clear functional incentive to uphold and adapt, and to round off existing integration in this policy area, and to introduce this priority into the discussion of the competent international fora. The Commission's role in sitting at the Basel Committee's table, and in the G-20, as well as on the FSB, strengthens integration in its turn by highlighting its familiar role of giving voice to the medium and small EU member states which do not have access to these crucially important decision-making fora. Of 27 member states only six (UK, France, Italy, Germany, Spain, Netherlands) are directly present at both FSB and Basel Committee level; of the small-medium ones Belgium, Luxemburg and Sweden make it to the latter's sessions. Excepting these six plus three, all the rest depend on the Commission's, or other member states' intermediation.
- (3) As to the implementation of these amendments' content: The first set of CRD amendments have to be implemented by member states in January 2011. Are EU member states likely to adopt a higher share of the reform content than if they were non-member states? They are, just as they have already been in the past, for Basel II. Assuring between themselves a full freedom of movement for capital and for banking services, they want to remove each and every legal difference which might falsify competition and put banks of one MS at a disadvantage in pursuing their business in another MS. This objective has led them to introduce within the Single Market a clearly larger share of the Basel Committee banking regulation, than sovereign states feel compelled to, outside of the EU, which often only introduce parts of the latter, preserving their national legislation for the rest.
- (4) As to the effectiveness and the uniformity of EU member states' compliance: Has this Plus of intra-EU effectiveness and uniformity in compliance been larger in comparison to former time? In fact, many States –even with the best of intentions to comply with the Basel Committee framework amendments– sometimes take very long to actually adopt them in their own legislations. After that, their judicial system may take its time as well, to fully apply them. And even then, they may be implemented in another manner, according to other administrative procedures etc., than in a neighbouring country. All this would be poison for the European

Union's Internal Market, the cohesion of which is built on the simultaneity and the uniformity of the member states' compliance, so as to avoid disadvantages for the early and effective compliers, to the advantage of the laggards. Thus indeed, the EU does add a true 'plus' as to effectiveness and uniformity, arming its directive with a deadline for transposition in member states, and closing as much as possible, all doors toward a substantially different application of the framework rules between member states. This is supervised by a European system of supervisors. The Commission and the Court of Justice are there to give additional punch to these rules.

International Context

An improved EU CRD cannot be created by the EU member states acting on their own. Its drafting takes place in an established and close co-operation in the context of the Basel Committee on Banking Supervision (Basel-Committee). The predecessor legislation in this area is the Basel II framework, elaborated by the Basel Committee in the first part of this decade.

This time around is different, insofar as the Basel Committee work is linked up with the intensive crisis-motivated financial regulations reform effort at the level of the Financial Stability Forum and the G-20 Group itself, assembling the finance ministers and central bankers of the G-20 member states. Both have become –in addition to the European Commission– strong political interlocutors for the Basel Committee, in its turn composed of central bankers and bank supervisors of its member states. Their input plays a larger role, insiders report, than ever before in shaping the Basel Committee's reform text.

This has consequences for the EU's role and for that of its principal actors, the European Commission, the European Central Bank, the national central banks and the finance ministers of six plus three member states which speak for the European interests.

Whom does this constellation favour, inside the EU political system? Constraining the small and medium member states to make their voice heard at this level only through the Commission (if not through allied large MS governments), this international context would appear to favour the EU institutions. The argument works also the other way around, as the Commission must try to get a consensual backing from this member state group to be able to throw in its full weight on any given topic.

But it remains also true that the six largest and financially most weighty member states come and speak for themselves. Given this constellation, the modified international context may well encourage splits between EU member states, according to their national interests.

Contra Integration Advance

In spite of the strong potential for integration deepening, advances are ambivalent.

As to the integrated EU system's contribution to the drafting of these amendments, there may even be a step back from former practice. This would be due to the fact that the six/nine largest and financially most potent EU member states take part in this drafting process as autonomous members of the G-20 group and the FSB, and of the Basel Committee, over a series of three negotiation and decision-making steps of which at least the first two in FSB and G-20 have high political potential. Once common positions are fixed at that level, they will be carried into the Basel Committee negotiations and can largely predetermine them.

The large majority of the medium and smaller member states have to find a common position to the issues at hand inside the Union, together with the Commission, to which they will try to rally the larger member states before negotiations at G-20-level begin. Otherwise the 'EU-position' in FSB and G-20, will in fact only be the one of the medium and smaller member states, as represented by the EU Commission, and it may or may not coalesce with that of the six/nine others which can negotiate on their own account.

Have common EU positions of the 27 been tabled more often during the Basel committee's recent sessions, than during the work on Basel II? At first view, this does not appear to be the case. The EU position has become one of the contributions to FSB's drafts for the G-20 input to the Basel committee. When the larger EU MS prefer to negotiate directly with other G-20 actors –according to their national, and not so much to their European, interests– the EU-position will weigh even less, at the Basel committee table.

As to the implementation of these amendments' content by EU legislation and rule-setting, there are justified concerns about "appropriate transposition of Basel III into EU legislation". The chair-woman of the European Parliament's Economic and Monetary Affairs Committee recently complained, that in a report about bank capital in anticipation of Basel III, due to be voted on September 12 2010,"amendments have already piled in demanding delay, watering down requirements, enshrining exemptions and specificities. There is little support for greater harmonisation."

Probability of Integration Advance

In spite of this ambivalence, there is reasonable probability for tangible integration advances in this important sector of EU bank-restructuring policy.

A more or less substantial advance in legislation can be expected which will change the regulatory landscape in EU member states. This will likely happen in a number of distinct steps, the duration of which are not yet determined.

The EU will likely introduce a large proportion of the new or amended legislation content under its own competence, and extend, all in all, the scope of its own competences over bank re-structuring in the process. In spite of concerns about certain aspects of this implementation, integration advance may be expected.

Likewise, a further step forward can be expected in the effectiveness and the uniformity of EU member states' compliance with the amended regulations.

There are indicators that the black spot in this stock-taking concerns the EU's integrated participation in shaping the content of this new legislation: here, stagnation or even a step backwards may be expected, because of the autonomous participation of large MS in a global financial diplomacy which has intensified strongly in the course of the financial-economic crisis, and in the Basel committee, alongside of the EU.⁴

⁴ For the last developments, check:

at EU-level, http://ec.europa.eu/internal_market/bank/regcapital/index_en.htm, and http://ec.europa.eu/internal_market/consultations/docs/2010/crd4/consultation_paper_en.pdf

Directive 2010/76/EU of the European Parliament and of the Council of 24 November 2010, as regards capital requirements for the trading book and for re-securitisations, and the supervisory review of remuneration policies <http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=OJ:L:2010:329:0003:0035:EN:PDF>

The ECB seems to defend a similar view, see: Document Press of ECB

12 April 2010 - Today, the European Central Bank (ECB) is publishing its fourth Report on Financial Integration in Europe, which notes the return towards integration in the European financial markets.

The second chapter contains an in-depth assessment on banking integration and supervision in the European Union (EU). It shows that integration in retail banking markets is lagging behind, while the wholesale banking activities have traditionally been highly integrated. The financial crisis has slowed down the integration process in the banking sector, but this effect is likely to be only temporary. The crisis has accelerated the debate on financial regulation and supervision, resulting in the proposals for a new EU supervisory architecture, which is expected to be beneficial to both financial integration and stability.

Seen from the vantage point of January 2011, this general assessment still stands. After prolonged negotiations, the Basel Committee has produced a set of new and clearly more demanding capital requirement (concerning the ratio of its core tier one capital to its risk-weighted assets), concerning especially new requirements for the core tier 1 capital, plus a countercyclical buffer, bringing the ratio up from 2 to 7 percent in future. The volume of credit the bank may concede on a given core capital is more limited as well, through the stiffening of leverage ratios. And Liquid asset requirements will be raised as well, to meet crisis-related demands on banks' liquidity for a 30-days period. All of these changes had to pass the scrutiny of the last G20 meeting in Seoul and are to be phased in over a number of steps until 2019.

The Commission plays its role in translating these changes into a comprehensive revision of the EU's Capital Requirements Directives, which are supposed to become national law by the end of 2011. For the time being, Member States seem poised to transpose the new rules quickly and without difficulty into national regulations.

The US, long resistant to Basel's rules, has also agreed to follow the new framework by 2011.

It remains true that the political role of the large Member States in shaping Basel Committee decisions and thereby the Capital Requirements Directive has become clearly larger. The simple fact that the G20 meeting in Seoul had to approve of the decisions before they could become part of Basel III appears a strong indicator of this development.

at Basel Committee level, Basel III: International framework for liquidity risk measurement, standards and monitoring, December 2010

Create an improved EU Emergency Regime for Future Transborder Banking Crises (“Dedicated Resolution Regime”)

Potential of Integration Advance

There is considerable Deepening Potential in an Improved EU Emergency Regime for Future Transborder Banking Crises. It would draw the consequences out of the legal halfway-solution which the EU had found for the reorganisation and the winding up of transborder credit institutions in distress in the different member states, and the consequences this had during the crisis. In fact the EU ensured and still ensures the mutual recognition and co-ordination of procedures under home country control and imposes a single-entity approach by which the 'parent' bank and its foreign branches are reorganised or wound up as one legal entity under the law of the home State. It prohibits the application of separate insolvency measures to branches under the law of the host State. But simultaneously, the national insolvency legislation for banks has remained very diverse. In addition, the single-entity approach does not cover banks' separate legal entities like subsidiaries, which still remain subject to their respective national legislation. (Cf. Directive 2001/24/EC on the Reorganisation and Winding Up of Credit Institutions. Cf. also COM(2009) 561/4 and now (COM(2010) 254) for further points raised in these paragraphs).

With the rapid internationalisation of the EU banking sector and the development of large cross-border groups in pre-crisis years, a perilous contradiction was allowed to emerge between the increasingly Europeanised activities of the EU's banks, profiting from the single market's 'single passport' on the one hand, and a very decentralised EU architecture for financial crisis management on the other, in which the crucial powers remained with national authorities which were bound into a very weak system of co-ordination. This contradiction has put the preservation of the single banking passport into jeopardy ('Turner dilemma') and provoked strong push for supplementary EU regulation to prevent similar problems in future.

In the hottest phase of the banking crisis, from fall 2008 to summer 2009, Member States paid the price for not having a truly common and effective *Emergency Regime for Transborder Banking Crises*. When transborder banks approached insolvency and needed urgent help to keep afloat, nationally separated bank emergency treatment, as practiced in these months, proved slow, costly, and economically dysfunctional, more so than what it would cost within a more europeanized framework. This explains the effort to set up or to improve bank resolution regimes in order to protect governments and taxpayers from the obligation to save systemically important banks by spending gigantic amounts of public money.

Strong functional push for such a regime comes also from outside, in the G20, in which leaders at the Pittsburgh summit of 250909 declared their intention to act together to "...create more powerful tools to hold large global firms to account for the risks they take" and, more specifically, to "develop resolution tools and frameworks for the effective resolution of financial groups to help mitigate the disruption of financial institution failures and reduce moral hazard in the future". The IMF has argued strongly in the same direction, explicitly supporting the EU Commission's project.

The integration deepening potential of an improved EU emergency regime for future transborder banking crises is substantial. As in the case of the CRD, its exact dimensions are hard to size up. Again, this is because the development inside the EU is only part of a larger worldwide effort. And again as for CRD, the progress represented by this EU banking resolution regime project is hard to

gauge because it builds on existing EU banking regulation, on the one hand, and on existing national rules - for resolution.

A first regard concerns the 'volume' of the crisis-motivated adaptation as compared to the pre-existing body of rules. This consists of EU-level regulation, and of national legislation. The latter are either dedicated banking legislations, or they are contained in general insolvency regimes.

Theoretically there is high deepening potential in an improved EU emergency regime for future transborder banking crises: Existing EU banking regulation already includes resolution rules for certain types of banks, the new project is to widen their scope. Including the whole galaxis of EU banks' subsidiaries, in other EU member states, up to now under national banking legislation, into a widened EU-coordinated approach would considerably extend the scope of EU financial emergency legislation over separate legal entities within a banking group (i.e. subsidiaries). Also, this improved regime would extend the EU's legislative reach over a larger number of steps, in the process between the explicit identification of difficulties of a bank, by supervisors, and early intervention, and down to management of bank insolvencies.

Our seminar gave only limited information on the kinds of national measures which Member State governments utilised to stabilise and re-structure banks in the national territory. However, to gauge Integration Deepening Potential emerging from the financial and economic crisis, a pre-crisis benchmark is necessary. This can be established from recent research, and the publications of the European Commission, together with official papers of Member State governments. A good summary of this is in a December 2009 Working Paper of the Brussels think tank BRUEGEL (Banking Crisis Management in the EU: An Interim Assessment, by Jean Pisani-Ferry and André Sapir), out of which much of the following is taken.

Following P-F&S' analysis, one can state that first, the prudential framework followed by national supervisors was largely harmonised by EU legislation, essentially following the Basel Committee norms (CRD). Second, a Committee of European Banking Supervisors (CEBS) was established in 2003, but its role is limited to facilitating consultation among supervisors and to providing technical advice to the European Commission on regulation and convergence of supervisory practices. Third, provisions were made for co-operation in time of crisis. This "architecture for crisis management" as P-F&S call it, is composed of a number of crucial functions: the "lender-of-last-resort" function, that of 'bailer-out' as one might call it, or "crisis-resolution", and that of "deposit-guarantee".

After looking at the volume of new legislation, a second regard concerns the integrated EU system's contribution to the drafting of these amendments. In fact, the EU is free, together with the member states, to legislate in this area, without accepting policy rules conceived in another international decision-making forum. Insofar, the Commission can cover considerable new ground by proposing legislation here, for those areas which fall under EU competence because they impinge on the preservation of the level playing field in the single financial market. Late in 2009, the Commission has reacted with a communication which addresses all the different elements which must be assembled to reach this objective inside the EU, and the conditions which must, on the other hand, be respected to preserve the Single Market. In May 2010 it has reported to the European Council on concrete policy proposals, and by the end of the same year is to submit drafts of legislation in this field.

But given that authority for governing this field still remains at national level, progress might well elude the advocates of a unified EU level emergency regime. In that case, an EU co-ordination effort would also be necessary to create the 'second best' alternative, i.e. introduce new (or adapt existing) **national** resolution regimes fit to take the new challenges into account, which acquire enhanced EU-

wide interoperability and must be enabled to function as a transnational EU-wide regulatory system in case of need.

The overriding aim is to put in place a framework that will allow a bank to fail –whatever its size– while ensuring the continuity of essential banking services, and minimising the impact of that failure on the financial system. This is essential to avoid the 'moral hazard' that arises from the perception that some banks are too big to fail.

Different from the CRD, which basically is a piece of regulation for a functioning bank system, to be respected by market actors and authorities, an indispensable part of single financial market regulation for the EU, banking resolution regimes are this as well, but they are also more: They provide for the commitment of executive action in urgent cases, as well as for public emergency funding of potentially very considerable volume. If this part of the resolution regime project succeeded, EU competences in this field would reach into policy areas which member states have not before opened up to the Union. Here, there would not only be a gradual and quantitative but a qualitative advance towards more and deeper integration.

There are three alternative degrees of public intervention into a bank group in crisis:

“Early Intervention”: Aid the group to survive by early supervisory intervention. A crucial point which needs EU harmonisation would be the rules governing intra-group asset transfer between solvent entities for the purpose of mutual support to keep the whole group afloat.

“Resolution”: Aid the group to overcome a situation of illiquidity intact, by restructuring, re-capitalisation etc., these measures also have to be brought into harmony between member states.

“Wind up (or down)”: Wind up and perhaps re-organise a group in definite insolvency, under the applicable insolvency regime. Here again substantial advances can be made from the present state of different legal regimes from one member state to the other. The largest advance of integration in these different areas would be the creation of an EU body of law for these different phases, in lieu of the multiple national legislations, and the installation of a new EU authority to implement it. The Commission proposes measures in this direction in its Communication of 20 October 2009, COM(2009) 561/4.

New EU legislation would strike a new balance between protecting the legitimate interests of shareholders and enabling resolution authorities to intervene quickly and decisively to restructure a failing institution or group to minimise contagion and ensure the stability of the banking system in affected Member States. An EU resolution framework would also have to contain appropriate mechanisms for redress and compensation. And a bank resolution framework could include compensation mechanisms to ensure that no creditor is left worse off than it would have been had the bank under resolution been wound up under the applicable insolvency law.

Perhaps the thorniest issue, there is also recognition that use of public funds may be unavoidable at some stage of a resolution. Urgently needed progress could come in clarifying how the potential costs of managing a crisis in a cross-border bank would be shared between affected Member States.

An EU bank resolution framework would also harmonise powers to facilitate or effect private sector acquisitions, transfer business to a temporary structure (such as a "bridge bank") or to separate clean and toxic assets between "good" and "bad" banks through a partial transfer of assets and liabilities.

Finally, a new EU resolution authority, put alongside of the new EU supervision institutions, would bring an unheard-of degree of effective EU-wide co-ordination of all these new measures.

As to the implementation of these amendments’ content, the deepening potential is not comparably evident. Integration advances will only be considered to be embodied by those parts of it which would not have been implemented by EU MS, if they existed outside the EU. If there is no EU-level regulation, but only a more interoperable set of reformed national legislations,

the integration deepening at the implementation level will only be identifiable in comparing these national legislations, and comparing them with EU-level recommendations as for instance in the EU Commission's communication (COM(2009) 561/4).

Insofar, the integration deepening potential as concerns the effectiveness and the uniformity of EU member states' compliance with these amendments appear rather limited as well, up to now.

Pro Integration Advance

There are strong functional incentives to advance in this direction, revealed in many EU governments' official reactions expressed vis-à-vis the recent communication of the European Commission.

- There appears to be a high degree of consensus with respect to the objectives for a crisis management framework, such as preserving financial stability, minimizing cost to the taxpayer and protecting depositors.
- Equally, governments could agree to the type and the harmonisation of early intervention tools.
- Similarly, Member State governments will support the need for orderly resolution procedures for ailing banks, and for the resolution tools suggested in the Commission's Communication (private sector acquisition, transfer of business to a temporary bridge bank, partial transfer of assets and separation of clean and toxic assets between good and bad banks).
- And finally, most of them agree about the demand that private sector financing should be available for crisis resolution measures in order to reduce public expenditures.

Contra Integration Advance

However, looking closer at the the feedback to the Commission's above-mentioned communication, there is an unmistakable sign of the difficulties for any follow-up to the seemingly convincing incentives : In fact, there was very little consensus in these official reactions, on how all this might be achieved. And as for the more daring concrete proposals of the Commission, for instance the idea of a rescue fund, it was typically suggested that it was pre-mature.

At a general level, precedent does not encourage the expectation of having the Union and its institutions strengthened, in piloting EU anti-crisis policies.

Past experience in the internal financial market does not support strong expectations for the present projects either. Where risks crop up for the survival of the single passport regime, this appears to be as much because of the Commission's failures as initiator of new legislation, where it was necessary to uphold the present level of integration or to advance further. What is striking is how little progress was achieved in terms of building a European crisis management framework, despite the urgency since fall 2007. As a matter of fact the recommendations contained in the October ECOFIN Council conclusions of that year, and in the June 2008 MoU were almost similar to those contained in the EFC report of April 2001 on financial crisis management, the so-called 'Brouwer Report'. At the heart of both sets of recommendations was the need to improve the cross-border exchange of information. Unfortunately neither created incentives or obligations to change the behaviour of national authorities, thereby leaving the problem of information exchange unsolved.

It took until 2009, that new Commission ideas on this subject were communicated to governments and other stakeholders.

Two other fronts of contradiction exist, vis-à-vis the pro-deepening argument.

The first concerns *EU integration as an acquis*, the highly valued freedom of circulation for capital, and of the establishment of banking services, throughout the EU. The expression of this is the EU 'single passport' for banks; threats to its continued validity constitute threats to EU economic integration. In spite of this, Member State reactions to the financial crisis since autumn 2008 have in fact not protected but threatened the survival of the single passport regime for banks, as governments continue to prefer national competence for all public bail-outs for banks, to EU coordinated or EU directed solutions. But if the single passport is not considered a high value worthy of defence, then a Europeanisation of the resolution of ailing cross-border banks does not appear so urgent after all.

The second concerns *EU integration as policy process*, the continuing transfer of legislation and executive competence in the financial policy field, from the national to the EU level. In this case, it concerns the resolution of cross-border banks. Coming back to the Commission's communication on an improved resolution regime for banks, one can point to serious points of resistance in the public reactions of member states against a fuller EU based regulatory framework in the sense just outlined, the principal points where new rules appear necessary, being highly sensitive in terms of national interest and sovereignty, as the Commission itself acknowledges.

This starts with the early intervention, where in spite of general agreement to having comparable tools (but no single toolkit), governments are unable to find consensual positions on issues as important as the branch or the subsidiary supervision in host states (cf. Turner dilemma), and the intragroup transfer of assets. It continues with the reserves vis-à-vis a single set of triggers for early intervention or for resolution, with the refusal of 'living wills' for cross-border banks, of creating a European Resolution Authority or accepting an integrated insolvency framework.

If governments accept talking about a co-operative network of national bank resolution funds which could be asked to co-ordinate their action in case of need, most of them will not accept to be told how to use them, by a European authority, neither do they want to europeanise this lever of banking policy by accepting a European Bank (or depositors') Rescue Fund.

Another sign of the Member States' hesitation vis-à-vis decisive advances in the field is the failure of the French initiative for a European Bank Rescue Fund. France, presidency power of the EU in the second half of 2008, tried to have the Chiefs of State and Government of the €-Group accept the idea of a European Bank Rescue Fund in October 2008. As rumours emerged that Mr Sarkozy was considering a €300bn (\$384bn, £255bn) European rescue fund for the continent's banks, the German government opposed the concept and the other governments gave no determined support to France. Anyhow, the French "idea" seems to have been not much more than just that. In October 2010, German refusal to consider such a scheme resulted in a Franco-German press-conference in which even the French president declared himself opposed to such a scheme and denied having any responsibility in this concept.⁵ Only after weeks of negotiations between Paris and Berlin, culminating in two summits in the French capital in October 2008, did Germany sign up to a joint European framework –what Ms Merkel dubbed a "toolbox" of measures– within which member states would take simultaneous action to salvage their respective banks (FT 24112008). Was this a missed opportunity of potential integration advance? The evidence does not support this

⁵ Finance Minister Lagarde was made to assume the responsibility because of her Handelsblatt interview proposing such a fund, <http://www.france-allemande.fr/Gemeinsame-Pressekonferenz-mit,3694.html>

speculation. If one considers the French policy stance since that moment, and especially in answering to the Commission's communication, then France did not and does not in 2010 consider europeanising cross-border banking resolution. It is clear that national governments refuse true advances in europeanising certain vital governmental intervention rights in the financial market. They want to retain them, even though accepting more EU constraint on the manner that they can utilise them.

Probability of Integration Advance

In sum, the Probability of Integration Advance in this sector did not seem very likely, seen from the vantage point of spring 2010. It may well be that direct EU regulations and EU centralised authorities will prove impossible to introduce. Advances of integration which are possible will rather be measured in degrees of further rapprochement and co-ordination of national legislations and of national banking emergency tools. The survival of the single passport for banks, and the freedom of the banks' EU-wide establishment in a truly single market for financial services for which the single passport is the symbol, is therefore no longer assured.

There is a general receptivity of MS governments to the objectives of a new crisis management framework for cross border financial institutions in the EU. Also, the early intervention tools against faltering banks, and the resolution tools proposed by the Commission were in general well received and strongly supported. But a translation of the general support into concrete common measures, and especially the more ambitious and more integrated measures, proposed by the Commission proves to be unacceptable to the large majority of governments, for the time being.

The same is true for the demand to have banks participate in the financing of intervention and resolution. Much as this principle is supported by the MS, there was only very little consensus on how this was to be achieved. An EU rescue fund, already turned down by the de Larosière group in winter 2008/9, found no favour either. But at least, the concept of a network of national funds met with some support. And Michel Barnier, EU internal market commissioner, tried to advance further in this direction on May 25, 2010 by setting out more substantiated [plans for member states](#).

The recent German draft law for bank resolution and its financing, with its explicit opening for EU-(or even world-)wide networking in this sense, is an important sign of support for this strategy. But up to end of May 2010, the other two decisive governments, in Paris and London, all in supporting the bank levy, refuse to 'save' it for a national fund and prefer to consider it as normal revenue (FT 260510).

Simultaneously the run-up for this German initiative once more puts the EU integration impetus very much into perspective, between global and local incentives. The idea of this kind of bank tax only moved centre-stage after the US announced a unilateral levy on its banks in January. The UK followed suit and now it is Germany, probably being followed by France. The second element is a difficult election campaign in a German Land, where the hope to aid its political allies, by flattering the popular anti-bank sentiments, gave the government the decisive incentive to hurry this draft through its first cabinet reading.

The further development up to the end of 2010 has confirmed the modest expectations of spring. The Commission's Communication of October 2010 (COM (2010) 579 final) sets out a general EU framework for crisis management concerning troubled and failing banks. The Commission intends to proceed gradually towards such a regime. As a first step it will adopt before the summer 2011 a

legislative proposal for a harmonised EU regime for crisis prevention and bank recovery and resolution. This will include a common set of resolution tools for national authorities and reinforcement of cooperation between them, in order to improve the effectiveness of the arrangements for dealing with the failure of cross border banks. The Commission also wants to build on the reformed supervision structures, including the new European Banking Authority, to coordinate and support national measures.

For the crucial point of financing intervention and resolution, the new regime has to content itself with relying on national capacities and will still abstain from measures which might “impinge on the fiscal responsibilities of Member States”, meaning that European authorities will not be invested with power to take, or to enforce, any consequential bank resolution measures without the express agreement of the responsible national authorities.

In January 2011, more than one year after its above-mentioned first communication on the issue (20 October 2009, COM(2009) 561/4), the Commission is still uncertain about the exact manner in which to advance even in for the prudent first steps of a ‘harmonised regime’. It starts a second consultation, for which reactions are requested by the end of March⁶. As to its more ambitious ideas for an “Integrated framework for the resolution of cross-border groups”, the European Commission has relinquished them for the moment. They are only to be re-considered alongside the review of the EBA Regulation, in 2014.⁷

The Commission’s Action concerning State Aid to Banks (further down) could compensate some of the lacking bank resolution competency at EU level. But this will not last indefinitely, and important elements are still lacking. In fact, where the resolution regime sought to establish a new consensus about a number of important and contentious steps, having to go on with the state aid regime forced the Commission, governments and banks into more protracted and uncertain case-by-case negotiations.

⁶ http://ec.europa.eu/internal_market/consultations/docs/2011/crisis_management/consultation_paper_en.pdf

⁷ For latest advances as of 01-2011cf. also http://ec.europa.eu/internal_market/bank/crisis_management/index_en.htm
http://ec.europa.eu/internal_market/bank/crisis_management/index_en.htm#framework

Handling the Emergency: Assuring the Compatibility of National Emergency Strategies of Bank-restructuring with the Internal Market: EU State Aid Policy

I. Introduction

The third part deals with the EU's response and is constituted by the *emergency actions* of the national governments between fall 2008 and summer 2009, as they attempted to stabilise national banks (of systemic relevance?) which risked default on account of their engagements in impaired assets, or because of the freezing up of all interbank credit. The principal operative competence of the Union in this domain is its Competition and State-Aid Policy. It is implemented by the European Commission, acting with an exceptionally high degree of autonomy (cf. TFEU Art.101 ff, especially Art.107 (formerly TEC 81 ff, especially Art.87). This is not a constructive role of advancing integration by new rules or institutions. Rather it is an ex-post role of protecting and preserving the integration acquis, by controlling Treaty implementation.

Given the aforementioned immense difficulties of the member states in advancing towards an emergency EU regime for the resolution of banking crises, the simple preservation of the acquis – the single financial market – against distortions by state-aid, took on much increased importance beyond this narrow objective. It emerged as a kind of intermediate answer to the resolution challenge in which the community preferences could become clearly visible.

II. The importance of the Commission's Role

In assuring the compatibility of national emergency strategies of bank-restructuring with the Internal Market, this ex-post role of the Commission was and is crucially important. Why is this so? The principal reason was the simple absence of other, more forward-going competences of the Union and the uncoordinated manner of Member States advancing to save their own banks.

Our seminar gave only limited information on the exact kinds of national measures which Member State governments utilised to stabilise and re-structure banks in the national territory. The Commission saw it like this: "The recent crisis has exposed the EU's lack of an effective crisis management for cross-border financial institutions. In autumn 2008, Member States agreed to take the necessary action to recapitalise and guarantee banks, and this unprecedented action was coordinated at European level on an ad-hoc basis. The measures were necessary in the exceptional conditions that afflicted the financial system. National approaches differed, but broadly speaking authorities either used public money to bail out banks, or ring-fenced a bank's assets within their territory and applied national resolution tools at the level of each entity rather than at the level of the cross-border group. This raised the risks of reduced confidence, competitive distortions, high bail-out costs carried by taxpayers and legal uncertainty." (COM(2009) 561/4, p.2 intro). This appraisal concerns specifically the cross-border banks. But of the systemically important banks almost all fall into this category, and those which don't were nevertheless dealt with according to the same rules.

"Co-ordinated ... on an ad-hoc basis", that is a euphemism for the pervading absence of effective EU-level co-ordination. "Competitive distortions ... and legal uncertainty", these risks highlighted the one point on which practitioners and recent research fully concur: The level playing field in the single financial market became seriously threatened by national governments' national strategies of bank stabilisation and restructuring.

P. Artus has looked at state guarantees for banks' debt. For instance, some countries gave a government guarantee on interbank loans (Ireland, Germany), others did not. In most countries, banks issue under their

own name with a government guarantee, in France a public agency (SFEF) has been created; the duration of the guarantee differs from one country to the other (2 years to 5 years). Again, the differences also imply very unequal benefits for foreign banks and their branches and subsidiaries (P.Artus, Berlin – SWP, May 26, 2009).

Another history was the uncoordinated and drastic adaptation of national deposit guarantees for bank deposits.

The different national actions vis-à-vis banking institutions in distress –capital injections, asset relief measures, guarantees on assets and liabilities and liquidity support– succeeded in stabilising the financial system. In doing so, they also propped up failing institutions and supported creditors at huge costs to public finances: Until the end of 2009 alone EU governments committed aid amounting to around 30% of EU GDP, while the aid used amounts to 13% (Brussels, 20.10.2010 COM(2010) 579 final, An EU Framework for Crisis Management in the Financial Sector, p.2). As the European Central Bank wrote in 2010, “The crisis affected financial markets to very different degrees. The most integrated ones, such as the money markets, showed clear signs of retrenchment within national borders. The bond and retail banking markets, by contrast, were less affected, and the equity markets did not show any appreciable retreat from cross-border integration. As financial markets gradually returned to more normal conditions in 2009 and 2010, the markets that had suffered most also returned more rapidly towards their pre-crisis integration levels.”

Again the degree of equality among financial market competitors, on the level playing field of the EU’s internal financial market, constitutes a highly valued *acquis* of integration reached in the EU. Putting it at risk, in the course of uncoordinated national emergency measures for saving national banks, constitutes a threat to Integration which has already been highlighted further up. Observers also feared for the preservation of the EU’s own regime for protecting economic competition, and for limiting and authorising state aid.

Whereas constructing an Improved EU Emergency Regime for Future Transborder Banking Crises, and improving banking regulation in the context of a reformed Capital Requirements Directive constitutes the proper mid- or long-term answer to this threat, in the years 2008-2010 neither the one nor the other was (and is not yet) in existence. It is discussed further up. The protection of the EU’s high level of financial market integration against distortions assumed the highest importance. The tools for this are the EU’s competition- and its state-aid regime. Preserving the market integration, and apply the EU’s regulative tools to do so, this has been the second, the more urgent, and the more effective line of defending, and perhaps even of strengthening, the EU’s integration in this field.

As already noted, the body of guidelines and decisions elaborated by the Commission in the pursuit of this policy could also be understood as a first intermediate Ersatz for the lacking emergency regime. Forbidding certain national resolution measures, conditioning others and supplementing them with rules and decisions prescribed by the Commission resulted in a set of rules which would serve, for the time being, some of the same purposes as an emergency regime.

This analysis of the ex-post handling of emergency action by the Commission cannot be cast in the frame of our usual approach, working through the ‘Potential of Integration Advance’, its ‘Pro’ and its ‘Contra’, and finally its ‘Probability’.

First there is actually no advance in this specific domain, it is all about preserving the *acquis*. Then intersections of the different aspects coming into play are even more numerous and difficult to

divide up in this order. Therefore we prefer to give a presentation of this whole issue and only then to try summing them up in the order utilised for the other topics.

III. The Complex Task of Competition and State Aid Control in a Financial Crisis

For the Commission this was and remains a challenging double task. On the one hand to uphold the level playing field of the internal financial market for the whole Union, by applying the strong and exclusive tools of EU competition and state aid control. On the other hand, it seeks not to jeopardize the financial stability of Member States, and of the Union as a whole. Doing the one, without harming the other, constituted and constitutes a first-rate challenge for the Commission, in which the autonomy of its normal competition and state aid control, and the integrity of this policy itself, may well be difficult to uphold.⁸

Concerning individual cases, this dilemma is not new or extraordinary. Situations where the basic objective of competition and state aid control has to be reconciled with different and potentially contradictory objectives, are foreseen by the Treaty, TFEU Art.107(3)b (aid ... to remedy a serious disturbance in the economy of a Member State); and 107(3)c (aid to facilitate the development of certain economic activities ..., where such aid does not adversely affect trading conditions to an extent contrary to the common interest) (=former TEC 87(3)b and c). Normally state aid may thus be authorised by the Commission, only on condition that there are no “adverse effects on trading conditions”. In addition the Commission referred to its 1994 Community Guidelines on State aid for rescuing and restructuring firms in difficulty, which have been applied on many occasions before by many member states.

Whereas cases of bank bail-outs in the EU had been treated according to Art.107(3)c, up to the Lehman Brothers insolvency, afterwards the Commission switched over to 107(3)b. With “a serious disturbance in the economy of a Member State to be remedied”, the remedial task had priority vis-à-vis an excessive attention to the preservation of the level playing field. Therefore, when it evaluates state aid to a given bank, and the financial stability at the respective national level is at risk, the Commission may have to accept the priority given to conserving or re-establishing financial stability, and the level playing field at Union level may temporarily take second rank. But it will nevertheless remain master of the case and decide according to its own judgment. But in the case of the financial and economic crisis, the financial stability was often not only at risk at the respective national level but also –due to the interconnectedness of the banks in the whole Internal Market– within this whole territory. And there was not just one case to decide but more than a hundred, within a few short months, in almost twenty Member States. In consequence, the Commission and especially DG Competition had to cede its established autonomy of judgment for a whole sector and an extended period of time, and accept a frame of criteria for its decisions in which general economic considerations took a much stronger place than they habitually did.

In the extraordinarily serious situation of the financial and economic crisis, this became the law under which the Commission had to act: in the words of its July 2009 communication, the Commission “recognised that the severity of the crisis justified the granting of aid pursuant to Article

⁸ For the State Aid Control of the Commission vis-à-vis the Banking Crisis cf. Doleys, Thomas, Managing State Aid in Times of Crisis: The Role of the European Commission. ECPR Fifth Pan-European Conference on EU Politics, June 23-26, 2010 (<http://www.jhubc.it/ecpr-porto/virtualpaperroom/084.pdf>); Elaine Gibson-Bolton and Michael Reiss, United Kingdom: Bank Bailouts, State Aid And The Financial Crisis, <http://www.mondaq.com/article.asp?articleid=87924>; CEPR report “Bailing out the Banks: Reconciling Stability and Competition” 2-2010,

87(3)(b) of the Treaty establishing the European Community and provided a framework for the coherent provision by Member States of public guarantees, recapitalization and impaired asset relief measures. The primary rationale of those rules is to ensure that rescue measures can fully attain the objectives of financial stability and maintenance of credit flows, while also ensuring a level playing-field between banks located in different Member States as well as between banks which receive public support and those which do not, avoiding harmful subsidy races.” Commission Communication (22072009): The return to viability and the assessment of restructuring measures in the financial sector in the current crisis under the State aid rules. For a scientific assessment, cf. *CEPR report “Bailing out the Banks: Reconciling Stability and Competition” 2-2010*, making the point that the insistence on minimum aid and on exit strategies must not lead to undercapitalised banks.).

Since autumn 2008, this rationale was applied to all important economic actors, especially undertakings of all kinds, of the financial sector and of the real economy. But distressed banks’ systemic crisis risk conformed most evidently to the criterion of ‘constituting a serious disturbance in the economy of a Member State’, with its potential to bring a dramatic slow-down to all economic activity in the affected Member State and beyond. Insofar the banks were accorded the most unquestioning and lenient application of Art.87(3)b.

The Commission has not had much help in defining a clear-cut role for itself from the interested actors, in a context where the banks, all in often needing state aid, would not whistle-blow against each other, whereas the big Member States’ governments did show strong but divergent interests. As to the banks, each of them is so dependent on the good functioning of the other one that they have nothing to gain from the bankruptcy or another severe disruption in a competitor’s business. So there is also little or no ‘whistle blowing’ of banks about their competitors receiving state aid.

As to the governments, depending on the Member States’ banks’ degree of exposure to bad assets (Spanish, Italian and also French banks were much less engaged in bad assets than were German banks, for instance), state aid was different in scope, guarantee schemes and grants were different in volume from one member state to the other.

Accordingly, the group of the largest most powerful Member States was divided in its positions vis-à-vis the commission’s state aid policy.

Those with highly exposed banks like the Germans would be expected to support an undiminished application of Art.87(3)b, whereas the other group, all in accepting this legal point, would fear competitive disadvantages for their banks from the state-aided competitors in other MS, and were liable to push for a strong consideration of the level-playing-field aspect.

Member States would seem to have had one more reason to look over the Commission’s shoulder in this affair, namely the resulting degree of influence which the Commission could gain in the banking sector. When reviewing and deciding on individual banks’ state aid packages, and starting from very mundane considerations about the adequacy of state aid as to the given bank’s business and to EU rules, it goes very far indeed in its power –ex-post– to adapt and down-size the effective state-aid, to adapt the bank’s size and business model, and the eventual spin-off of excessive capacities (branches, subsidiaries, business fields).

Exercising both functions together within a relatively narrow industry sector and short time window, on a very large number of cases, granted potentially a highly political role to the European Commission, which went far beyond the watchdog role and constituted a step toward a European industrial policy in the banking sector.

IV. Translation into Institutions, Rules, and Decisions

Institutions:

As a result of this complex and multifunctional task of the Commission in its competition and state aid policy, the Competition Directorate General's habitual autonomy in wielding the EU's competition policy and the anti-state-aid tools was reduced. According to high-ranking Commission officials, the DG Competition has been "induced" for the first time to an ex-ante consultation and co-ordination within the Commission, with the economic and financial General Directorates, but more importantly with the governments in the Ecofin Council, with the Economic and Financial Committee, the ECB, and the ECE. This has meant a new experience and sometimes long and difficult discussions, but it assured –according to these officials– that the approach taken was a joint one and that actions were supported by everyone.

Co-ordination with the Council and with Member States has become very important, the Council's definition of financial stability, its position on key questions of dealing with the crisis and the level playing field issues it raises, the Member States' national approaches and schemes, became an important frame of reference for the Commission DG Competition's attempts to define its own approach. The Commission thus underlined that its action was supposed to "help Member States to put in place coordinated (national! CD) concrete measures to restore confidence in financial markets in accordance with the 12th October Eurogroup declaration". Clear enough: In a first movement, national schemes were to be utilised and authorised in spite of the challenge they might pose to the level playing field ! (cf. 13 10 2008 - State aid: Commission gives guidance to Member States on measures for banks in crisis (state guarantees), [IP/08/1495](#))

Rules:

In this same first communication, the Commission quickly established a rough and flexible frame of criteria to be observed by Member States' measures. Again in its own terms: "EU state aid rules require that measures taken do not give rise to disproportionate distortions of competition, for example by discriminating against financial institutions based in other Member States and/or allowing beneficiary banks to unfairly attract new additional business solely as a result of the government support. Other requirements include that measures must be limited in time and foresee adequate contributions from the private sector."⁹ In consequence of the basic decisions referred to further up, the Commission demanded nothing more, at the height of the crisis, but that the Member State apply to it before implementing its measures, informing it about these measures, about their justification, and explaining how the basic requirements would be respected, so that the Commission had the official motive to give an authorisation or –theoretically– to condition or refuse it.

⁹ In more detail this list of criteria contained the following:

- Non-discriminatory access, eligibility for a support scheme not based on nationality
- State commitments only so long as necessary to cope with the current turmoil in financial markets but to be reviewed and adjusted or terminated as soon as improved market conditions so permit
- State support defined and limited to what is necessary, while excluding unjustified benefits for shareholders of financial institutions at the taxpayer's expense;
- An appropriate contribution of the private sector by way of an adequate remuneration for the introduction of general support schemes (such as a guarantee scheme) and the coverage by the private sector of at least a significant part of the cost of assistance granted;
- Rules preventing an abuse of state support, like for example expansion and aggressive market strategies;
- An appropriate follow-up by structural adjustment measures for the financial sector as a whole and/or by restructuring individual financial institutions that had to rely on state intervention.

Authorisation was to be given much faster than ever before, to applications which complied with its guidance. The Commission promised to react within 24 hours if necessary. Another manner to indicate that the first examination would be rudimentary and that the primary goal was to get Member States moving all in keeping the Commission abreast of the action.

Finally, the authorisations were given for a much longer period than normally, up to two years and extensible beyond that if necessary. The only obligation to be accepted at the start of this procedure was to give the Commission, every six months, a review of the measure (ad hoc intervention, or scheme), covering the justification for its continued application, and the potential for adjustments to the evolution of financial markets.

In an effort to make national schemes and measures at least more compatible with each other and with internal market rules, the Commission then worked out and published a series of “guidance” papers, addressing the principal issues which Member States had to deal with in their effort to stabilise or to restructure the banks. The delays needed to get them out (nine months from the first to the fourth) testify not only to the difficulty of finding answers to new, critical and highly complex issues, but also of finding common ground between the conflicting logics of EU action, and between the many actors involved.

13 10 2008 - State aid: Commission gives guidance to Member States on measures for banks in crisis (state guarantees), [IP/08/1495](#)

08 12 2008 - State aid: Commission adopts guidance on bank recapitalisation in current financial crisis to boost credit flows to real economy, [IP/08/1901](#)

25 02 2009 - State aid: Commission provides guidance for the treatment of impaired assets in the EU banking sector
IP/09/322

23 07 2009 - State aid: Commission presents guidelines on restructuring aid to banks IP/09/1180

Finally, even though conceding long periods of state aid, the Commission’s DG Competition does demand to terminate the help as soon as the situation of the bank and the financial market will permit it. One instrument to control for this, are the reviews which the Commission can take as the occasion to demand the adaptation or reduction of a measure, or to turn against its further continuation. And even though the start of state aid measures is eased by the Commission, these intermediate occasions, or the measures’ end sees the Commission at last assuming its role of level playing field watchdog. “Where a financial institution has received State aid, Member States should submit a viability plan or a more fundamental restructuring plan, in order to confirm or re-establish individual banks’ long-term viability without reliance on State support. The criteria and specific circumstances which trigger the obligation to present a restructuring plan, ... refer in particular, but not exclusively, to situations where a distressed bank has been recapitalised by the State, (or otherwise received substantial aid). By contrast, ..., where a limited amount of aid has been given to banks which are fundamentally sound, Member States are required to submit a report to the Commission ... necessary to evaluate the bank’s viability, the use of the capital received and the path towards exit from reliance on State support.”

It is at these moments when the Commission negotiates with the Member State, but also with the bank in question, that it can impose farreaching action in exchange for its agreement to an extension, or to an official and consensual end of the measure (cf. under ‘Decisions’). But even in

these moments, the Commission's DG Competition does not appear to enjoy its habitual autonomy of judgement any more.

(cf. Commission Communication (22072009): The return to viability and the assessment of restructuring measures in the financial sector in the current crisis under the State aid rules)

Decisions:

Within this institutional and regulatory context, the Commission handled state aid authorisations for banks very leniently. Out of ca.103 applications for schemes and ad hoc interventions, between June 2008 and June 2010, it authorised 95 without "objections", many of them getting three or more extensions within this period. Only 8 especially big and problematic cases, among them alone three German Landesbanken, had their authorisations conditioned after a "formal investigation procedure" (which the others did not get).¹⁰ Knowledgeable experts speak of approved recapitalization plans for € 313 billion from the beginning of the crisis to autumn 2009.¹¹

With months going by and the financial markets, and the banks, regaining more stability, the Commission's watchdog role comes more to the fore, even if it still appears partly muzzled. Reviews and demands for extensions of aid programs or for official wind-downs of such aid programs by Member States, the viability plans, and even more so restructuring plans which all aided banks have to present, with their corollary of proving the banks' ability to survive without additional state funds: Under improving circumstances all these give the Commission's DG Competition occasion for introducing new conditions in exchange for extending or adapting its authorisation. Conditions can include repayment of aid received, sale of assets, cession of loss-making activities, adaptation of the business model etc.. GD

Competition officials declare themselves decided to apply state aid rules with much more rigour in this second phase of bank restructuring, even in still allowing for the financial instability risk. In June 2010 the Commission listed already 9 cases currently under formal investigation procedure in cases like these. Just two examples drawn from the press, of which especially the case of Commerzbank nicely shows key elements of DG Competition's restructuring-conditions imposed on banks in exchange for state aid authorisation.

Commerzbank will have up to five years in which to

- under a restructuring deal that will see Germany's second-largest bank
- cut about 45 per cent of its assets in return for a further €10bn (\$13.4bn) in state aid.
- The restructuring is being demanded under European Union state aid rules to offset competitive distortions created by the assistance.
- Commerzbank has agreed to a three-year ban on acquiring competing businesses
- it agreed to a "no price leadership" commitment, stopping it from giving more favourable rates than competitors in markets or products where it has more than a 5 per cent market share.
- It will sell its troubled property finance unit, Eurohypo,
- plus, by 2011, a number of private banking assets inherited from its acquisition of Dresdner Bank. These include Kleinwort Benson private bank in the UK and private banks in Belgium, the Netherlands, Germany and Austria.

The terms, agreed after weeks of negotiation with competition officials at the European Commission, will be scrutinised by other banks that must devise restructuring plans to satisfy Brussels in return for aid given during the financial crisis.

¹⁰ cf. Commission MEMO /10/284 Date: 29/06/2010, State aid: Overview of national measures adopted as a response to the financial/economic crisis

¹¹ cf. E.Carletti, EUI, 11/2009

Asked if the Commerzbank deal had set a template for other banks, Neelie Kroes, EU competition commissioner, said: “Yes and no.” She said that the principles should be common in all cases but stressed that Brussels would “make tailored decisions” depending on individual circumstances.

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Dexia Bank had warned that its profits would be dented by

- a [large-scale deleveraging and divestment plan](#) imposed on it by the European Commission in the wake of the financial crisis.

Dexia had sought [state support as early as September 2008](#) after the short-term interbank borrowing market on which it relied for financing dried up.

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For other very similar examples with very consequential interventions of the Commission into the set-up, the size, and the business practice of many of the largest European banks, see Doleys, Thomas, *Managing State Aid in Times of Crisis: The Role of the European Commission*. ECPR Fifth Pan-European Conference on EU Politics, June 23-26, 2010¹²

V. EU Competition- and State-aid Policy in the Crisis, and its Effects on Integration

Potential of Integration Advance

The integrated part of the EU was fully involved here, with its most exclusive and consequential competences, and the most effective of its actors, namely the Commission’s Competition GD, playing the principal role. Its powers are especially large exactly vis-à-vis those instruments with which the Member states attempted to stabilize and re-structure their banks, namely state aid and state control over banking: The European Commission is the principal EU actor responsible for authorising or for conditioning *state aid* to private enterprises. And it is the principal EU actor for watching over the application of the *competition rules*. Even so and considering the issue in the narrow sense of state aid control, there was no evident deepening potential in the diligent application of these tools; if at all, future deepening would be favoured by confidence building in the crisis. For the short term, the DG’s effort served the simple preservation of one of the most important EU acquis, namely the level playing field within the Internal Market. This was a great opportunity to confirm the Commission’s role and for strengthening the acquis.

Pro Integration Advance

The co-ordination of its competition/state-aid policy in a new and complex manner with other EU institutions and with the Member States is a problem for the preservation of the Commission’s DG Competition’s powers. Even so, there might be a pro-integration aspect in this: help to build a more realistic and sustainable regime in this sector, adopting a more comprehensive view, supply DG Competition with more data and context information for well-informed decisions. This could be interpreted as an advance in economic policy integration. It would be preferable to a DG Comp exercising its pleins pouvoirs in relative isolation from other actors.

¹² <http://www.jhubc.it/ecpr-porto/virtualpaperroom/084.pdf>

As already noted, the body of guidelines and decisions elaborated by the Commission in the pursuit of this policy could also be understood as a first intermediate Ersatz for the lacking emergency resolution regime. Forbidding certain national rescue measures, conditioning others of them, and supplementing them with rules and decisions prescribed by the Commission, resulted in a set of rules which would serve for the time being, some of the same purposes as an emergency resolution regime. In this respect, the Commission's state aid control was not only a 'negative' integration measure of *acquis* preservation, but contributed also 'positively' to the emergence of a new *de facto* EU regime for handling future banking crises.

Contra Integration Advance

We have seen that a rigorous application of the watchdog arm of the Commission's competition/state-aid policy tools was not possible; thus the preservation of the level playing field for EU Member State banks is up to now not assured – we will have to wait. As to a more complex and sustainable regime of competition/state-aid policy, this is nothing more than reasonable speculation at this moment. Is this what the MS and EU reactions to the financial and economic crisis up to now promise to give? The continuing lack of true co-ordination on the Member States' side is no encouraging sign; on that side there is up to now no valid partner for a responsible dialogue. Thus the half-enforced openness on the side of the DG Comp, for this new complex regime risks to result in nothing but a reduction of state-aid control, without adequate compensation on the integration front.

Probability of Integration Advance

Rescue considerations took precedence in a first phase, when states were authorized to save all banks (a look at the official list of decisions confirms this generally very permissive approach, cf. Rapid Memo/09/499, 12.11. 2009, knowledgeable experts speak of approved recapitalization plans for € 313 billion since the beginning of the crisis; cf. E.Carletti, EUI, 11/2009). Nevertheless, the Commission established a measure of legal certainty by addressing a series of guidelines to MS and the principal concerned actors, on the manner in which it aimed to apply most frequently utilized measures.

At the turn from 2010 to 2011, the Commission is conscious of the recent reappearance of stress in financial markets and the risk of wider negative spill-over effects. In consequence, the special state-aid control regime of the financial crisis could not yet be discontinued. For the time being it is prolonged until the end of 2011. A final assessment remains as yet impossible.¹³

In December 2010, the most recent cases of state aid authorisation, concerning the latest instalment of help to Irish banks to be bailed out by Dublin with the help of the EU-IMF support program, confirm the continuing difficulty of the Commission's action, between the preservation of financial stability on the one, the protection of the level playing field on the other, all in respecting the national governments' policy priorities.

Financial Stability and national priorities: As Commissioner Almunia said, "The measures approved by the Commission today for Anglo Irish Bank, INBS and Allied Irish Bank *are necessary to ensure that these institutions meet their respective obligations and will help to preserve financial stability in*

¹³ 'Communication from the Commission on the application, from 1 January 2011, of State aid rules to support measures in favour of banks in the context of the financial crisis', 2010/C 329/07, 7.12.2010, <http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=OJ:C:2010:329:0007:0010:EN:PDF>

Ireland.” And: the banks had a guarantee from the Irish government to bail them out, which only now runs out. The transition of banks to more normal times takes place with the help of the EU support program.

The protection of the level playing field: As of 1 January 2011, in a change from the sound/distressed bank approach of 2008ff., a restructuring plan will be minimum to be required from *every* beneficiary of a new recapitalisation or an impaired asset measure. Thus, both Anglo Irish Bank and INBS will have to submit a *plan dealing with their resolution in early 2011*, while Allied Irish Bank will have to submit a *revised restructuring plan*.¹⁴

This tightened strategy thus conveys the signal –and an incentive– that banks have to prepare for a return to normal market mechanisms without State support. Simultaneously, the Commissions retains the flexibility to permit state aid to banks in a scenario of an overall or country-specific deterioration in relation to financial stability, which cannot yet be excluded.

Even after December 2011, the Commission’s DG Competition may well have to continue its special regime for the banks. There are, after all, troubling levels of distressed sovereign bonds in the portfolios of many of the largest European banks. The ECB retains the amassed collateral of meanwhile almost two years’ enhanced liquidity supply to banks, still waiting to be taken back by these. Without a renewed stress test for Eurozone banks which takes these risks explicitly into account, proving the contrary, many will consider that these banks have not yet exited from the danger zone and continue to need the special state aid regime.

In addition, an EU-wide *bank resolution scheme* for which the Commission GD Market has been lobbying for well over one and a half years, has not yet been formally submitted to the member states, not even in its weakest initial form. The DG Competition with its body of state-aid guidelines and decisions will therefore remain the only rampart –for the foreseeable time– against uncoordinated and incompatible national emergency reactions to a renewed bank crisis. But this will not last indefinitely, and important elements still lack. In fact, while the resolution regime would have established a new consensus about a number of important and contentious steps, having to go on with the state aid regime forces the Commission, governments and banks into more protracted and uncertain case-by-case negotiations.

In a narrow sense of holding on to the full legal and de-facto status quo of the Commission’s competition and state aid control competences, it may not even be possible to preserve the pre-2008 integration level, let alone to deepen integration in this field. Indeed the current period may have enduring consequences for the distribution of power over state aid control in the EU. Knowledgeable experts have already predicted a difficult uphill battle if DGCompetition would ever again want to impose the full anti state aid toolbox in opposition to the member states’ interests.¹⁵

Even so, other expert observers like the already cited CEPR, Doleys, Reiss & Gibson-Bolton, still see the DG Competition in the possession of its toolbox against state aid offenders some of them seeming still concerned that the DG Competition would rather overdo its watchdog role. If this was so for the majority of cases, it would be a welcome indicator of healthy counterweight against member state pressure. Preservation of integration levels in this field, or even their advance, would appear more probable. The Commission’s state aid control was not only a ‘negative’ integration measure of acquis preservation, but contributed also ‘positively’ to the emergence of a new de facto EU regime for

¹⁴ cf. http://ec.europa.eu/ireland/press_office/news_of_the_day/state-aid-anglo-aib-irish-nationwide_en.htm

¹⁵ ZEIT, 190309, p.23, cf. also CARLETTI, Elena, The post-crisis competition landscape in financial markets, EUI

handling future banking crises. A final evaluation can only come when the DG Competition will have closed its books on the bank crisis, and also when the other pieces of new banking regulation will be in place, including for instance the supervision and the information sharing part. Until then, the probability of integration advance in this area will remain highly uncertain.



Effects of National Measures and their EU-control on EU Countries outside the Eurozone and their Financial Systems

Introduction

The fourth part is to identify the effects of national measures and their co-ordination and control at EU-level, on Eurozone neighbourhood countries and their financial systems, especially inside the EU. Does membership in the EU and in its open financial market add to the economic problems in times of crisis, or does it give added growth chances and added financial stability to European emerging economies?

In terms of integration-effects this is less about advances and rather about the prevention of integration losses, especially because of Eurozone neighbourhood countries' possible dis-integration from the open EU financial market.

A debate had cropped up since late 2008 about the effects which a presumed retention of West European capital flows to the Central European emerging economies might have on the financial policy agenda of the EU. Concern was fanned by the fact that on average more than 60 percent of bank capital in these countries is controlled by foreign banks, most of them based in EU Member states and affected by the financial crisis.

In fact two economic and political effects of the EU membership can be highlighted: On the one hand membership strongly encouraged the rapid influx of foreign banks and capital into CE, provoking a credit-boom with dangerously excessive levels of foreign exchange indebtedness, but aiding quick economic growth in all of them. FDI inflows and high export dependence on EU markets also carried implicit risks, but contributed to quick growth.

But once financial and economic crisis struck Western Europe, the risks of this high dependence on Western European banking and export markets became visible, with high external debt levels, devaluation vs. the Euro and the strong credit dependence of much of foreign trade becoming a dangerous liability (via foreign exchange debt the servicing of which became much more difficult).

Indeed, these Central European economies sustained steep, even though heterogeneous output declines, from late 2008. The liabilities created by international financial integration did indeed aggravate the effects of the collapse of export markets. But contrary to widely shared concerns they did not translate into a sudden outflow of external capital initiated by cash-strapped Western European banks (capital outflows being clearly lower than in the Asian crisis 1997-9), or to widespread collapses of domestic banks, including the branches of West European banks.

In fact, foreign owned bank presence and other foreign investments were a clearly mitigating factor, given that parent banks held on to their Central and Eastern European engagements. Would they have held on only by themselves? That is not impossible, but it seems clear that the IMF-EBRD inspired 'Vienna initiative', bringing the foreign-controlled banks together and linking multilateral support directly to banks' commitments on rollover and recapitalization, together with other International and European Financial Institutions' support was of decisive importance in encouraging banks to stay.¹⁶

¹⁶ Agreement with Banks Limits Crisis in Emerging Europe, IMF Survey online, October 28, 2009, <http://www.imf.org/external/pubs/ft/survey/so/2009/int102809a.htm>

Thus there is no reason to put the EU-oriented international integration of Central European banking, or for that matter of its economies, into question. In sum, they have been and are liable to remain, important positive pillars of the specific growth model of these emerging economies. But even so, three important aspects of this European financial integration merit critical discussion:

- Within a context of largely beneficial and foreign-bank-driven capital transfer to Central Europe, certain of these foreign banks may well again descend into crisis, and certain EU Member States may not again provide the help which they could give a year ago. Greece is a case in point. Its banks have very strong and positive engagements in Central Europe. But the same banks hold large stocks of Greek sovereign bonds and suffer heavily from any risk to their market value; the speed and volume of foreign exchange credit expansion remain elements of concern which the Central European governments and certain IFIs search better to contain or to neutralise;
- whereas *national* bank restructuring policies in Western Europe seem to have endangered the Central European engagements of their banks less, it was rather *EU state aid policy* which created more pressures toward bank divestment in Central Europe. As the Commission acknowledges, it is important that balance sheet reductions do not lead to a retreat of banks within their national borders, thereby contradicting the goal of a single market in this sector (Cf. once again CEPR report “Bailing out the Banks : Reconciling Stability and Competition”). But in the second stage of evaluating and authorizing government rescue packages for banks engaged in that region the DG Competition applies a more restrictive approach in the interest of viability without longer-term state subsidies. At that point it would also ask institutions to get rid of of problematic (loss-making, or not essential to their business model) subsidiaries –for instance in Central Europe– which endangered their longer-term viability, and the sale of which would enable them to repay state aid. Certain concerned Member State governments, for instance France, tended in the same direction. The ECB is on the same line of thought: “Within the euro area financial system, important risks include the possibility of: vulnerabilities of financial institutions associated with concentrations of lending exposures to commercial property markets and to central and eastern European countries.(press release ECB 310510).
- What also remains, are concerns about banks’ home states’ strategies in situations where their debt ratio would no longer permit them to subsidise their banks’ Central European subsidiaries.

As for forex credit expansion, the resulting very specific risk supplement continues to provoke contradictory evaluations. The EBRD has seemed to favour, in its 2009 annual report, strategies which would permit CE countries to limit the forex content of foreign banks’ regional lending, all in respecting the internal market rules of the EU. For non-Member states this can still function, for instance by introducing special taxes on foreign bank borrowing (as in Croatia or Serbia). Under EU membership this would likely become illegal, being considered as a control of capital movements. It remains to be seen whether and how far this kind of measure could be acceptable even inside the EU, as a kind of prudential measure.

Probability of Integration Advance

In concluding this topic on competition and state aid policy in a situation of financial crisis, it is not really integration advance which one worries about. Indeed, the most positive result would seem to

be status-quo-preservation, as to the acquis of the internal financial market, within the Eurozone, but also beyond it, especially in the newly entered Central European Member States.

As yet, the internal financial market does not seem to be in danger, in consequence of Member States' national emergency measures. But has the Commission really been able to find the proper compromise in its role as watchdog over treaty compliance ? To be sure, it appears to have practiced a sufficiently judicious combination of macro-economic responsibility on the one, and of watchdog severity on the other to prevent the spread of moral hazard and preserve the credibility of the level playing field in the single financial market. But whether the macro-economic responsibility has not come at the longer-term expense of necessary autonomy vis-à-vis the Member States, and its watchdog competences, this remains still open to doubt.



EU-WIDE CO-ORDINATION OF GROWTH STIMULATION AND OF STIMULI WIND DOWN

Introduction

As in the other 'chapters', here too we try to understand if and how the Financial and Economic Crisis has changed the manner in which economic and financial policy actors in the EU have utilised their macro-economic tools. To find out about "change", we have to look at actors' behaviour at the beginning of the crisis, and compare it with the way in which it evolved over the next two years.

Each time, in looking at the behaviour of specific actors, we have to decide on a way in which to measure integration, and integration deepening. These actors are the Member States, acting autonomously or in common. Or they are the EU institutions.

For the EU institutions, two kinds of actors and two kinds of behaviour:

- On the one hand certain of those institutions, i.e. the ECB and the EIB, dispose of economic stimulus levers of their own, in addition to and independent from the Member States, where 'integration' consists in exercising these powers as much in co-ordination as the treaties and secondary law stipulate, and eventually widening their scope. The European Commission has certain budgetary powers which it can utilise as economic stimulus levers of its own.
- On the other hand, and given the EU's very limited budget (upper limit 1,26 % of EU gdp), the multi-annual budgetary perspective fixing large parts of it years beforehand, and the interdiction to borrow, there is almost no room for manoeuvre at the Union level to react to an unforeseen economic shock with targeted supplementary funding. The European Commission disposes at most of the power to generate ideas and initiatives in implementing the economic co-ordination objective which the TFEU formulates in its preamble and A.5, and can support the Member States to co-operate in striving for certain economic policy objectives, defined in common agendas (like the 'Lisbon agenda'). Again, 'integration' here consists in exercising these powers in the manner stipulated by the treaties and secondary law.
- For both kinds of institutions, deepening integration would then consist in widening the extent and the quality of the levers activated by these institutions within the scope of their existing powers, or in extending these powers themselves.

The Member States' economic policy, including fiscal stimulation of economic activity, belongs to their reserve of autonomous policy-making for which only non-binding obligations for mutual co-ordination, certain red lines for public borrowing, and obligatory co-ordination for avoiding or for reducing excessive public deficits have been accepted (cf. TFEU, Art.2-5; Art.119 ff.).

A kind of 'implicit Integration status' at the outset of the crisis may be deduced from looking at Member State governments' de-facto behaviour, as to more or less co-operative and integration-friendly economic, or fiscal policy. And any step toward more, or/and more explicit mutual consultation and co-ordination of economic policy, coming from that very low de-facto economic policy integration, could be considered an increase of integration in this field. Any step towards formally obliging the Member States (within the €-Group, or among the 27) to explicit consultation and mutual co-ordination in economic policy fields beyond the narrow sector just mentioned must even more be considered a clear advance towards more integration.

The Role of the European Central Bank and the European Investment Bank

The European Central Bank in Fiscal Stimulus in the EU

Potential of Integration Advance

The European Central Bank and the European Investment Bank are both institutions which can aid EU economies by supplying liquidity to Banks and capital to investors, in times of financial crisis. Do their mission and their action also contain potential for integration advance?

In the absence of a common EU fiscal policy response to the crisis, the common monetary policy, under the direction of the European Central Bank, was and is the only instrument with the potential of reacting in a common, Euro-zone-wide manner against the financial effects of the crisis. The minimum this can bring about in the sense of integration advance, is demonstrate the value of a common EU currency and a common monetary policy to its participating Member States, especially in the financial and economic crisis: They are achievements to be cherished and preserved for European integration.

One consequence of this effect would be an increased acceptance of the Euro-system among the incumbent Member States, another augmentation of entry-pressure of non-participating Member-States. In the best of cases, the demonstration of the benefits of unified monetary action, as compared to the damage created by isolated and differentiated fiscal action, ought to create a new dynamic for a europeanisation of national fiscal policies.

The official mission of the Central Bank was not liable to change quickly, not even in the heat of the crisis. But the ECB could fulfil it in a reactive, effective, forward-looking or even innovative manner which might confirm, re-enforce and enhance its role, implicitly deepen integration.

The most striking aspect of the new challenges was to open the ECB up, in dramatic manner, to the second part of its mission, after preserving the stability of the Euro, namely of taking measures in favor of Euro-zone's economic stability and growth in the context of an unprecedented crisis, and function as provider of ample liquidity to the Euro area's financial system.

Pro Integration Advance

In fact, the instruments were there for the ECB to utilise, once the central bank had recognised the seriousness of the situation and the need of banks for additional liquidity. Inflation risk was and is not considered a real menace in the foreseeable time. The more the financial and economic crisis created comparable economic distress across all Member States of the Euro zone and the less inflation threatened, the easier it was for the European Central Bank to devise an accepted one-size-fits-all monetary policy.

Already in August 2007 the ECB had decided to supply €95 billion of liquidity in a few hours because the Euro area's money market was being disrupted. Then from fall 2008 the ECB reduced its key

interest rates to unprecedented low levels and introduced a series of non-standard measures to support credit provision by banks to the euro area economy. This was essential at a time when the financial crisis had led to a virtual “free fall” in economic activity and severe problems in the money market were hampering the transmission of lower key ECB interest rates to money market and bank lending rates.

The ECB’s non-standard measures, which it referred to as “enhanced credit support”, aimed to sustain financing conditions and credit flows above and beyond what could be achieved through reductions in key ECB interest rates alone.

Its open market policy instruments were especially remarked for the full-allotment rule and the drastic prolongation of the average maturity to one year (unlimited 12-month liquidity, at the 1 per cent policy interest rate, have dominated the so-called “enhanced credit support” strategy), and for the enlargement of the eligible collateral accepted from banks, for instance by lowering the required rating (from AAA- to B-) until end 2010. Their very great flexibility of design and of application and the enormous volumes of liquidity which they actually permitted to mobilise for the disposal of the banks and according to their needs, since October 2008 and through the year of 2009: All these factors are clearly readable as highly integration-friendly, they have a pro-deepening perspective. They were extended and even enhanced in May 2009, to become even more accessible and useful for banks and enterprises.

Contra Integration Advance

The ECB might underestimate certain risks involved in some of its vast liquidity supply operations. For instance, the renunciation to a quantitative control over enhanced credit supply, via the ‘*fixed rate full allotment procedure*’ for longer periods is likely to augment the liquidity demands on the concerned banks, at the moment of maturity. As to the ECB, faulty valuation on accepted collateral could magnify the risk for the ECB to have excessive amounts of impaired assets on its books at maturity, especially with the longer allotment periods, which the banks might have difficulties to take back again at nominal value. The ECB’s procedures neutralise part of this risk, insofar as the ECB will contact banks the collateral value of which falls below the amount they have been lent. On very short notice, they will have to provide additional collateral to make up the difference, or accept a sanction.

Even so, at maturity of these emergency loans, the ECB might feel, or even become unable, vis-à-vis certain banks, to draw the full liquidity due at a given moment, back again. On June 29, 2010, on the first occasion of that kind, this concern has not yet materialised. The ECB has obliged banks to repay €442bn of emergency one-year loans. In place of this lifeline, it has again offered unlimited liquidity – but for just three months at a time. Eurozone banks rolled over just €132bn of the €442bn into the new, shorter-term facility. This suggests many are sufficiently confident about their access to funding to require less of a liquidity buffer (FT 300610).

The FT writes that the ECB would just have to return to the longer-term facility if the banks needed more liquidity. This is seeing the issue only from the banks’ perspective – another important aspect of the ECB strategy which was addressed further up. But there is also risk for the ECB’s position and autonomy. If it were after all forced to continue monetisation of large proportions of the collateral accepted for the one-year refinancing operations, or even to restart and extend it, this would impair its ability to de-monetise the accepted assets, in the moment, and at the value, that it had intended.

The ECB might thus become unable to reconcile its monetary stabilisation objectives with its efforts to aid economic growth, endangering the adherence to its money supply targets. This can still happen.

One-size-fits-all monetary policy of the ECB does not suffice to give each of the sixteen Euro-States the adequate monetary policy. In the financial-economic crisis the legitimacy of a unique monetary policy –one of the principal achievements of European integration– may therefore decrease.

The separation between the Member States inside and those outside of the Euro-zone may create additional conflicts which act back on integration in a more general sense.



The European Investment Bank in Fiscal Stimulus in the EU

Potential of Integration Advance

As shown further up, the Union herself is not able to set up fiscal stimuli in the EU. The only exception at the EU institutional level is the European Investment Bank, one of the oldest EU institutions. It can indeed borrow in considerable amounts. It can also be highly reactive in the amounts it borrows and lends, and in the sectoral orientation of its credits. In times of need, and vis-à-vis specific regions and industries, this institution permits to leverage the limited capital means put at its disposal, into a true and targeted supplement of the Union's own expenses.

This is illustrated by the comparative dimensions of EU budget and EIB Lending: EIB-Lending amounted to 56 % or more than half of the EU-Budget in 2009! Given that EIB-Lending went exclusively into investment, its contribution to EU-wide investment was about as high or even higher than that of the EU-budget. And incidentally it surpassed the combined national stimulus effort of France and the UK in extra credit etc. for the two years of 2009 and 2010.

Table: EU Budget and EIB-Lending*

Year	Volume of EU Budget, in bn € and p.a. increase	Volume of EIB Lending, in bn € and p.a. increase	EIB Lending in % of EU Budget	National stimuli, extra credit + similar measures, in bn € for 2009 + 2010
2006	120,60	47,00	39,0 %	
2007	124,46 + 3,2 %	48,00 + 2 %	38,6 %	
2008	132,89 + 6.8 %	58,00 + 21 %	43,6 %	UK: 22,4 **
2009	140,98 + 6,1 %	79,00 + 36 %	56,0 %	France: 52,7 **

*calculations by C. Deubner, from EUCOM and EIB documents, ** BRUEGEL 15 01 2009

In addition, contrary to the EU budget, the EIB financial frame was highly reactive to the financial and economic crisis: A capital increase came into force in April 2009 and raised subscribed capital to EUR 232bn (from EUR 164bn) corresponding to an outstanding loans ceiling of EUR 581bn. EIB lending showed strong reactivity as well, from 2007-08 it already increased by 21 %, whereas from 2008-09 this increase accelerated to +36 %. In the year before the crisis growth had lain at a very modest 2 %. In consequence, lending also dramatically increased in relation to the EU budget: from around 39 per cent of the latter in 2006-2007, to the already mentioned 56 per cent in 2009. The bank even raised its loan target for 2009 two times, once at the end of 2008 from 45 to 60 bn €, and the second time in June, to 70 bn €.

This reactivity extended also to the conditionality of the EIB's lending, to a limited degree. In contrast to the EU Budget, and similar to the European Central Bank, the EIB could change the criteria under which it supplied funds to EU-wide economic actors, in reaction to the crisis. Its president Mr Maystadt underlined in May 2009 that the bank had loosened its lending standards to give

companies with weaker credit ratings access to funds. Comparable to the Central Bank, the EIB was “taking more risk in lending to companies which don’t meet our usual criteria.” In fact, the EIB’s own data appear to show that this statement exaggerated the dimensions, the novelty and the risk of an innovative lending model which the EIB had already introduced in 2002, to experiment with lending to riskier projects, matched by higher allocations to reserves. This new model encountered much interest during the crisis period. But compared to the Maystadt-remarks reported in the FT, the text of the EIB ‘Group Vision’, in its Corporate Operational Plan 2010-2012 appear more adequate: “The EIB will help Europe emerge from the economic crisis and beyond by doing more, better and faster: compared to pre-crisis levels, we will substantially increase our EU financing volumes while maintaining quality.” In sum, there is potential for integration advance in the EIB’s activity.

Contra and Pro Integration Advance

To be sure, the EIB is a bank. It does not give grants or subsidies. It must only lend to “sound” projects with limited risks, according to the accepted criteria of the financial market. The scope of its activities appears therefore circumscribed.

But even so, the EIB follows the logic of European integration. Its credits are also expressions of a political intention. Its principal lending criteria are for projects to “further” EU policy goals, and at a general level the single market, cohesion and convergence in the EU. But they also are reactive to contingencies like the crisis. Its principal governing body, the board of governors, reflects this logic. It is composed of the EU Member States’ ministers of finance. And in the crisis it acts politically, not just as a bank. It decided to raise its loan target, i.e. its lending activity, on express demands from the European Commission and the Member States.¹⁷

In lending, the EIB also normally demands co-financing by borrowers and additional guarantees if it considers this necessary. Aside of granting credit, the EIB may also guarantee credit arrangements of third parties. In all constellations governments and even the EU’s regional or cohesion funds can be partners.

Finally, even if the EIB’s credits are not subsidies, their very advantageous terms profit from the sovereign capital guarantees backing the bank and the resulting AAA rating which give it privileged access to the international capital market on which it re-finances itself. Its lending ceiling is directly determined by the capital subscriptions guaranteed out of member states’ budgets. It is to all intentions an instrument of the Member States to finance economic development and infrastructures where they see the greatest need, inside the EU or in its neighborhood. In the crisis, the evolution and the orientation of its lending clearly reflects the stimulus objective of Member States’ governments.

In contrast to the EU Budget, but also to the European Central Bank, and certainly the 27 Member States, the EIB can follow a coherent set of priorities in its EU-wide lending. And it can target.

¹⁷ Already in February 2009 the European Commission had expressed its expectations vis-à-vis the EIB: The EIB is expected to approve **€3.8 billion worth of automotive sector projects** in March while additional projects in the pipeline add up to a total of € 6.8 billion (IP/09/318, 25/02/2009). And in a public letter of May 26 (FT 26 05 2009) Gordon Brown explicitly asked the EIB president to increase lending, accelerate disbursement, and take on higher risks, to aid EU economies in the crisis.

Industrial policy considerations can therefore enter into its strategy, as the crisis lending strategy proved again (cf. EIB's engagement in the automobile sector and for small and medium enterprises).

Probability of Integration Advance

Thus, even though the Member States of the Union never wanted to concede a discretionary funding competence, nor a sovereign borrowing privilege to the EU itself, or to the European Commission – no Euro-Bonds!– they have nevertheless created an EU-institution invested with both: the EIB. But it is directly controlled by the Member States according to their capital share, and it is framed in the institutional structure and the logic of a bank. The first might be taken to limit the pro-integrationist vocation of the EIB. But the second tends to compensate that effect, the states being limited to supervising bank executive bodies which operate –as for them– in majority modus (except for decisions concerning its own structures and capital setup), and under the dictate of business effectiveness. And its structure has not prevented the bank from becoming a very important and effective funder of EU policy projects.

The crisis has given it the chance –and the task– to expand its lending activity very considerably and thereby become an important partner in the fiscal stimuli effort of the EU in quantitatively and qualitatively significant terms. Significantly, it is the only full EU institution which can do so, in a targeted and reactive way.

The EIB has also become even more appreciated as a laboratory for trying out EU-level financial stimulation and the instruments to carry it out. Two examples: practitioners see the possibility of accompanying EIB credits by well designed subsidies from EU budgets, which could substantially and usefully boost the leverage per EU-Euro spent, even without expanding budget volume. More theoretically, others see the EIB in the role of future emission house of Eurobonds, obligations guaranteed by the EU, to enlarge access to cheap credit on an EU-wide level¹⁸ for instance.

Will the expanded role of the EIB remain only a temporary affair, bound to shrink again significantly to pre-crisis levels after 2011? As at the ECB, the exit issue is intensively discussed in the EIB, and a certain wind-down is advocated. Even so, the increased capital level and lending ceiling does not as such appear to be as unsustainable, as is the debt- and deficit level of most of the EU Member States; the exit does not appear as imperative for the first as for the second. The EIB thus retains more of its reactivity vis-à-vis an eventual continuation or aggravation of the crisis and may become even more important in such a case, than it has been up to now. In sum, gravity and volume of the crisis might well have confirmed the need to have this kind of an institution in the toolbox of fiscal stimulation.

But as all institutions re-financing themselves on the international capital market, in this crisis the EIB will have to watch out even more to protect its reputation as an AAA borrower. For this reason alone, certain well-considered and visible wind-down measures may be advisable in the leverage level of lending. The risk-exposure of the EIB must continue to inspire confidence and trust. The line between solid banker's lending business, and politically alert and reactive funding, will therefore have to be walked with even more prudence than in the past. This would appear to be the main barrier to a further advance on the road already taken towards a more explicit role as growth stimulator and as funding institution for the EU and for its key policies.

¹⁸ cf. f.i. R.BOYER, La crise grecque, 21.04.2010

Fiscal Growth Stimuli in EU Member States 2009-10: Build-up and Exit

Build-up of Stimuli

Potential of Integration Advance

Most EU Member States' governments started to see the necessity for fiscal stimuli to compensate for the strong recessionary influences resulting from the financial crisis, by the fall of 2008. Effects of uncoordinated national fiscal stimuli of neighboring countries are well-known. Especially within an internal market without barriers they invite free-riding. The absence of co-ordination tends to discourage own stimulation either for fear that its effects will benefit foreign free-riders, or for hope to be able to free-ride oneself, on foreign fiscal stimulation. Alternatively, governments will take great pains to fashion fiscal stimuli with minimal external effect which either risk to infringe on the competition and state-aid-rules of the single market, or which quite simply give sub-optimal results, in proportion to the sums engaged (cf. for instance the recent work of the Economic Council of the Labour Movement (Denmark)). Thus once the need for stimuli was recognized, clear incentives existed for a measure of co-ordination by every partner. They were added to by the fact that the threat seemed to be a common one, originating from outside the EU and basically affecting its members in an identical manner.

Pro Integration Advance

Even though the EU lacks the competence for economic and fiscal policy making, the onset of the financial crisis brought an initiative of closer co-operation in this policy field. The French presidency pushed in that direction, during a number of European Council sessions in October 2008, by the European Heads and Chiefs of State partly meeting in Eurogroup formation, after the Lehman Brothers default.

Given the absence of other EU initiatives in this crucially important field which necessitated quick and united reactions, this initiative was extremely welcome because it helped to link member states' national approaches to a few crucially important common principles. The *Eurogroup on October 6 2008* agreed on common principles for stimuli: They must be timely, temporary and targeted.

The *European Commission* prepared proposals on 26 November 2008. The *European Council*, in its session of December 11-12 2008, accepted this Commission framework called a "European Economic Recovery Plan" (EERP). Especially for the activation of the EU's own budgetary and credit facilities, it set binding new quantitative and qualitative objectives. For the vastly more important Member States' national measures it:

- stipulated a fiscal policy response equal to 1,5% of the EU's GDP in 2009-10,
- All measures were to be timely, temporary and targeted,
- The response was to be differentiated in accordance with the availability of fiscal space.

More far-reaching proposals for a Europe-wide fiscal stimulus, or suggestions that the Euro group Member States should help co-ordinate economic policies in the single currency region, supporting

French ideas in the same direction, came even from political heavyweights in Germany, like foreign minister and vice-chancellor Steinmeier (FT 24112008).

Peer pressure, it appears, can help in enforcing de-facto co-ordination where EU rules lack. At the end of 2008, Germany for instance came under pressure from its neighbours to do more to stimulate domestic demand after an initial €12bn package of measures was considered insufficient. This dovetailed with the government's promise to consider a second package which was in fact decided in February 2009 and very substantially increased the German contribution.

Contra Integration Advance

Even though the member states' governments were well aware of the pro-deepening incentives inherent in decisions for fiscal stimuli, they had no adequate institutions and rules at their disposal. The Treaty's reservation of economic and fiscal policy to the Member States had prevented EU-internal structures to evolve which might have built practice of and acceptance for a measure of effective co-ordination in this field. If at all, such structures have been built in the context of the Economic and Monetary Union's economic policy co-ordination. Its principal tool are the **Broad economic policy guidelines (BEPG)** for the whole of the European Union, to which the Member States are supposed to conform, on a voluntary basis, pushed on by peer pressure and regular discussions. The results of this have been very disappointing indeed.

The only established co-ordination structure for fiscal policy, with 'harder' rules, is the EMU Stability and Growth Pact (SGP), But it exists to organise the opposite of stimulation of the economy, namely for limiting or reducing public expenditure so as to comply with the Monetary Union's stability criteria. But even this structure has only given unsatisfactory results in the past, all three large Euro-States having flouted its rules for longer or shorter periods of time, together with two small ones, Portugal and Greece. This lack of accepted and effective 'machinery' is a serious lacuna.

That said, the SGP review procedure has assessed the stimulus build-up in 2008-09 (cf. Council Opinions on the updated stability programmes of Germany, France and Italy, 2008-2012, of 10 03 2009). But judging by the remarks made on three large EU economies, this assessment only consists of a very short qualitative introductory remark on the forthcoming stimulus, linking it to the Member State's budgetary situation in a very few words –not even explicitly noting its absence in Italy for instance–, then continuing with SGP-specific observations on the effects which this might have on the fiscal stabilisation efforts of the respective Member State.

The diversity in Member States' budgetary capacities was another important barrier against co-ordinated stimuli. Given this diversity, effective co-ordination might well lead to adjusting the individual member states' stimulation assignment not in accordance with the respective Member State's needs, but with its means. Once this was accepted, those member states better positioned from a budgetary perspective would have to assume a part of the stimulation charge of less well-off Member States, be it directly or indirectly. Co-ordination would thus function as a forced transfer mechanism, hitherto never accepted by Member States.

The already mentioned measures taken from fall 2008 confirm the inability to organize effective co-ordination. Far-reaching proposals for a Europe-wide fiscal stimulus, or a Euro group co-ordination of economic policies in the single currency region, remained all the same a small minority. And the initiative for an ex-ante co-ordination of national measures at EU level, launched in October 2008 by the Euro European Council, after the Lehman Brothers default, was only a very partial success.

Member states had drastically different programs,

- ✚ as to the total volume of additional public stimuli created and
- ✚ the share of their respective GDP,
- ✚ as to their distribution over the years 2009 and 2010,
- ✚ as to the part of taxes forgone or to additional expenses engaged,
- ✚ as to the accessibility of stimuli for non-national economic actors.

Calling the sum of these national stimulus measures a “European Economic Recovery Plan” proves to be an ex-post ‘labelling’ more than ‘packaging’ of qualitatively and quantitatively very different national stimulus programs.

If the global fiscal policy response was to be equal to 1,5% of the EU’s GDP in 2009-10, the Member State effort varied considerably already between the six largest of them: Germany had started with 1,5% in October 2008 and heightened to 4,2% by January 2009, Poland 3,8%, France 3%, Spain 1,9%, UK 1,8%, and Italy 0,0%. Only two Scandinavian MS plus Cyprus and Luxemburg lay slightly higher than Germany, the EU-27-average amounting to 1,9 per cent. This did in fact reflect “the availability of fiscal space”, but probably more as a result of member states’ individual adaptation to their perceived possibilities and interests than of conscious co-ordination.

The picture became even more disparate if one takes the quality of the stimulus into account. In macro-economic terms the estimated GDP-impact of national stimuli (if they were temporary) varied even more than their GDP-share: taking just the six largest, between ca. 3,0% for Germany, UK 1,4%, Spain 1,1%, Poland 1,0%, Italy 0,7%, France 0,7%.

This had to do with their very disparate character: aiding households’ spending by tax reduction, and supplementary government spending for infrastructures will impact GDP by a direct increase of global spending; which will incidentally give competitors in the whole EU a fully equal chance to benefit. This will not be the case for measures which mainly aid companies, e.g. for cuts in their welfare contributions or loans at favourable interest rates to companies, supposed to increase their competitiveness.

Aside from their very different impact on GDP, these differences also make for less positive externalities. National fiscal stimuli can thus be more or less ‘co-operative’ at the EU level, in the terms of Patrick Artus. Among the larger member states’ stimulus programs, Artus’ analysis of May 2009 found the highest share of *non*-co-operative stimuli for France with 48%; follow Italy 15% and Spain 15%, with the smallest share for Germany with 13% (P. Artus, Berlin – SWP, May 26, 2009).

Some of these programs contain substantial industrial policy elements, for instance for the automobile industry. Again, the differences were large. Commission figures confirm what other data have already shown: Germany put up the biggest car scrapping/new car buying bonus program in the EU, worth 0,2 % of the GDP, which benefitted mainly the small to medium sector with its numerous

foreign competitors present on the German market. Direct benefits for German-based manufacturers with loans and guarantees were comparatively minuscule, with 0,06 %. For France, the picture was inverse: 0,03% of GDP for car-scraping bonus, 0,33 % for direct benefits for French-based manufacturers. For these latter, the government tried to condition these aids to the preservation or creation of jobs inside France, an extremely non-co-operative strategy which only the EU Commission was able to block. It is true that this picture might have been different if the original Opel-rescue plan of the German government, even though supposedly co-ordinated with other Member State governments, had been accepted by General Motors. Then Germany as well, might have had very heavy manufacturers' loans and guarantees share in its aid.

As to the Internal Market, the national stimuli had their price: In sum, the EU not having a framework for effective co-ordination of active stimulus measures in the MS and being unable to stitch it together in the heat of the crisis, and stimuli being urgently necessary, the Internal Market rules have been loosened, to give the space needed, effective market integration has taken a step backward.

Probability of Integration Advance

Probabilities of Integration Advance do after all remain very limited for the build-up of fiscal stimuli within the EU or the more restrained Euro-Group. This was true for the experiences made in 2008-9, which confirmed the path taken since the creation of the Economic and Monetary Union, already confirmed by the Constitutional Convention from 2002-2004 and the reform of the SGP in June 2005. Peer pressure can produce reactions from Member State governments. But there is no predictability or regularity in its results. Member States cannot 'count on' them.

Exit from Fiscal Stimuli

Potential / Incentives for Integration Advance

For fiscal exit strategies the incentive for deepening looks somewhat more promising than for build-up.

Between the averages of 2002-2006, and the results and previsions for 2009-10 very high differences of deficit have emerged, between EU-Member States and beyond. The debt pressure has built up to a point that most governments are acutely aware of the imperative necessity to wind down, and that abstaining from co-ordination will have a high price. But even so, differences still remain in their strategic approaches. Governments are liable to be guided by the assessment they make of fiscal stimuli utility to their domestic economy, in two directions. The first one is the perceived link between short-medium growth effects and fiscal stimulus, and the second one between the internal and the external parts of these growth effects of this stimulus.

If governments have a positive assessment on both counts, they may want to wait somewhat longer before exiting from stimulus. In that case, it may become important to concentrate the stimulus on domestic economic actors so as to gain maximum effect from limited resources. If on the other hand governments have a negative assessment, neither counting on a relevant multiplier, nor on their

ability to limit the stimulus to domestic actors, their tendency will be relatively higher, to pass on to exit.

For those cases, if there is no co-ordination there is a temptation for governments to rush out, because they will try to avoid remaining the last one to stimulate their economy by the public budget, incidentally building up more debt than their neighbours, and incidentally and indirectly having to subsidise the export sales of these neighbours for the longest time.

The advantages linked to advancing together, and even more the disadvantages of dispersed and opposite national strategies, appear evident to economists and practitioners alike.

Pro Integration Advance

Institutional conditions would facilitate co-ordination in 2010 and the following years, as compared to summer-fall 2008. After all, Member national governments are not in a state of surprise shock any more, they have had time to reflect on, to set up and to manage fiscal stimuli and to build the appropriate institutions and procedures.

And the Union is equipped, vis-à-vis Member States' fiscal policies, to control and co-ordinate limitation and reduction, not expansion. Much as its existing instruments (especially the Stability and Growth Pact) limited its official role for -coordinating fiscal stimulation, they put it into the driver's seat once the budgetary expansion has led to excessive deficits which Member States agree to correct. The Commission's potential role in a graduated exit is therefore strong and has been enhanced by Member States explicitly accepting to use the corrective arm of the Stability and Growth Pact as the institutional frame within which to achieve co-ordination¹⁹. Indeed, to the degree that all Member States come around to the insight that a coordinated exit is in everybody's interest, the Commission and the SGP procedures are likely to prove the only instrument at hand to implement an equitable and mutually acceptable process in that sense. This SGP-coordinated exit-procedure has started in spring 2010.

Insert Document: European Council 16.III.2010, 7498/10 (Presse 63) 14

Exit strategies: crisis-related measures in labour and product markets - Council conclusions

The Council adopted the following conclusions, and agreed to submit them to the European Council, with a view to its spring meeting (25 and 26 March). "Member States have implemented a wide range of temporary measures to respond to the economic crisis and support the emerging recovery under the European Economic Recovery Plan (EERP). The large majority of these measures are consistent with EERP principles of being temporary, timely and targeted and have usefully supplemented the important role of the automatic stabilisers in supporting employment and economic activity during the depths of the crisis.

The Council EMPHASISES that it is important to complement existing principles for exit strategies in the areas of fiscal policy and financial markets with principles to underpin the coordinated withdrawal of short-term measures in labour and product markets. If left in place too long these measures could hinder adjustment processes within and across sectors by distorting price and cost signals and by introducing wrong incentives.

¹⁹ Cf. Ecofin decisions 20 October 2009

The Council NOTES there have been some extensions of temporary measures beyond 2010 and calls for Member States to withdraw these measures as soon as possible.

A credible long-term structural reform agenda is an integral part of any comprehensive exit strategy. The Council further STRESSES that exit strategies in the area of product and labour markets should be accompanied by the phasing in of medium and long term reforms that bolster potential growth and employment, improve competitiveness and support fiscal consolidation efforts. These reforms will be further discussed as part of the Europe-2020 strategy.

The Council AGREES on the following principles for the withdrawal of temporary measures in product and labour markets, while emphasising that country-specific conditions, including the economic situation and different fiscal constraints, should be taken into account. They should also be seen as complementary to and consistent with earlier agreements on fiscal and financial sector exit strategies and the end of the temporary state aid framework in December 2010.

Regarding temporary crisis-related sectoral support measures:

- these should be phased out as quickly as possible given their relatively large budgetary costs and the risks that the continuation of supply side measures may hamper efficient resource allocation and hence distort competition and the functioning of the internal market;
- in view of recent Commission economic forecasts, no new short-term schemes should be introduced nor existing ones extended;
- where they have longer term objectives and are considered for extension, e.g., restructuring, greening or research and innovation, they should continue to be scrutinised under the relevant State Aid rules.

Regarding measures to ease financing constraints:

- withdrawal of temporary schemes to ease financing constraints should depend on the capacity of financial institutions to supply adequate credit to the credit-worthy corporate sector and should be consistent with agreed principles for exit from support schemes in the financial sector and the end of the temporary state aid framework;
- continued careful monitoring is required to prevent the recovery from being hampered by undue credit supply constraints;
- SMEs may continue to be more limited in their access to finance than larger firms even as the recovery takes hold, which should be taken into account when deciding on the withdrawal of measures to address financing constraints given the central role that SMEs play in the restructuring of the economy.

Regarding temporary labour market support measures:

- these should be gradually withdrawn when the recovery is secured. On the basis of the most recent Commission forecasts on growth this could begin with a benchmark of mid- 2010 for the EU as a whole, taking into account the historic lag before employment reacts positively to an upturn in economic activity;
- the precise timing of withdrawal should depend on the country-specific situation;
- the gradual phasing out of temporary labour market support measures should be accompanied where necessary by a strengthening of activation, training and other flexicurity policies to facilitate job reallocation and workers' reskilling.

Reduced working time schemes

- the too late withdrawal of measures may carry substantial costs in terms of locking in labour to declining activities, thereby preventing the necessary reallocation of resources, damaging future growth prospects, distorting competition and interfering with the functioning of the internal market.

Temporary increases in the generosity and coverage of unemployment benefits

– temporary measures that increase the generosity and coverage of unemployment benefits and other income support should be phased out in a way fully consistent with the objective of facilitating sectoral reallocation of labour and employment creation, and taking into account the relative level of coverage and and benefits in the social insurance system.

On the sequencing of exit strategies, the withdrawal of sectoral support schemes should be prioritised, followed by the withdrawal of labour market support measures when the recovery is secured, and the withdrawal of measures to ease financing constraints based on economic evidence and consistent with other agreed principles for exit strategies as noted above. There is also a need to ensure that any permanent measures adopted during the crisis are supportive of long term growth and employment and consistent with fiscal consolidation strategies. The Council therefore invites the Commission to conduct an assessment of the main structural reform challenges and existing bottlenecks facing Member States and report back in May in accordance with the timeline set out by the Europe 2020 strategy."

Contradictory Role of Financial Markets

The role of financial markets will be examined in more detail in the following chapter on dealing with public debt crises inside the Euro area. Here one can just underline that financial markets have started to exercise strong pressure on national fiscal policies from winter 2008-9. In 2010 one witnessed an effort of member state governments to neutralise this pressure, by strengthening the role of EMU institutions and rules in co-ordinating the member states' public debt management and incidentally their exit policy. If this effort succeeded it could contribute to a deepening of fiscal policy co-ordination in the Euro zone. The preceding Council document shows the limits of ambition to exit-co-ordination in terms of Member States and budget volumes. In fact, the most explicit agreements concern the sequence of withdrawal for different *types* of measures, so as to protect as much as possible the level playing field in the Internal Market. Full understanding is expressed for continuing measures for credit expansion.

Contra Integration Advance

Even given the forceful incentives for co-ordination and the strength of institutions, strong arguments and evidence still push Member States in the direction of more autonomous and uncoordinated strategies. Fiscal situations of Member States remain very divergent, exacerbating the problems of co-ordination. The largest challenges against successful exit-co-ordination result from the inequality of exit demands, as to the proper starting time, volume and speed of winding down fiscal support. In a political, but also in an objective appreciation, they invite discord and non-co-operative behaviour.

Free-riding incentives remain, for breaking ranks and stopping fiscal stimulation quicker than other Member States. On the other hand, certain national governments are tempted to persist with deficit spending, even if their neighbours already wind down borrowing.

Objective reasons remain as well, the most general being that nobody has a convincing scenario on which effects fiscal stimulus exit steps will exactly have, in the different national economies of the EU.

Recovery from the crisis has taken place at very different speeds, also creating objective reasons why Member States should differentiate their time of exit. But differentiation is politically much more difficult to manage, within a project of co-ordination, than an advance in lock-step.

New Role of Financial Markets?

The Greek debt crisis and Greece's apparent inability to exit on its own, from its excessive debt, highlight the new role of financial markets in disciplining MS fiscal policies and incidentally also enforcing exit from unsustainable debt positions. Rating agencies are able and increasingly willing to apply differentiated ratings to EU governments' debt paper. And governments start to heed these ratings, because the cost of ignoring them has become too high. They may well become a determining factor in determining exit strategies, taking the steering wheel out of the hands of governments which have not respected their own stability criteria.

Probability of Integration Advance

Are developments visible in spring 2010, which might indicate the degree of co-ordination to which exit strategies are likely to be subjected, under the pressure of these different variables? A comparison between national exit plans, evaluated by the Commission, is instructive.

Commission's recommendation for a Council Opinion of 22 April 2010 on the updated Stability Programmes (SP) 2009-2013, of Germany, France and Italy. "EDP" = Excessive Deficit Procedure (Summary by C. Deubner)

	Germany	France²⁰	Italy
02 02 2009		EDP renewed, after >3,4 % of GDP deficit in 2008	
year of 2009	fiscal expansion appropriate under EERP	fiscal expansion appropriate under EERP, up to 7,9 % of GDP deficit	quasi NO expansion appropriate under EERP
02 12 2009	EDP . opened at deficit 3,2 % of GDP		EDP opened at deficit 5,2 % of GDP
year of 2010	continued fiscal expansion appropriate under EERP, up to deficit 5,5 % of GDP	fiscal policy almost neutral, deficit up to 8,2 % of GDP	mild fiscal restriction of 0,3 % - point of deficit

²⁰ F. Fillon in Paris, 22072010 confirmed this plan of deficit reduction: **Je veux vous dire que la France s'est engagée** dans une politique exigeante pour faire revenir ses finances dans une trajectoire vertueuse.

Aujourd'hui, nous avons un déficit public qui est de 8 % du PIB ; nous avons lancé un plan d'action qui va nous permettre de le ramener à 6 % en 2011, et à 3 % en 2013. Concrètement, cela veut dire qu'en 2011, nous allons réduire de 40 milliards d'Euros le déficit public, et de 100 milliards d'euros d'ici 2013.

year of 2011	signif. fiscal tightening 1 % - point of deficit	fiscal restriction 2,2 % point of deficit	stronger fiscal restriction 1,1 % - point of deficit
year of 2012	signif. fiscal tightening 1 % -point of deficit	fiscal restriction 1,4 % point of deficit	stronger fiscal restriction 1,2 % -point of deficit, to 2,7% of GDP. EDP deadline for correction ED
year of 2013	fiscal tightening 0,5 % - point of deficit. EDP deadline for correction ED	fiscal restriction 1,6 % point of deficit EDP deadline for correction ED	
Commentary of Commission	“in line with the advocated exit strategy”, but lack of specific consolidation measures from 2010, Fear that “the budgetary outcomes could turn out worse than projected in the programme”	“consolidation in line with the advocated exit strategy”, but overly optimistic macroeconomic scenario 2011-2013, and given French “track record”, “Substantial risks that the deficit outcomes ... may be worse than targeted in the programme”	“broadly in line with the recommended exit strategy, also taking into account the very high ... debt ratio” but tax and expenditure intentions lack credibility and given Italian “track record” Fear: “overall, the budgetary outcomes could be worse than targeted in the programme”

Fiscal Exit Strategies: EU-Level: The Stability and Growth Pact as Instrument and Modus Operandi The case of France and Germany

The **German fiscal exit strategy**. In Germany as in France there is concern that the fiscal consolidation should go hand in hand with a strengthening of the growth perspectives, so that the deficit shrinks vis-à-vis an expanding GDP. (Cf. FEPS expert seminar, cf. Recommendation for Council Opinions on the updated stability programmes of Germany, France and Italy, 2009-2013). Germany only entered into ‘Excessive Debt’ (ED) in consequence of the crisis development in 2009.

The SGP-coordinated exit procedure having started with the Commission’s reactions to Member States’ updated stability programmes, integrating their exit proposals in March 2010, *Germany proposes to start fiscal exit 2011 and continue 2012; to have achieved the correction of the excessive deficit by 2013; with a minimum annual improvement in the structural balance of at least 0.5% of GDP. “A key challenge will be to raise potential growth, in particular by strengthening domestic sources of growth”.*

The **French fiscal exit strategy** has followed contradictory logics. Its 2009 fiscal stimulus got under full swing in the context of an official Excessive Deficit Procedure already declared in February. As to EDP, this put it into contradiction with the other Member States, whereas its fiscal expansion was

considered “appropriate under the EERP”. *France intends to swing back to fiscal restriction only in the year of 2011*, with an extremely ambitious rate of annual contraction.

In spring 2010 the approach remains basically national. Only extra-EU regions enter into the assessment, concerned with the question whether the emerging economies might provide a supplement of external demand which would compensate for demand loss in Europe. As to the exit strategy’s approach, it is three-pronged:

- Keep an accommodative fiscal stance in 2010 in order not to jeopardize the recovery in the short run.
- Start consolidation in 2011.
- Support investment in order to increase potential growth (« Grand emprunt » + reform of corporate tax).
- Undertake reforms with medium term effects on public spending → pension reform to be adopted in 2010.

The government thinks that France still has some fiscal room for manoeuvre to adopt a graduated response to the current crisis. Manifestly, it seeks to exploit this room in searching the best moment and the rhythm of consolidation. But risks are obviously growing: if economic growth remains weak, there may never be an ideal time to exit.

Interdependence

In the year 2010, as compared to Germany and Italy, *France* still continues an accommodative fiscal stance when *Italy* already begins its fiscal restriction, whereas *Germany* has entered into the strongest phase of its fiscal expansion. Germany therefore stands to compensate the restrictive policy of its neighbours, by import expansion.

In 2011, when *Germany* enters into full restriction, its restriction quote will still lie below that of the other large Euro member states, which are in the middle of their respective restriction as well.

This continues in 2012.

Only in 2013, when *Germany* further softens its restrictive line, may *Italy* already have returned to normal, whereas *France* still continues with a very ambitious fiscal contraction, still risking to need compensation from the two others, and mainly from *Germany*.

New Role of Financial Markets?

Interestingly, in 2010 the market rating of French government bonds is has become the crucial yardstick for this remaining fiscal space. Excellent as this rating still is, with a public debt over 80% of GDP France is getting closer to a reassessment. Not only is this considered to have become a de-facto criterion to be heeded. In French Central Bank and in the Finance Ministry circles, officials also begin to view it as a necessary constraint for stabilising fiscal policies in the Euro-Group, given the lack of compliance with the group’s stability criteria.

In Sum

In sum, the three national governments have proposed stability programs which attempt to satisfy the criteria of their respective EDP, plus the extra demands resulting out of the exit-strategy decisions of the Ecofin Council of 20 10 2009. They have done so in their respective national fiscal policy competence. Between the Member States, especially between Germany and France, this has already resulted in public recriminations, France being accused of negligence vis-à-vis its obligations under the SGP.

In its recommendation for a Council Opinion on the respective updated stability programs, the Commission has added commentaries to each of them, concerning their compatibility with the exit strategy, and the probability of succeeding with the declared fiscal policy intentions. These commentaries reveal explicit approval, or more or less far-reaching reserves vis-à-vis these stability programs. They also suggest possible improvements. Incidentally they demonstrate the inability of the Union to enforce a common, coordinated exit strategy for the Member States.

But since financial markets have started to weigh on Member States' fiscal policy considerations, even French decision declare to feel a stronger pressure to respect the common norms, within a shorter time delay. Paradoxically, the common frame of financial markets' pressure might succeed in something which institutions and procedures are not able to achieve.



OPTIONS OF DEALING WITH SOVEREIGN DEBT CRISES INSIDE THE EURO AREA

Member States

Potential of Integration Advance

In preparing for its new common currency, and in having managed it for one decade, the EU has developed a toolbox for dealing with profligate sovereign borrowing and the threat of debt crises: Basically it consists of solidarity plus discipline and conditionality, plus markets. This assortment of instruments can and should be adapted and supplemented in accordance with the needs uncovered by the crisis, in a process which holds clear potential of further integration advance.

Solidarity is manifest in the Cohesion Fund accorded to the less developed economies of Southern Europe and Ireland on the occasion of the EMU's creation in Maastricht in 1992, to compensate for the increased competitive pressure which weaker economies would encounter within a common currency zone.

Discipline was given explicit institutional and procedural form with the No-Bailout rule and the Independence of the ECB, contained in the Maastricht treaty revision, supplemented by the Stability and Growth Pact on the occasion of the next treaty revision in Amsterdam 1997.

Financial *Markets* were to contribute to discipline in an important manner. The EMU's founders explicitly reckoned that without a bailout perspective for over-indebted Euro states, the financial markets would –in spite of the single Central Bank interest rate inside the new Euro area– charge risk premiums for their public debt and insofar create incentives to limit borrowing. But this 'instrument' suffered from the beginning under the markets' pervasive doubts that the No-Bailout Rule would ever be applied.

This whole set of instruments had and has the potential to evolve in a manner drawing the consequences out of the experiences of the Euro's first decade, and out of the first massive challenges to certain Euro states' public debt status, starting in Greece. In this policy field, integration advance can well be the answer. In fact, compared to the other fields covered in this report, this may be the most dramatic integration advance potential of all of them.

Pro Integration Advance

In fact the reactions of Member States and Commission vis-à-vis the sovereign debt crises, starting with the one in Greece, have produced a number of very interesting innovations. They do lead to integration advances in important sectors of fiscal and especially in borrowing policy inside the Euro-area and they permit to expect further advances.

Bail-outs and Emergency Funds (Solidarity)

As to Greece, it demanded the help of the Euro group in a situation of impending insolvency for its public debt, in spring 2010. The *Euro group together with the IMF*, trying to stem itself against the tide of market pressure, accorded a bailout credit of ca € 120 bn. on May 2, with the larger part assumed by the governments of the Euro-Zone, and the smaller by the IMF. The 16 EU countries which use the euro promised to provide €80bn in bilateral loans, with up to €30bn available in the

first year. The *European Commission* assumed the role of organiser and facilitator for the governments, and the *European Central Bank* took unprecedented steps to aid the sustainability of the Greek debt, by continuing to accept it as collateral in its long-term refinancing operations in spite of its ever-decreasing rating and rather renouncing to qualitative criteria altogether. This emergency structure is to function for three years.

This was not enough. Less than a week later the unfolding fiscal and economic effects of this deepest recession since the 1920ies had also led to a dramatic aggravation of the public debt situation for other Southern European €-States, and the financial market extended its pressure to Portugal, Spain, Ireland and Italy. As ECB officials have meanwhile argued in numerous interviews, “On 6 and 7 May, the days immediately prior to the decision to purchase bonds, the markets were massively disrupted”. “Adverse dynamics had taken hold across a range of asset markets in an environment of diminishing market liquidity”. This situation, which was quickly deteriorating further, was very serious and convinced governments that rapid intervention was urgent if a post-Lehman Brothers style bank crisis was to be avoided. In a second step after the Greek bailout promise, governments and IMF, with the help of the ECB, decided to guarantee the public debt of these €-states in its turn, for the case of manifest insolvency, by creating a “European Financial Stabilisation Mechanism” on May 10. A bail-out fund with a total credit volume of ca. € 750 bn has been created, the EU and €-states covering up to around 500 billion euros (60 bn in Eurobonds, a facility controlled by the European Commission, 440 in bilateral credit promises by Euro MS, via a Special Purpose Vehicle, controlled by the Member States). The IMF is to contribute 250 bn. As the aid program for Greece, this one is also to expire after three years. The ECB, going even further than for the Greek public debt, has announced, and meanwhile begun, an outright purchasing program for distressed government bonds, without limitations on volume and time.

These are truly dramatic innovations which could well qualify as advances of integration! To do so, they must be re-balanced and partly modified in a second step.

Plus Conditionalities (Discipline)

Greece accepted stiff austerity conditions in return for the loans from €-countries and IMF. Under these, the country is expected to reduce its budget deficit from 13.6 per cent of gross domestic product to below 3 per cent by 2014, and to stabilise the public debt at about 140 per cent of GDP, even though it is expected to peak at almost 150 per cent of national income. The package includes tough measures to reduce the size of Greece’s bloated public sector, cuts in public sector salaries and pensions, a rise in value added tax and an increase in fuel, alcohol and tobacco taxes, plus reforms to labour markets.

To press Greece into compliance with these conditions, the EU Commission and the IMF conduct a rolling quarterly review process of what has been done by Greece and what needs to be done. Only when EU Commission and IMF see the conditions complied with, for this quarter, the instalments are paid out. The same kind of conditionality mechanism is planned for the “European Financial Stabilisation Mechanism”.

This is ‘hard’ fiscal policy co-ordination of the Eurogroup vis-à-vis (as yet only one of) its Member States, of the kind which many integration supporters would consider a substantial advance in the right direction, for the whole group.

Plus a Re-enforcement of the SGP and a Framework for Crisis Resolution (Discipline again)

An EU-Council-level task force of the finance ministers, chaired by European Council president Van Rompuy has presented the European Council with proposals on how to strengthen the fiscal-economic governance in a way which would prevent sovereign debt crises from happening again, and, for the case that they do happen, on the design of a “robust framework for crisis resolution” which might constitute a new approach for the long term.

In fact the proposed reform of the Stability Pact intensifies very sensibly the institutional and the bureaucratic components of the EMU’s fiscal/economic governance, in the logic of the existing SGP. In the same step, there is a substantial advance of integration. , in implementing the reformed SGP (according to the present drafts), the Commission would wield considerable additional power by making more and more consequential assessments, and recommendations, on the rule-conformity of member states’ fiscal policies.

There are five domains for which the Task Force proposes improvements of or additions to the SGP: The first concerns the deficit prevention, more or less in its familiar form, the second concerns a better reflection of the excessive debt criterion in the budgetary surveillance mechanism, the third the introduction of a new mechanism for macroeconomic surveillance underpinned by a new legal framework, and the fourth the early budgetary warning system embodied in the so-called European semester. Fifth are the all-important procedural innovations which sharpen the sanctions against non-compliers in the first three of these domains, and which render the Member states unable to prevent a sanction being applied against one of their number, except by raising a qualified majority against a sanctioning recommendation pronounced by the Commission.

Each time, this step has to be preceded by the Council declaring the MS concerned in non-compliance with the respective set of criteria and setting a deadline for re-entering into compliance. As for the debt criterion, in case of the 60% of GNP being surpassed, the implementation of a debt-reduction strategy by the respective member states will be asked for even when the deficit is still below 3%. Absence of a certain degree of debt will trigger an Excessive Debt Procedure for the concerned MS.

Both were adopted by the European Council of December 17-18 2010 The fiscal governance reform proposal is already formulated in some detail but is waiting to be changed into legislation, while the crisis mechanism is due to be put in concrete terms by the end of March 2011. But even modest steps towards more effective fiscal policy co-ordination between EuroMember States and for preventing public debt crises would certainly constitute advances in integration.*Plus effective financial markets intervention (Markets)*

The dramatically exacerbated public debt situation of Greece pushed market actors in early spring 2010 to test the No-Bailout rule, leading to high yield spreads between EU benchmark bonds and those of Greece. As expected, the Euro states did not uphold this rule. In fact the same sequence of steps followed for the rest of the SGPII group, with the same result. Bailout was accorded, with the important proviso that this solution was only good for three years. In this year of 2010 market pressure could demonstrate its enormous disciplinary power vis-à-vis profligate sovereign borrowers in the Euro area. It compelled –for the first time since the creation of the Euro– an effective and immediate corrective movement from the same fiscal policy actors who had more or less disregarded the admonitions of the Stability and Growth Pact over the 10-year-history of the Euro-zone! Contrary to what one has learned to expect, even European governments can and do act drastically,

to correct imprudent fiscal politics and to enforce structural changes which may prevent debt crises in the future. Already during the decision process for the “European Financial Stabilisation Mechanism”, Spain and Portugal were persuaded to accept very substantial additional belt-tightening to improve their fiscal credibility vis-à-vis the markets. Even the governments of the largest Euro countries acknowledge, publicly and in their internal strategic debates, that their room of fiscal policy manoeuvre has become effectively limited by the new concern about how the financial markets might react to their actions.

Insofar financial markets played their role of supplementing the institutional and rule-based disciplinary framework of the Treaty, thereby decisively re-enforcing its integration clout.

Contra Integration Advance

The measures reviewed in the preceding paragraphs, may be considered as bringing dramatic advances toward more integration in their respective sector, This assortment is nevertheless overall unbalanced and provisional. Unbalanced in its lopsided preference for a solution composed only of 100-percent bailout plus more discipline, provisional because of the full maintenance of the existing debt obligations with only pushing the date of repayment into the future, and the sunset clause for its central element, the funds cum bailout procedure. Therefore it needs to be revised and supplemented, for better balance and for long-term sustainability. Only then can it generate an overall positive advance in European integration.

Central elements of such re-balancing and stabilisation are

- a replacement of the 100-percent bailout structure, and moderation in the ambitions for centralised borrowing control over the Euro member states. - The existing debt obligations should be restructured and the cost of a bailout should be shared with the distressed state’s creditors.
- The emergency bailout structure should therefore be replaced by a *permanent scheme* combining only a partial bailout promise by other €-states plus an emergency fund, with a debt restructuring procedure including explicit provision for a haircut for distressed sovereign bonds.

This would also reduce the repayment charge for the state in question, and could soften conditionality.

In January 2011, there is still a clear risk that revision and consolidation cannot be achieved in a balanced manner, even by the end of March 2011. Unbalanced and unsustainable as the present assortment of measures is, perhaps with its provisional aspects superficially amended and perpetuated by leaders unable to find a consensus on a more balanced and sustainable solution, it will lead to controversial and unpopular results, and will in consequence lead to risks and not to advances for integration.

Conditionalities

The conditionality for an insolvent Euro state bailed out at par has grave consequences for its chances of an economic rebound. Apart from reducing its structural credit requirement by slashing public expenditures and eventually raising taxes, it still has to assure repayment of 100 percent of its old debt. In fact, the bail-out consecutively replacing fully serviced old market debt by new official debt

from EU and IMF with its super senior status even reinforces the debtor country's strait jacket for the future, instead of loosening it up. The Greek example with the bail-out envisaged for a duration of 3 years as we have seen, demonstrates the severity of the austerity obligations, which risk to stifle its growth potential for a considerable period, with negative social and economic effects for itself and for the rest of the EU. Integration advance of this kind has a very bitter taste and may disappear under the shock of social and political unrest.

Re-enforcement of the SGP and a Framework for Crisis Resolution

At the end of 2010, the Van Rompuy group has made a first step towards the necessary adjustments of the Euro system's toolkit, first by introducing a sovereign insolvency option with true financial participation of creditors in the risks of distressed sovereign bonds, and second by weakening the element of quasi-automaticity of sanctions and fines under the reformed SGP. . It was the French-German agreement of Deauville²¹, , which opened the way towards this re-balancing of the provisional solutions of 2010 by putting this point on the Euro group's negotiations agenda for the spring of 2011 and lobbying for less automaticity of sanctions and fines under the reformed SGP. This SGP reform will be taken up in more detail when looking at EU actors' changing powers.

But there is also a strong political and business current in favour of strict supervision-plus-/co-ordination of fiscal policies (intended to flank the assured-bailout option), which seems intent on extending this solution beyond the three years. For different reasons –political and/or economic– they believe it to be sustainable, and in the interest of their country. Best known for this position is France, confirmed by the recent plea made by French European Affairs minister Pierre Lellouche in a Financial Times interview (FT 280510).

The Changing Powers of EU Actors

This push for community style policies is also meant to support the role of procedures and institutions which have oftentimes in the EU proved their superior effectiveness and equity, as compared to policies organised by intergovernmental methods.

Those promoting this orientation seem to expect that this will also hold true for the new crisis management policies of the Union. But this is not just an issue to be judged in terms of effectiveness and institutional merit. It is also an issue of basic orientation for the EU's future integration logic.

This combination of institutional jostling, considerations over effectiveness and basic structural choices is nowhere more evident than in the EU's search for how best to reform the EU member states' fiscal and economic governance within the EMU.

1. Deciding on the forum for formulating the proposals was the first important decision: the member states put themselves into control, in creating the Van Rompuy task force composed mainly of national ministers of finance, and sidelining the Commission and for that matter the ECB.
2. Secondly deciding on the mission: the European Council asked the task force to submit proposals for two crucial domains, first how to "strengthen and complement the existing framework to

²¹ Cf. the reporting about Deauville in: <http://ici.tf1.fr/economie/conjoncture/2010-10/crises-paris-et-berlin-veulent-plus-de-sanctions-6105558.html> with the demand for „arrangements nécessaires pour une participation adéquate du secteur privé », and the result in the statement of the Eurogroup of 28.11.2010, http://www.consilium.europa.eu/uedocs/cms_data/docs/pressdata/en/ecofin/118050.pdf

ensure fiscal sustainability in the euro zone and enhance its capacity to act in times of crises”, and secondly the design of a “robust framework for crisis resolution respecting the principle of member states' own budgetary responsibility”²².

3. And third deciding on the respective roles of the institutions in this new governance frame.

This is potentially the most critical field of EU policy innovation for the medium and long term. Which logic should the Union trust, in reforming these policies? Should it be one more determined by Community institutions and procedures, with their strong bureaucratic and democratic components, and their strong strain of solidarity? Or should it be one which concedes a larger role to the competition and the auto-responsibility of member states and their respective fiscal and economic policies, on the level playing field of a well regulated Internal Market? Depending on the answer, the supranational institutions and most of all the Commission, or the member states and the European Council will see their weight increase or decrease in the future EU.

Negotiations continue and the decision making process is by no means already over. The next answers to these questions were scheduled by the European Council of December 2010²³ to be given in spring 2011, when the economic governance proposals of the Van Rompuy task force are to be finalised (until June) and the new financial stability mechanism, integrating the crisis resolution framework (until March). Judging by the decisions of 2010 and beginning of 2011, a few conclusions can nevertheless be drawn, as to the three issues of reform set out above and numbered 1 – 3.

1. As to the forum for formulating the proposals, the member states put themselves into control, in creating the EC Council president’s task force composed mainly of national ministers of finance, with the Commission and the ECB only entitled to ‘inputs’, alongside the member states.
2. As for the two domains of the mission, the first answers are contained in the final proposals of the Van Rompuy task force²⁴. They bring out the two perspectives mentioned above: (1) In fact the proposed reform of the Stability Pact intensifies very sensibly the institutional and the bureaucratic components of the EMU’s fiscal/economic governance, in the logic of the existing SGP. In the same step, there is a substantial advance of integration. (2) The crisis resolution framework on the other hand, in the first draft of the Euro group, accepted by the December European Council²⁵, contains the explicit option of an orderly debt restructuring foreseen for an insolvent Euro member state. This option, if it became a credible instrument of EU’s fiscal-economic governance, could drastically reduce the importance and indispensability of the SGP reforms. Financial markets and fiscal policy competition could make a very substantial contribution to keeping the Euro member states on track in respecting the Euro zone’s stability criteria.
3. As for the respective roles of the actors, they would clearly change in function of the weight which either one of the two aforementioned perspectives would gain in the implementation of this officially proposed new governance frame.

(1) The governments assembled in the Councils and especially the European Council (full and Euro group members) have further strengthened their innovative role even in the EMU domain, *vis-à-vis* the Commission and ECB, confirming previous developments.

²² 26 March 2010, EUCO 7/10, CO EUR 4, CONCL1

²³ 17 December 2010, EUCO 30/10, CO EUR 21, CONCL 5

²⁴ STRENGTHENING ECONOMIC GOVERNANCE IN THE EU. REPORT OF THE TASK FORCE TO THE EUROPEAN COUNCIL, Brussels, 21 October 2010, in: http://www.consilium.europa.eu/uedocs/cms_data/docs/pressdata/en/ec/117236.pdf

²⁵ cf. Annex II

In fact, after an initial negotiation phase lasting into September 2010, in which they appeared willing to cede quasi-automatic sanctioning power to the Commission concurrent with a Council decision on an excessive debt (or imbalance) procedure (EDP) for one among them²⁶, they had explicitly disavowed the Commission's legislative proposals one month later. Now, sanctioning requires an additional explicit vote of the Council half a year later, stating that the offending state has not taken the corrective measures it was supposed to.²⁷ Even after this climb-down, in implementing the reformed SGP (according to the present drafts), the Commission would wield considerable additional power by making more and more consequential assessments, and recommendations of member states' fiscal policies, and their conformity to the rules. No wonder then, that the Commission has itself lobbied strongly for these and even tougher fiscal surveillance and sanctioning rules. (2) In case that the orderly debt restructuring became a credible instrument of EU's fiscal-economic governance, the whole procedure of the sharpened SGP with its enhanced Commission competences could lose much of its importance. Governments could well pay more attention to sovereign bond yields than to the preventive and the corrective arm of the SGP.

Depending on the probability of success of either the more institutional or the more market-driven variant of disciplining member states' fiscal policy behaviour, the integration advance in the financial and economic governance of the Eurozone might indeed take very different paths in the future.

Effective Financial Markets Intervention

With preparations made for a *partial* debt restructuring scheme, creditor risk might at last be taken seriously also for sovereign debt. In consequence the Euro system would preserve the precious value-indicator for distressed sovereign bonds, which functioning markets provide. It would also preserve a disciplinary power which has proved so much more effective against profligate sovereigns than any institutional arrangement, SGP or other. This could also underpin the credibility of any improved 'economic governance' in the EU.

Probability of Integration Advance

Bail-outs and Emergency Funds

Since November 2010 a restructuring scheme for the sovereign bonds of over-indebted Member States is on the table of the Van Rompuy group, a project to which the European Council of December 17-18 2010 has explicitly agreed. The Van Rompuy group must also develop ideas about the termination of the Euro group's two emergency umbrellas from 2013 and vis-à-vis the numerous

²⁶ Commission proposals in: http://ec.europa.eu/commission_2010-2014/rehn/headlines/press-releases/2010/09/index_en.htm, draft legislation in: http://ec.europa.eu/economy_finance/articles/eu_economic_situation/2010-09-eu_economic_governance_proposals_en.htm

²⁷ 'Quasi-automatic' refers to two aspects, (1) the element of unavoidability once an EDP is engaged, (2) the decision-mode of the Council acting on the Commission's sanction-recommendation: not having the right to approve it, but only the one to refuse it – with a qualified majority. In the end only (2) was maintained, compare REPORT OF THE TASK FORCE TO THE EUROPEAN COUNCIL, Brussels, 21 October 2010, and the Commission proposals of September

wishes – France among them – to have them enlarged and grant new responsibilities to them. There may be space for negotiation between these two lines of thought, which could still lead to a European ‘crisis resolution fund’ of sorts, which would only work in close linkage to a debt restructuring scheme.

There is a big unknown in this calculation: The next Eurozone debt crisis. Depending on the moment it comes along, on its dimensions, on the governments involved, it may strengthen the hand of Euro group Member States interested in continuing and stabilising the existing emergency structures.

Conditionalities

For a defaulting Member State, the creation of a re-structuring option instead of a bail-out would be beneficial. Re-structuring of its public debt would ease the load on its shoulders for the short, but also for the medium term. An EU ‘crisis-resolution’ fund could reduce this load further. The State in question would thus get a better chance to avoid a long drawn out slump with negative knock-on effects for the whole EU. With the fund, an important lever would remain in the hands of the ‘virtuous’ Member States, which could be used to keep the State in question on track towards meaningful fiscal and economic reform. Again, an end result of integration advance appears possible in this area, as well.

Re-enforcement of the SGP and a Framework for Crisis Resolution

As to the strengthening of the SGP, there would also be a good message contained in any lack of real progress: For the pre-federal, sui-generis group of states assembled in the EU, and in its Euro group, a truly centralised and coercive co-ordination of national fiscal policies is not the right strategy! Not even the large and mature federal states in the world have it ²⁸, they do not even have rules comparable with the Euro area’s SGP ! Euro states do not need to accept this kind of sovereignty loss to improve their compliance with the Euro group’s stability criteria. Having coercive co-ordination powers vis-à-vis each other might well change Ecofin and Euro group sessions into difficult and tension-laden confrontations between the ‘virtuous’ and the ‘non-virtuous’ in the future. Not an attractive perspective of advancing fiscal policy integration in the Euro area! Re-balancing and reforming the scheme for handling sovereign debt crises in the Eurozone, together with a moderate improvement of the SGP, might already suffice to assure a long-term advance in this sensitive and crucial sector.

Effective Financial Markets Intervention

Effective financial markets intervention may still have a chance if these modifications were introduced to the emergency solutions found in spring 2010. It can then supplement a moderate SGP reinforcement. Together this would give a qualitative jump in effective fiscal policy convergence, which would merit the term ‘integration advance’.

²⁸ Neither the USA, nor Canada, nor for that matter Germany. An exception is for instance Australia with its Australian Loan Council, cf. Deubner, Christian, Optionen fiskal- und schuldenpolitischer Koordinierung in der Eurozone, in: Wirtschaftsdienst, 12/2010, pp. 800-804

The European Central Bank as Actor in EU Member State Debt Crises

Potential of Integration Advance

The European Central Bank is one of the central pillars of economic and political integration in the European Union. It plays a central role as well, in the Greek bailout and the following wider-flung European Financial Stabilisation Mechanism.

In the following, it is this vector of its activity –and not its role in growth stimulation– on which we concentrate.

Because of this central role, the manner in which this institution plays its part, in which it uses its treaty powers and its institutional weight and role, gives key evidence on the question how European Integration stands up or develops under the pressure of the financial and economic crisis.

Pro Integration Advance

The ECB has successfully introduced new objectives and new instruments into its policy: so-called quantitative easing which aided banks, but also the liquidity of sovereign bond markets; acceptance of low-quality sovereign bonds as collateral which directly aimed at the same effect; most dramatically, buying Euro-MS sovereign bonds in the market which monetised sovereign debt. Altogether, the ECB will be able to increase its institutional weight and its functional reach, an unquestionable strengthening for this pillar of European Integration.

It has done so in a direct and intense dialogue with the member states of the Euro Group in the Council, and with the other economically relevant EU institutions, namely the Commission. Together with them, it has made important steps toward a new kind of “fiscal government” at EU level in which all these institutions contribute and interact, to reach more effective policy-making. It does so in a certain sharing of roles with the Member States, in which its function is to serve as bailer-out of last resort for troubled member states’ public debt agencies. Here again, it contributes successfully to more European integration for Member States’ fiscal policy.

Both of these advances are inscribed –indirectly or directly– into emerging EU structures for the stabilisation of financial markets and for strengthening EU-wide fiscal policy coordination. They help to consolidate the functional effectiveness of these emerging structures and to enhance their status as legitimate steps toward deeper integration.

Finally, the ECB and advocates of its strategy maintain that the Bank does all this in respecting the rules of the Treaty, enhancing its legitimacy and its reach at the same time.

Contra Integration Advance

But there are powerful counter arguments. Concerning its *institutional legitimacy* there is the accusation that the ECB has infringed if not the letter, then the spirit of the Treaty. Already the progressive easing down to zero, of the quality criteria for Greek public debt taken as collateral by the bank, challenged the treaty interdiction of financing a Member State’s debt. The ECB’s outright and massive sovereign debt acquisitions later in 2010 appear to have violated the Treaty even more.

“In all independence”, as it maintains, it is now aiding a ‘Financial Stability System’ to emerge which is politically unsustainable in the longer term, given the limits of EU integration. It does so in a certain sharing of roles with the Member States, in which its function is to serve as bailer-out of last resort for troubled member states’ public debt agencies.

As Peter Ludlow confirms in a recent note (and he is not the only one), this last decision has perhaps been taken “in all independence” by the ECB, but certainly also in an intense negotiating context with Euro Member States on May 7/8 2010, where heavy pressure was exerted on the bank to move in this direction.²⁹

Even if it does not purchase impaired public debt titles directly from the emitting agencies, it buys them from banks or other first purchasers which could fulfil nothing but a transfer function on behalf of the respective government. In purchasing these titles with the explicit intention to prop up their prices, knowing that these prices would substantially descend without its intervention and that of the other Member States, it does monetise the debt of a Member State and aid it in exceeding its debt limits, in economic and in treaty terms. For the greater disadvantage of that MS, and the Union, the moment of necessary adaptation will be pushed further into the future. The assumption of this role may well force its hand in the future. Other MS and debt agencies may expect it to do for them, what it is doing for Greece and the EU financial system right now, even when the ECB would rather refuse. Then, it will not be able to point to the letter of the Treaty any more, but only to its own judgement. Will that always be enough to resist pressures? In sum, the autonomy of the ECB, permitting it to act only according to its official mission, appears reduced. This view appears to gain voice among experts and in the ECB board itself.³⁰

The negative judgment on this behaviour is tempered by the recognition that the ECB has taken over a part which is urgently needed within the Euro system, but for which this system has not up to now provided. In fact, in an urgent liquidity crisis with systemic breakdown potential an emergency source of quick liquidity provision for specific parts of the market can be absolutely necessary. As no other actor would take over this role on short notice, during the crisis, the ECB passed beyond the limits of its statute to assume it, with the already mentioned consequences.

Member states were responsible for taking care of this issue. But given their differences of opinion, it took too much time for them to create an effective structure. The making and the functioning of the European Financial Stability Facility shows this dilemma. It is a complicated structure controlled by national governments. It will be able to hand out emergency loans, but under time-consuming conditions. The procedure begins with a decision to permit it to start borrowing on the money market for a given emergency, against loan guarantees from national governments. How much time will pass in an urgent case until a MS could actually draw on a loan of the facility, is not even now really clear.

Another option appears to have been on the table, a much more ambitious move by the Commission: to use the same treaty clause to create a stabilisation fund of unlimited size that it

²⁹ Peter Ludlow, “In the Last Resort. The European Council and the Euro Crisis, Spring 2010”, Eurocomment Briefing Note Vol. 7, Nr. 7/8

³⁰ Cf. Handelsblatt 14.12.2010, which cites the well-known cases of Axel Weber, but very recently among others also Mario Draghi, with his new concern that an imprudent expansion of sovereign bond acquisition by the ECB could have the consequence of seriously compromising its independence

would also control. Institutionally speaking, this kind of structure would probably be able to act more quickly in an emergency.

But at the insistence of Germany and allies like the Netherlands and Finland, leaders preferred the inter-governmentally controlled SPV because it leaves Member States more control. The result of this may well be that this solution remains durably unfit to resolve urgent emergency crises of the kind of May 7/8 2010, and that there is no other institution than the ECB left to act quickly in an emergency.

Concerning the *financial effects on the bank*, and in the last account on its ability to always give highest priority to a stability-oriented monetary policy, the bank's departures from orthodoxy can also be considered as risky. For instance the progressive easing down to zero, of the quality criteria for Greek public debt taken as collateral by the bank, appeared to create risks for the ECB's balance sheet in case that its client banks were unable to re-purchase these bonds at par. Especially the ECB's outright and massive sovereign debt acquisitions in 2010 have endangered its balance sheet by the impairment risk of these assets.

Against probable losses on both of these accounts, the ECB has to make provisions; and it is not allowed to make provisions and reserves in excess of its paid-up capital – otherwise it would appear insolvent. But provisions had almost reached that level in 2009.³¹ In December 2010 the ECB thus had to ask Euro system central banks for a capital increase which will almost double its paid-up capital. These perspectives might also weigh on the autonomy and the stability orientation of the bank's monetary policy. For instance when the market for impaired bonds should turn illiquid and prevent the ECB from re-selling them at the desired moment and in sufficient volumes to take excessive liquidity out of the market again.

Probability of Integration Advance

As with the other points of evaluation, we will start out with dividing between the initial reactions of the ECB to the crisis, up into early 2009, and the evolution since then.

From 2007 onwards, the ECB has demonstrated willingness and the ability, to react effectively and adequately to the financial and political challenges. Up to the end of 2008, this amounted to an unequivocal reinforcement of its hugely important place, and of integration in the Euro system.

Since 2009, its active participation in the Greek crisis aid and (since May 2010) in the European Financial Stabilisation Mechanism has decisively contributed to defuse dangerous tensions and devise temporary solutions to the EU's public debt sustainability crisis (as BINI SMAGHI has recently called it, Rabat 280510), and to implement them. The most striking advances have come concerning the instruments, and the ECB's place among the institutions deciding on EU debt crisis management. Both of these advances also led to important progress toward a more integrated EU reaction to the challenges in this important field. But they have also led to a "relativisation" of certain centrally important treaty rules concerning these fields of advance.

³¹ according to the Financial Times of 16.12.2010 which reports in detail on the different aspects of this issue

In consequence, it appears doubtful, whether the position of the Bank and its ability to play its specific role in future EU monetary and fiscal policy making, has actually been strengthened. After all, enduring success in EU governments' policy co-ordination in this field remains improbable. But in a Euro-system without longer-term fiscal co-ordination, the ECB depends on its treaty-defined institutional place and role to be able to make an effective contribution. This point agreed, the conclusion is that the bank might well have bought, for a short term success in crisis management, a weakening of its long term role in EU monetary integration.

Even so, there is also an important positive aspect: Without the ECB prepared to fill the institutional void, a systemic breakdown of the banking system might have ensued in the EU in early May. The common currency and its institutions might have suffered a deep crisis and been challenged in an even more dramatic manner. In this interpretation, the actually chosen solution would be the one which preserved the relatively highest degree of integration in the Euro area's institutional set up, and which actually did open up new venues of integration advance.

A second institutional point may be raised. As David Marsh recently remarked³² "the days are long gone when European politicians could claim that members of the ECB council represent the whole Eurozone, rather than their individual countries". Whether it is "individual countries'" positions which come to the fore, is hardly provable. But in any case among Council members confronting difficult and contentious choices in the crisis, the divergence of their monetary policy convictions comes out into the open more explicitly than before. And between outspoken actors like the Italian Bini Smaghi on the one hand, and Axel Weber from Germany on the other hand, the difference in opinion strongly resembles that between national positions.

This kind of position-taking does indeed challenge the representation concept at the institution ECB. If it were ever more individual Member States' monetary policy preferences and not any more conceptions of the optimal policy line for the Euro area as a whole, which struggled for assertion in the ECB Council, then indeed the decision-making structures would have to be changed. The US Federal Reserve System might be a source of inspiration. This need not reduce the level of integration in the European monetary system. But the risk for this is clearly there. The options for this and their possible consequences cannot be further discussed in this paper.

³² in the FT 02.08.2010; but cf. also Handelsblatt 14.12.2010, citing a number of officials and experts. There is no convincing theory around for this development. A hunch would be that an ECB policy which departs from the line of strict orthodoxy and in doing so favours certain member states, invites the fantasy of its national central banker board members, at least from those member states which might, in one way or another, be positively affected by analogous measures for themselves.

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