THE EU ECONOMY

RESPONSE TO THE CRISIS AND PROSPECTS FOR THE NEW DECADE

Edited by
Marcin Koczor, Paweł Tokarski

PISM | POLSKI INSTYTUT SPRAW MIĘDZYNARODOWYCH
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INTRODUCTION

This publication is based on the contributions of speakers who participated in the conference "The EU economy: response to the crisis and prospects for the new decade." The conference was organized on 18 January 2011 by the Polish Institute of International Affairs (PISM) in support of the National Bank of Poland and TP S.A. Group and was devoted to the EU response to the crisis and the European strategy for the post-crisis period. The economic and financial crisis seriously affected the EU economy—according to the European Commission, the crisis wiped out, on average, four years of growth.[1] The PISM conference put an emphasis on analyzing the key measures that were launched by the EU in order to minimize the effects of the crisis and prevent Europe from such a crisis in the future. Following the conference discussion, this publication contains articles about the two basic types of anti-crisis measures that were adopted by the EU, namely:

– **Mitigating actions**, which have been focusing on providing immediate support to the financial sector and real economy in order to ease the effects of the crisis. Mitigating measures encompassed mainly State aid support to financial institutions as provided in a special legal framework adopted by the Commission, liquidity support provided by the ECB and stimulus actions adopted under the European Economic Recovery Plan. Financial assistance for six Member States (Greece, Ireland and Portugal from the eurozone and Hungary, Latvia and Romania outside the eurozone) can be also qualified to these types of actions.

– **Preventive actions** that put an emphasis on prevention of future crises in the EU. Preventive actions provide systemic response to crisis and include regulatory reform in the financial system (e.g., strengthening capital requirements, adding new rules about the functioning of credit rating agencies, improving rules concerning managers of alternative investment funds and rules about payouts and bonuses in financial institutions), reform of the EU financial supervisory architecture and strengthening of economic policy coordination in the EU.

The intention of the conference was also to look ahead and assess the future prospects of the EU economy. The publication contains papers about the Europe 2020 strategy in the context of the main levers of this new economic agenda, namely, the EU budget, the Single Market and EU trade policy.

1 European Commission, Annual Growth Survey: Macroeconomic report, COM(2011) 11 final ANNEXE 2, p. 6.

As the people in charge of the organization of the whole event, we would like to thank the speakers for their participation and for their contributions to this publication. The event and issuing of the publication would not be possible without the generosity of our sponsors, the National Bank of Poland and TP S.A. Group.

Marcin Koczor, Paweł Tokarski

Opening Speech

PAWEŁ SAMECKI

THE EU RESPONSE TO THE CRISIS AND RECESSION: WHAT HAS BEEN DONE, WHAT IS MISSING

Four issues deserve attention when looking at how the European Union has handled the financial crisis and recession up to now. First, the causes of the crisis; second, the symptoms and course of developments; third, what the EU has done in response to the crisis so far; and, fourth, what is still pending or missing. Particular attention will be given to the last two points.

THE CAUSES OF THE FINANCIAL CRISIS

It seems that there are three main causes of the financial crisis: global imbalances, some market failures and the inadequacy of the Fed's pre-crisis monetary policy.

Global imbalances are a well-known phenomenon. They have existed for many years as the leading players on the global scene are slowly changing their internal structures, while the rules of the game—that is, the global economic order—have remained intact during the last decade of the Great Moderation. To put it in simple terms, the U.S. has had an almost permanent trade deficit, China and the Far East have enjoyed enormous trade surpluses, while Europe's current account on the whole has been either neutral or slightly positive, usually thanks to German exports. The American budget deficit was financed by the East Asian purchases of U.S. government bonds. Huge public spending in the U.S. was accompanied by a high level of private consumption, driven by lax monetary policy conducted by the Fed for many years. Today, with hindsight, we know that this policy contributed to the outbreak of the crisis, as it induced excessively high demand for relatively cheap mortgage loans. The financial markets felt really safe, indeed, and the risks were consciously or unconsciously neglected. When at a certain point the Fed started raising interest rates to counteract inflationary pressures generated by autonomous hikes in the prices of oil, foodstuffs and raw materials, the customers on the sub-prime market started to have difficulties servicing their loans. Despite obscure efforts made by financial institutions to solve the problem by securitizing bad debts, the crisis burst forth.

THE SYMPTOMS AND COURSE OF DEVELOPMENTS

The symptoms and course of the crisis were quite dramatic. The initial crisis on the sub-prime market spilled over to the rest of the banking sector, and shortly afterwards the whole financial sector was affected. Through the purchases of impaired assets, European banks and, more broadly, financial institutions got contaminated. The reluctance of banks to lend on the inter-bank markets was enormous. The credit supply sharply diminished, causing substantial liquidity problems.

The credit crunch was bound to have a serious impact on the real economy. It was inevitable. One may recall that there were one or two quarters in 2009 when international trade dropped by as much as a quarter. In many countries, the quarterly GDP growth rates were below minus 10% year-on-year. The effects of the crisis were differentiated in terms of their geographical distribution within the EU. Their distribution was highly uneven. A comparison between Poland with a 1.8% GDP growth and its neighbours—Lithuania and Latvia—whose GDP fell by more than 15% is a good example.

The year 2010 was supposed to bring some relief to the European economy. In some countries of the euro area, indeed, slow recovery was coming. But unfortunately, another monster started haunting European peripheries—the sovereign debt crisis. Recession mercilessly exposed the structural weaknesses of several EU Member States. The fiscal stimulus aggravated the fiscal stance in those countries. The borrowing needs of first Greece then Ireland exceeded their financeable limits, and after a somewhat lengthy bargain, the leaders of the euro-area Member States reluctantly agreed to apply the bail-out mechanism, which will be discussed later.

THE EU RESPONSE TO THE CRISIS

Already in 2008, the gravity of the situation made central banks and governments undertake substantial measures to fight the crisis. The response to the crisis and the ensuing recession can be classified as three types of measures:

– pumping of liquidity into the system by central banks,
– a fiscal stimulus by governments, the European Commission and European international financial institutions, and,
– regulatory and institutional changes at the EU and national levels, some of them coming from the global level.

The focus of the European policy response to the crisis evolved together with the crisis, from stabilisation of the financial markets to addressing the slump in the real economy by fiscal stimulus and bail-out arrangements. The initial response consisted of the provision of

additional liquidity by the European Central Bank and central banks outside the euro area on an unprecedented scale and injections of fresh capital into ailing financial institutions by governments. From today's perspective, they seem right and timely moves. For the time being their cost in the form of higher inflation has not materialized yet, though it does not mean that inflationary pressures will not come.

Fiscal means were deployed to combat the recession. The value of public government aid, as per the European Economic Recovery Plan for the years 2009 and 2010 amounted to €400 billion, or *circa* 3.3% of the combined EU GDP. It was agreed by the EU in quite a fast manner. Although the plan was basically composed of individual Member States' national programmes, the pace with which the programmes were brought together under a single umbrella was quite impressive. An important feature of the Plan was that the investments foreseen within its framework aimed, on the one hand, at stimulating demand in the short-term, while on the other hand and at the same time, at helping to restructure the European economy and prepare it better for longer-term challenges, such as climate change or energy vulnerability. The EU budget was also involved: the frontloading of advances from the EU cohesion policy was a minor, yet useful step, especially for New Member States' governments stripped of cash due to the shrinking tax base. The European Investment Bank and the European Bank for Reconstruction and Development followed suit and at least doubled the value of their lending programmes for both public administration and the private sector, which had been deprived of part of its conventional credit supply from commercial banks.

The third group of measures, that is regulatory and institutional changes, is most probably the most important from the long-term point of view. Some of the reforms originated at the global level. The crisis inspired the G20 to propose improvements in the functioning of the Bretton Woods institutions and in vital areas of international regulatory framework, such as new Basel III requirements relating to the banking sector. These novelties, as the strengthening of the capital base through a higher Tier 1 threshold, anti-cyclical buffers or new minimum liquidity requirements, seem useful though distant in time. The ongoing work related to schemes aiming at orderly bank resolution should also improve the current situation.

The European Union itself is well advanced in changing its financial supervision architecture to make it more efficient in handling the risks—three new European authorities have just been established. Apart from the harmonization of supervisory standards, they will have the power to mediate and perhaps eventually *de facto* settle disputes among national financial supervisory authorities. The first meeting of the European Systemic Risk Board was held in Frankfurt in January 2011. The Board is responsible for assessing the systemic risks of financial instability in individual Member States. Although one may have doubts about the operational capacity of a body consisting of so many members, and whether

signals to be given by the Board will not be played down by finance ministers, the idea of this body itself is valuable.

Another broad area of reform is the Stability and Growth Pact. Some elements of the reform have already been introduced, some are still being discussed. In general, the strengthening of the preventive arm is welcome. To say that the previous SGP was not sufficiently stringent is an understatement. It allowed certain Member States to run irresponsible fiscal policies for years. Prudent fiscal policy-making based on the principle of growth in public spending not exceeding medium–term GDP growth rate, combined with sanctions if this requirement is not met, is progress indeed. The reverse voting mechanism related to sanctions is to ensure a more rigorous approach, replacing weak peer pressure that did not work in the past decade. But even the fact that the negotiations over the introduction of sanctions drag on show how politicized the process is and confirm that full automatism in applying sanctions is unlikely. This means that, regretfully, some room for opaque exceptions is to remain.

The changes proposed by the Commission as regards the corrective arm of the Pact should also be welcomed. The operationalisation of the public debt criterion in the excessive deficit procedure and stronger enforcement measures with regard to members of the euro area make sense, particularly now that we see that in certain circumstances public debt can be time-bombs with explosions possible in all parts of Europe.

When looking at public debt it is difficult to resist the temptation to make a brief digression about the need to take into account the consequences of pension systems reform when assessing the overall sustainability of public finance in individual Member States from the economic point of view, especially in the long run.

The next area where changes are being introduced is the surveillance of macroeconomic imbalances and, more generally—coordination of economic policies. Regular risk assessments, an early alert mechanism and the principles of enforcing corrections through the Excessive Imbalances Procedure seem to be a promising package. However, the proof of the pudding is in the eating. Today it is difficult to say how efficient the package will be as it will cover a wide range of areas to be monitored. Also, among other things, we do not know to what extent the European Council recommendations will require concrete actions by governments.

The last item of institutional reform that is worth mentioning is, of course, the European Stability Mechanism (ESM)—as a successor to the temporary European Financial Stability Facility(EFSF). The EFSF is an *ad hoc* scheme worked out in pains during the Greek phase of the sovereign crisis. The EU institutions were not prepared to handle the financial crisis when it burst forth. In the end, the Facility was agreed on. From 2013 the ESM will take over the job of aiding Member States that are unable to roll over their debts. There are several characteristics that make the European Stability Mechanism interesting, and perhaps even

controversial, not to mention that the very establishment of the Facility was perceived by some economists as a mistake, because they argue it induces moral hazard on the part of governments. Financial aid will be provided on a case-by-case basis with no automatism involved. The application of collective action clauses (CACs) to bonds issued by the EMU Member States, practised in the IMF rescue programmes for emerging and developing countries, is quite symptomatic. It means that private investors may suffer partial losses in case of a default. But first and foremost, it means that a default is possible at all. This translates into a lower credibility for some Member States and more differentiated treatment of individual EMU Member States by the financial markets.

This is how one may see the reforms and changes already introduced or underway. But there is another question, quite important, especially when one thinks of prospects for the new decade. The question is, is there anything missing from this reform package and if so, what is missing. To judge what is missing it is necessary to make a step backward and take a look at the euro area once again.

WHAT IS PENDING?

Even if the current problems are mitigated in the forthcoming months, which is most likely to be the case, it is true that this crisis has revealed a range of weaknesses in the euro area.

One is its high heterogeneity combined with low degree of structural preparation of the peripheral Members of the euro area to functioning in this system under the umbrella of a single monetary policy. Today we are finding that the Maastricht criteria and institutional and regulatory framework designed in the early 1990s have not been sufficient to ensure homogeneity and convergence inside the euro area. Nor have the principles of economic governance inside the euro area been strict enough to ensure sound economic policies and the appropriate behaviour of financial institutions. The coordination of economic policies in the euro area and the EU in general is weak. Lack of common fiscal back-up for the common currency is not only evident, but also, from today's perspective, is here to stay in the foreseeable future. There is no reason today to think that political integration will accelerate to such a degree that individual Member States' preferences related to individual budgetary spending or size of spending will have disappeared, say, by the end of this decade.

At the same time, those New Member States that are still outside the Economic and Monetary Union will probably continue their efforts to adopt the euro, although at varying speed. Many economists believe that entry into the EMU will protect these economies from the negative effects of excessive volatility in exchange rates (in the case of countries with floating exchange rate regimes) or protect them from turmoil in their

financial markets. As the cases of Slovenia, Cyprus, Malta or even Slovakia show, these judgments have quite solid foundations, as none of these economies has experienced serious turbulences on their financial markets, although all of them did experience serious downturns.

So the euro area is likely to be enlarged in the course of this decade, maybe towards the end of it. One may speculate that in 2020 it may embrace "twenty plus" Member States, leaving the United Kingdom, Denmark and Sweden aside. This enlargement would make the euro area even more heterogenic in terms of real convergence than it is now.

The increased heterogeneity of the enlarged EMU combined with lack of common fiscal policy at the EU level will expose the EMU to risks even higher than today, stemming from the inadequacy of the "one-size-must-fit-all" monetary policy. With integrated markets for goods and services, with the true freedom of short- and long-term capital movements, but without a common fiscal policy and without labour mobility, EU Member States will need to have other strong instruments to gain flexibility to be able to cope with risks of asymmetric shocks that cannot be accommodated due to the common monetary policy.

And here there would be a role for EU common policies financed from the EU budget. They may and should be applied in order to give more flexibility to the EU economy as a whole. In this sense the EU budget should substitute for the lack of common EU fiscal policy. David Marsh, one of the best experts on the political economy of the euro, writes in his book titled *The Euro* that all the experts connected with the EMU project have made clear from the beginning that mechanisms for smooth-running economic adjustments should be in place within Member States and across national borders. But he adds that this condition is never likely to be realised in view of downward pressure on funding and reluctance to accept any sign of fiscal federalism at the EU level.[2] Transfers from the EU budget to Member States amounting to merely around 1 percent of EU's GDP are definitely too small to be considered sufficient for the financing of the mentioned smooth adjustment mechanism. They would probably have to be several times bigger than today's budget, and of course would have different functions than those performed by the present EU budget.

What is more, the relative volume of actual transfers from the EU budget has been decreasing for the last dozen years. On top of that, nowadays we hear voices of a few net payers that a further decrease is warranted as an input to overall pan-European fiscal consolidation. It should be underlined that this is not advocacy of more funds for the New Member States. Put simply, the EMU project has not been completed and

2 D. Marsh, *The Euro. The Politics of the New Global Currency*, Yale University Press, New Haven and London 2009, pp. 242–244.

despite that the EU budget could be a good complement to that project, it is unlikely to be the case, because of *realpolitik*.

CONCLUSIONS

The overall problem with the reform of economic governance in the European Union is that so far it has been rather patchwork and ad-hockery. The changes are partial and driven by *ad hoc* developments. The way we have been fixing the system of economic governance up to now can and should be improved. These changes and reforms are useful, but not sufficient. Certainly, it is difficult to expect EU leaders to have a holistic vision of the necessary changes in the EU "building" and its architecture, when the building is on fire. This crisis provides us with an opportunity to prepare a fully-fledged plan for the completion of the EMU, once the fire is put out. But to produce a common vision requires political will. There is no sufficient political will on the part of EU leaders to prepare such a vision.

Central bankers talk a lot about uncertainty. There is plenty of uncertainty ahead of us. We live in the world of uncertainty as regards our life and fate and this is a natural state of affairs for us. But uncertainty with regard to our own objectives and targets is bizarre. The European Union used to work with deadlines and targets. In the 1960s the customs union was established well in advance of its deadline. The Single Market and the euro adoption had clear plans with deadlines. It is regrettable that today EU leaders are unable to provide us with a clear answer to a simple question: where are we heading? And this is not the question about the *finalité* of integration. Put it other way: are we going to complete the EMU project sometime in the third decade of this century?

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* *Opinions expressed in this text are those of the author alone.*

PART I

The EU's Response to the Global Economic and Financial Crisis: Assessment of Actions

CHRISTOPHE GALAND

THE APPLICATION OF STATE AID RULES TO THE FINANCIAL SERVICES SECTOR IN THE CURRENT CRISIS

Article 107 of the Treaty on the Functioning of the European Union (TFEU) laid down a general prohibition of State aid that distorts competition. It, however, provides certain exceptions to this general prohibition of State aid, notably for aids that "remedy a serious disturbance in the economy of a Member State" or "facilitate the development of certain economic activities (…) where such aid does not adversely affect trading conditions to an extent that is contrary to the common interest." Article 108 TFEU stipulates that the Member States have to inform the Commission and get its approval before granting any aid.

The Commission has clarified how it will apply these general principles to aid firms in difficulty in the Community Guidelines on State aid for rescuing and restructuring firms in difficulty[3] ("R&R guidelines"). In that document, the Commission recalls that "The exit of inefficient firms is a normal part of the operation of the market." Aid to firms in difficulty "raises particular competition concerns as it can shift an unfair share of the burden of structural adjustment and the attendant social and economic problems onto other producers." Consequently, aid to firms in difficulty is considered as "among the most distortive types of State aid." Consequently, the R&R guidelines clarify restructuring aid to firms in difficulty will be authorised only if a series of conditions are cumulatively met: (i) the aid beneficiary implements a restructuring plan that tackles the sources of the difficulties and restores its long-term viability. Aid cannot be granted to keep artificially alive non-viable businesses but only to allow a restructuring that results in the firm being again able to stand on its own feet without continuous aid support; (ii) compensatory measures have to be taken to avoid undue distortions of competition. These measures may comprise a divestment of assets, reductions in capacity or market presence and a reduction of entry barriers on the market concerned; and, (iii) the aid beneficiary and its owners have to finance a significant part of the restructuring costs through internal measures (e.g., sale of assets) or by raising funds on the market. In addition, the aid has to be limited to the minimum necessary to finance the restructuring.

[3] Official Journal of the European Union (OJ) C 244, 1.10.2004, p. 2.

The collapse of Lehman Brothers mid-September 2008 triggered a general erosion of confidence in the financial sector. From the end of that month, several large bailout packages were successively announced and joined soon by the introduction of State guarantee schemes aiming at ensuring the continuous access of banks to financing. There was a real threat to the stability of the financial system, which would have had dramatic effects on the whole economy.

At that time, some voices called for a temporary suspension of the control of State aids to the financial sector. Indeed, there was a perception that most banks would eventually need aid. In that context some were questioning the rationale of asking all aid recipients—including several banks that were believed to be fundamentally sound—to submit a restructuring plan including the divestiture of assets and reduction of market presence. "Penalizing" banks that were until then not known for having taken excessive risks seemed inappropriate to tackle the moral hazard. In addition, there seemed to be no buyer ready to purchase banking assets at that time, so requesting banks to rapidly divest assets could only further reinforce the negative price spiral, forcing competitors to further mark down to market their own assets. Finally, asking all aided banks to downsize their activities seemed inappropriate as it would aggravate the credit crunch and depress the economy, which in turn would generate higher credit losses for the other banks. In summary, in the first months post Lehman failure, the criticism was that the Commission intervention under State aid rules would be counterproductive in the specific circumstances of this global financial crisis and given the specificities of the banking sector.

In the last quarter of 2008 and at the beginning of 2009, the Commission's intervention under State aid rules was focused on trying to ensure a level playing field in the rescue phase, notably by requiring the Member States to charge at the minimum a certain level of fee and coupon rates, respectively on the guarantees and recapitalisations granted to the banks. The Commission explained its approach in three successive documents,[4] which laid down requirements regarding the design and remuneration of State intervention in favour of financial institutions. If a Member State's intervention was fulfilling these requirements, the Commission was granting its approval, which, for the institutions having received a significant amount of recapitalisation or asset relief, was only temporary pending the submission of a restructuring plan. At that time,

4 Communication from the Commission—The application of State aid rules to measures taken in relation to financial institutions in the context of the current global financial crisis, OJ C 270, 25.10.2008, p. 8; Commission Communication—Recapitalisation of financial institutions in the current financial crisis: limitation of the aid to the minimum necessary and safeguards against undue distortions of competition, OJ C 10, 15.1.2009, p. 2; Communication from the Commission on the Treatment of Impaired Assets in the Community Banking sector, OJ C 72, 26.03.2009, p. 1.

the Commission indeed already indicated that institutions having received a lot of aid would have to submit a restructuring plan, but had not clarified yet which criteria it would apply to assess the restructuring plans to be submitted. It did not approve restructuring plans during that first period. This prudence towards issuing detailed restructuring requirements in this most acute phase of the global crisis was justified by the lack of clarity regarding the future evolution of the crisis and the criticisms described above.

In the first half of 2009, it progressively became clear that contrary to what was feared in the first months post-Lehman Brothers collapse, not all banks would need large amounts of State recapitalisation and asset relief measures, but only those that took excessive risks and relied on unsustainable business models. In other words, while initially the global financial crisis seemed more as an external factor affecting all banks in an equal manner, it turned out that the degree to which each bank was eventually affected depended a lot on its own risk-taking policy in the boom years pre-crisis. It also appeared that some sale of banking businesses were taking place, showing that within the short- to medium term, it would again be possible to sell banking activities at reasonable prices. In these circumstances, there was no solid reason anymore not to apply the usual approach towards aid to firms in difficulty—asking aided firms to restructure and reduce their market presence. In July 2009, the Commission adopted a Communication explaining how it will assess the restructuring plans requested from banks having received a large amount of State recapitalisation or asset relief[5] ("the Restructuring Communication"). This Communication defines three conditions—directly inspired by the three aforementioned conditions laid down in the R&R guidelines—that have to be cumulatively met for getting the Commission's definitive approval of aid measures.

Under the first condition, the Member State has to submit and implement a restructuring plan that identifies the causes of the bank's difficulties and the bank's own weaknesses and outline how the proposed restructuring measures remedy the bank's underlying problems. The restructuring should be implemented as soon as possible and should not last more than five years to be effective and allow for a credible return to viability of the restructured bank. It may be noticed that the five-year period allowed for under the implementation of the restructuring is a couple of years longer than the average period allowed in pre-crisis restructuring cases. The Commission therefore took into account that in a context where a large part of the financial sector has to restructure (with or without aid) it may be more difficult to implement a rapid restructuring.

5 Commission communication on the return to viability and the assessment of restructuring measures in the financial sector in the current crisis under the State aid rules, OJ C 195, 19.8.2009, p. 9.

Under the second condition, the aid should be limited to the minimum and an appropriate contribution to restructuring costs should be provided by the aid beneficiary. This means that aid should be limited to covering costs that are necessary for the restoration of viability. This condition also entails banks should first use their own resources to finance restructuring. This may involve, for instance, the sale of assets. However, contrary to the R&R guidelines, the Commission found inappropriate to fix thresholds concerning burden sharing *ex ante* in the context of the global financial crisis. Finally, banks should pay an adequate remuneration for State intervention and should not use State aid to remunerate equity and subordinated debt holders. It that respect, the Restructuring Communication is somehow stricter than the R&R guidelines.

Under the third condition, measures to limit the distortions of competition generated by the aid should be adopted. They should be designed to address the distortion identified on the markets whether the aid beneficiary will continue to operate and vary according to the aid amount received. Adequate remuneration is one of the most appropriate limitations of distortions of competition. In addition, structural measure like the divestiture of assets and reduction of business activities may be required. The Restructuring Communication provides explicitly that where finding a buyer for assets appears objectively difficult, the Commission will extend the time period for implementing the divestment, which, however, should not exceed five years. Finally, measures should be taken to avoid the use of State aid to fund anti-competitive behaviour, such as a commitment not to make acquisitions.

On the basis of the rules described above, the Commission so far has adopted 108 decisions on 45 banks and 125 decisions on 42 schemes, which concerned 22 Member States.[6] The Commission has approved €546 billion of capital injections, €3,485 billion of guarantees on bank liabilities, €401 billion of relief of impaired assets and €155 billion of liquidity support.[7]

Through these financial sector-specific State aid rules and their application, the Commission has endeavoured to achieve several objectives.

First, it was fully aware of the need of these exceptionally large aid packages to "reach the objective of financial stability," including maintenance of credit flows to the economy. The Commission has therefore tried to provide legal certainty to the Member States and the financial institutions by clarifying its requirements through the rapid adoption of guidelines and by approving the individual measures and schemes fulfilling these requirements in record time.

6 Cut off date: 14 January 2011.

7 Cut off date: 30 September 2010.

A second objective was to "ensure the competitiveness and efficiency of the European banking sector." By requiring restructuring tackling the sources of the bank difficulties and the elimination of business models hinging on excessive risk taking, the Commission's intervention under State aid rules helped avoid a situation when aid is granted to maintain artificially alive non-viable banks. Allowing aid to keep afloat zombie banks would not have contributed to the long-term competitiveness of the banking industry, would not have ensured provision of sustainable lending to the economy and would have been highly distortive for viable banks.

Third, notably by requesting that the aid is limited to the minimum necessary, by ensuring that an adequate remuneration for the aid is paid to the State and by avoiding the use of State aid to fund anti-competitive behaviours, the Commission tried to "maintain a level-playing field between banks." In other words, the objective was to ensure that outcome of market competition continues to depend on the quality and price of the services offered and not on the amount of aid received.

Fourth, by requesting the Member States to charge a certain level of remuneration and by prohibiting too generous measure, the Commission tries to "avoid a subsidy race," which would have been highly distortive of competition and lead to a higher cost to national budgets and the taxpayers of rescue the banks.

Finally, by ensuring that the losses are first absorbed by existing capital and that highly aided banks have to restructure and reduce their size, including by the sale of core assets, the Commission avoided a situation in which highly aided banks, their shareholders and their management would be sheltered from losses arising from past excessive risk taking and mismanagement. Thereby, it tried to "limit moral hazard," i.e., incentives for banks to adopt again unsustainably risky business models based on the expectation that the State will be allowed to rescue them and shelter them in case these risks materialise again in the future.

* *The views expressed are personal to the author and do not necessarily reflect those of the European Commission.*

EU COMPETITION POLICY DURING THE ECONOMIC AND FINANCIAL CRISIS

This short paper's overall objective is to show how the financial and economic crisis impacted selected aspects of competition policy of the EU. The crisis was (or still is) an unprecedented event, which shook the economies of almost all Member States. Not only did it affect financial institutions but the resulting downturn impacted various sectors of European industry. There were some voices calling for setting aside competition law rules, as was done in the U.S. during the New Deal after the Great Depression and in Japan during the crisis in the nineties.[8] Yet, this temptation was resisted and the rules on competition remained to be enforced.[9] This was so perhaps because one of the Union's main objectives is to maintain undistorted competition on the Internal Market.[10] It is therefore interesting to see how the Union fulfilled its tasks with respect to competition policy during the crisis, and which role competition rules might have played in this period.

There was much debate on the control of State aid by the EU and in particular on the application of State aid rules to the financial services sector in these troubled times,[11] and much less was said and written about the remaining areas of EU competition policy, that is about the application of articles 101 TFEU and 102 TFEU as well as about merger control.[12] Thus, this will paper focus primarily on the latter issues.

First of all, issues pertaining to the application of Article 101 TFEU will be presented. In this connection, the market behaviour of

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8 J. Fingleton, *Competition Policy in Troubled Times*, Office of Fair Trading, 20/01/2009.

9 A. Italianer, *Challenged for European Competition Policy*, International Forum Competition Law for the Studenvereinigung Kartellrecht, 9/03/2010, p. 3.

10 As now recognized in Article 3 TEU and Protocol No. 27 on the Internal Market and Competition.

11 Several recent publications touched upon this issue: B. Lyons, "Competition Policy, Bailouts and the Economic Crisis," *CCP Working Paper* 09-04; D. Gerard "EC Competition Law Enforcement at Grips with the Financial Crisis: Flexibility on the means, consistency in the principle," *Concurrences* 1–2009; P. Anestis, S. Jordan, "State Aid after the Financial Crisis: restructuring Measures to Restore Viability and Minimise Competitive Distortion," *Global Competition Law Review* (2011); A. Mateus, "The Current Financial Crisis and State Aid in the EU," *European Competition Journal*, April 2009; E. Carletti, G. Spagnolo, S. Caiazza, C. Giannetti, "Banking Competition in Europe: Antitrust Authorities at Work in the Wake of the Financial Crisis," *World Competition* 33, No. 4 (2010); D. Gerard "L'Union européenne au chevet de la crise financiPre: un état des lieux," *Reflets & Perspectives de la Vie Economique* (2010).

12 As established by the Council Regulation No. 139/2004 of 20 January 2004 on the control of concentrations between undertakings, OJ L 24, 29.1.2004, pp. 1–22.

undertakings in the times of the crisis will be outlined. Then some focus will be put on the European Commission's enforcement priorities and at the application of the so-called Inability-to-Pay doctrine. Second, the paper will touch briefly upon the enforcement of Article 102 TFEU. Third, attention will be given to the merger control system of the EU. In this regard, it is going to be discussed how the financial and economic crisis affected the number as well as the character of the mergers scrutinized by the European Commission. In the concluding part, I will try to assess which of the recent initiatives of the EU in the field of competition policy contribute to a smooth exit strategy from the crisis as well as to the attainment of the objectives of the Europe 2020 strategy.[13]

APPLICATION OF ARTICLES 101 TFEU AND 102 TFEU

Pursuant to Article 101 TFEU, the European Commission is able to ensure that rules about competition concerning agreements, decisions of associations of undertakings and concerted practices, which are liable to be anticompetitive and to affect trade between the Member States, are applied. The Commission has a number of powers to take decisions, to conduct investigations and to impose penalties.

There are two major concerns with respect to the application of Article 101 TFEU in times of economic downturn. First of all, it should be observed that in times of crisis, while demand is dropping, cartels are more likely to appear. With shrinking consumer interest for a given type of goods or services, it very likely that less efficient firms will be driven out of the market. Thus, their only chance to survive would be to collude with their competitors.[14] Yet, the negative impact on competition might be twofold: collusion will decrease consumers' welfare and inefficient players will remain on the market.

Second, fines that the Commission has the right to impose once it finds that Article 101 TFEU has been infringed might in times of crisis have the unexpected result of causing bankruptcy of the punished undertaking.[15] Thus, the ultimate result of such a fine might be to drive financially distressed but competitive companies out of the market. This is something to be avoided as it might have adverse social and economic consequences.[16]

13 The objectives of which are set out in the Communication from the Commission "Europe 2020: A strategy for smart, sustainable and inclusive growth," Brussels, 3.3.2010 COM(2010) 2020 final.

14 B. Lyons, "Competition Policy, Bailouts and the Economic Crisis," *CCP Working Paper* 09-04, p. 21.

15 *Ibidem.*

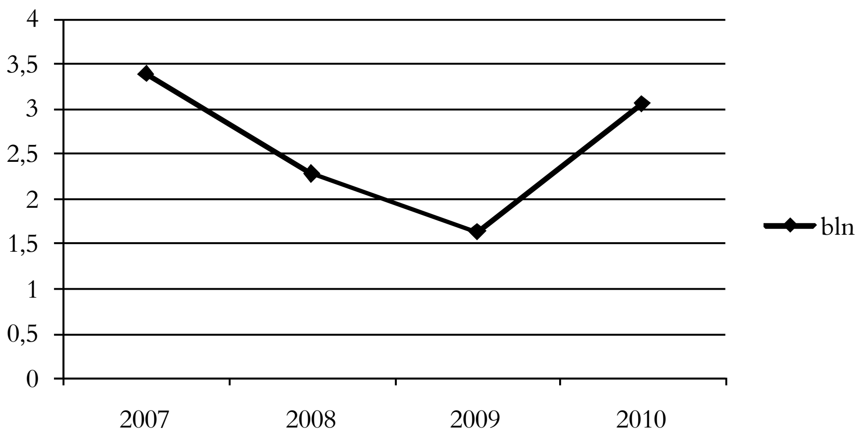
16 "Inability to pay under paragraph 35 of the 2006 Guidelines on the method of setting fines imposed," Information note from Mr. Almunia and Mr. Lewandowski, SEC(2010) 737/2, 12.06.2010 p. 3.

The Commission seemed to take both of the aforementioned concerns into account in its activities pursuant to this Treaty provision. First of all, together with the NCAs it was all the more attentive while analyzing affected markets. Indeed, the Commission has demonstrated its seriousness in not changing its approach in investigations carried on pursuant to Article 101, giving utmost priority to detection, investigation and sanctioning of cartels.[17]

The level of fines imposed by the European Commission seems also to prove the soundness of this approach. While in 2007 the overall amount of fines reached €3.38 billion, there was a drop to €2.27 billion and €1.62 billion in 2008 and 2009, respectively. After this decrease, nevertheless the Commission seemed to be back on track in 2010 with an impressive €3.05 billion in the overall amount of fines imposed.[18]

The latter result might be proof of the recovery, but at the same time it should be kept in mind that the Commissions' proceedings leading to the adoption of a decision condemning prohibited behaviour usually lasts several years. Thus, infringements penalized in the most recent decisions took place—in most cases—well before the crisis.

Figure 1.
Total Amount of Fines Imposed by the Commission in Years 2007–2010



Source: http://ec.europa.eu/competition/cartels/statistics/statistics.pdf.

This brings us closer to the second of the aforementioned concerns related to application of Article 101 TFEU during the financial and economic crisis, namely flexibility on fines. As already has been mentioned, because fines relate to past behaviour it could not be excluded

17 Report on Competition Policy 2009, COM(2010)282 final, 03/0/2010; in a similar vein: A. Italianer, *op. cit.*, p. 12.

18 Source: http://ec.europa.eu/competition/cartels/statistics/statistics.pdf.

that companies' financial situations can be substantially aggravated due to the imposition of fines.[19] The European Commission's Fining Guidelines from 2006 contained only very scarce reference to the possibility of a reduction of fines in case of an inability to pay (ITP).[20] Thus, the Commission proposed a set of criteria for assessing whether fines it imposes "irretrievably jeopardize the economic viability of the undertaking." In particular, the Commission will have a look at indicators of company profitability, capitalisation, solvency and liquidity.[21] To carry on the assessment, it will use financial statements for recent years, provisional current year statements and future projections, financial ratios that measure a company's solidity, profitability, solvency and liquidity, company's relations with banks and shareholders as well as claims of significant loss of value of the company's assets were it to be liquidated as a result of the fine.[22]

Indeed, the EC made use of this provision. In the case of the "bathroom equipment manufacturers cartel,"[23] 17 companies were sanctioned and 10 ITP applications were made to the Commission. Three companies saw their fines reduced by 50% and two companies saw their fines reduced by 25%. In a similar vein, in the "prestressing steel producers cartel" decision (30.06.2010), 17 firms were punished and the Commission, after having reviewed 13 ITP applications, granted reductions of 25%, 50% and 75%, respectively, to three companies.[24] What should be kept in mind is that in any case, the application of the ITP has to be company-specific and it should be objective and quantifiable to ensure

19 A. Italianer, *op. cit.*, p. 12.

20 Paragraph 35 of Guidelines on the method of setting fines imposed pursuant to Article 23(2)(a) of Regulation No. 1/2003, Official Journal C 210, 1.09.2006, pp. 2–5, states: "In exceptional cases, the Commission may, upon request, take account of the undertaking's inability to pay in a specific social and economic context. It will not base any reduction granted for this reason in the fine on the mere finding of an adverse or loss-making financial situation. A reduction could be granted solely on the basis of objective evidence that imposition of the fine as provided for in these Guidelines would irretrievably jeopardise the economic viability of the undertaking concerned and cause its assets to lose all their value."

21 "Inability to pay under paragraph 35 of the 2006 Guidelines on the method of setting fines imposed," *supra 10*, p. 4.

22 "Commission fines 17 bathroom equipment manufacturers €622 million in price-fixing cartel," Press Release of 23/06/2010, lIP/10/790; available at: http://europa.eu/rapid/press ReleasesAction.do?reference=IP/10/790 &type=HTML

23 Decision of the European Commission of 23.06.2010, "Bathroom equipment manufacturers," not yet published; Press Release of 23/06/2010, lIP/10/790; available at: http://europa.eu/rapid/pressReleases Action.do?reference=IP/10/790&type=HTML

24 Decision of the European Commission of 30.06.2010, "Prestressing steel producers cartel," not yet published; "Commission fines prestressing steel producers €458 million for two decades long price-fixing and market-sharing cartel," IP/10/1297, Date: 06/10/2010; available at: http://europa.eu/rapid/pressReleasesAction.do?reference=IP/10/1297&format=HTML&aged=0&language=EN&guiLanguage=en.

equal treatment and preserve the deterrence aspect of EU competition rules.[25]

In a similar vein, in a number of decisions under Article 102 TFEU the Commission imposed in the time of crisis a significant number of fines on undertakings that abused their dominant position in the internal market. Paradoxically, the highest fine in the history of European Competition law for the abuse of a dominant position by a single firm was imposed by the Commission right in the middle of the crisis. In May 2009, the remarkable fine of €1.06 billion was imposed on Intel for the abuse of its dominant position by giving its customers illegal loyalty rebates, and by paying computer manufacturers and retailers to restrict the commercialisation of competitors' products.[26]

MERGER CONTROL

It has to be observed at the outset that the financial and economic crisis affected merger control in three important dimensions. First, there was a question of whether rescue mergers resulting in nationalization of financial institutions needed to be notified under normal conditions. The German Hypo Real Estate case[27] was a perfect example. Hypo Real Estate was taken-over by an entity owned by the German state. The Commission made it blatantly clear that the notification was necessary.[28] This was because the transaction did not include any safeguards to protect Hypo's autonomy. Furthermore, the Commission felt that post-merger the company would not constitute an economic unit with independent decision-making power within the meaning of EUMR.

Second, the number of merger notifications to the Commission during the crisis was also affected. While in 2007 (i.e., before the outbreak of the financial and economic crisis) the number of mergers reached the impressive number of 402, it significantly dropped in 2008 and 2009 to 347 and 259, respectively. In 2010, it was only slightly higher than in 2009: achieving a level of 274, or similar to the level of mergers in 2004.[29] It is worth stressing that the crisis had various impacts on the number of

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25 Joaquín Almunia Vice President of the European Commission responsible for competition policy, Bathroom Fittings Cartel Press conference, Brussels, 23 June 2010, SPEECH/10/335, Date: 23/06/2010.

26 Commission Decision of 13 May 2009 relating to a proceeding under Article 82 of the EC Treaty and Article 54 of the EEA Agreement (Case COMP/C-3/37.990—Intel).

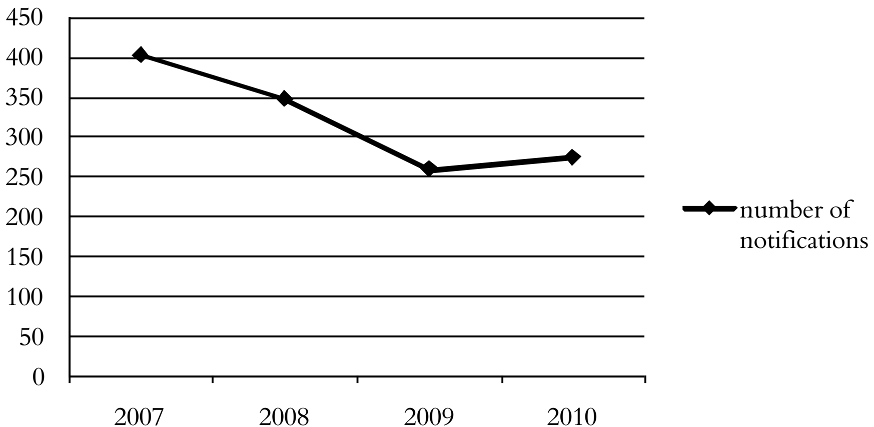
27 Case M.5508 SOFFIN/Hypo Real Estate.

28 Commission Decision of 14/05/2009 declaring a concentration to be compatible with the common market (Case No COMP/M.5508—SOFFIN / Hypo Real Estate) according to Council Regulation (EC) No 139/2004, OJ C 147, 27.6.2009.

29 http://ec.europa.eu/competition/mergers/statistics.pdf. It should be noted that until 30.04.2004 the Union had 15 members. Thus the numbers relevant for this year are only partially representative for the EU25/EU27 setup.

mergers depending on the sector of the economy. Thus, there was an observed continuity in the energy and pharmaceuticals sectors (which were apparently not that strongly affected by the crisis) whereas there was a significant worsening of the situation in the air transport sector.[30]

Figure 2. Number of merger notifications



Source: http://ec.europa.eu/competition/mergers/statistics.pdf.

Third, the crisis had some impact on the types and rationales of the notified mergers. While there were fewer mergers motivated by the willingness of financial investments, there were many more mergers with industrial consolidation as the main objective. In a similar vein, the companies that were merging did so not because they wanted to expand their markets but rather wanted to preserve them (defensive mergers).[31]

Interestingly enough, however, in spite of difficult market conditions and the higher probability of potential bankruptcies reflected in a bigger number of defensive mergers, the concept of a "failing firm defence" was used only to a limited extent.[32] According to this concept "the Commission may decide that an otherwise problematic merger is nevertheless compatible with the common market if one of the merging parties is a failing firm."[33] It is argued that it should be applied with rigidity. In fact, in times of financial and economic crisis the less efficient

30 N. Calvino, "Recent developments In EU merger control," presentation given at International Forum on EU Competition Law, Brussels, 10.03.2010.

31 *Ibidem*.

32 *Ibidem.*

33 Guidelines on the assessment of horizontal mergers under the Council Regulation on the control of concentrations between undertakings, paragraph 89, Official Journal C 031, 05/02/2004, p. 0005–0018. The concept was developed in the case law of the Court of Justice, Joined Cases C-68/94 and C-30/95, Kali and Salz.

market players are driven out and only stronger and efficient players remain on the market. This can, in turn, facilitate strong growth in the period following the crisis. Thus, leniency in this regard might have the side effect of leaving on the market weaker players, who could contribute to slowing down the recovery process.[34]

CONCLUSIONS: WHAT ROLE FOR THE COMPETITION POLICY IN THE EXIT FROM THE CRISIS?

The EU has recently adopted a number of instruments in the field of competition policy that may contribute to a smoother exit from the crisis. As it is widely known, effective competition is a prerequisite to innovation and efficiency. Two newly adopted tools seem to be of relevance in terms of pursuing this goal.

The first instrument that should be mentioned in this context is the new block exemption regulation for vertical agreements.[35] It contains particularly interesting new provisions that extend the 30% market threshold to buyers. It is a way to protect producers of goods or services from exploitative behaviours of powerful buyers who can impose anticompetitive purchase conditions on them. Furthermore, the new block exemption contains new provisions for online sales that aim at promoting and improving Internet sales.[36] There is no doubt that more clarity in this regard can boost cross–border trade, and as a consequence, contribute to the attainment of the objectives of an innovative and knowledge-based economy.[37]

The second of these instruments recently adopted and worth mentioning is the new guidelines on horizontal cooperation agreements.[38] Among the many novelties that it brings about are new chapters about information exchange and standardization. The former aligns the guidelines with the relevant case law of the Court of Justice and brings more clarity as to what is information exchange and how it is to be assessed in the context of horizontal cooperation agreements. The latter contains totally new provisions for the standards setting process, including new guidance on the meaning of what are Fair, Reasonable and Non-Discriminatory (“FRAND”) terms for companies licensing technology.[39]

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34 J. Fingelton, “Competition Policy in Troubled Times,” OFT, 20/01/2009, p. 5.

35 Commission Regulation 330/2010 of 20 April 2010 on the application of Article 101(3) of the Treaty on the Functioning of the European Union to categories of vertical agreements and concerted practices. Official Journal L 102, 23.4.2010, pp. 1–7.

36 A. Italianer, *op. cit.*, p. 6.

37 *Ibidem*, p. 6.

38 Communication from the Commission—Guidelines on the applicability of Article 101 of the Treaty on the Functioning of the European Union to horizontal cooperation agreements, Official Journal C11, 14.1.2011, p. 1.

39 A. Italianer, *op. cit.*, p. 7.

Certainly these new instruments will help attain the objectives of smart growth, fostering an innovative, knowledge–based economy, and they are as a consequence obviously relevant for attainment of the Europe 2020 Agenda goals.

In conclusion, it should be observed that the competition policy has played an important role in these troubled times. Not only has the uninterrupted enforcement of relevant provisions of EU law turned out to be necessary to maintain the integrity of the internal market,[40] but it could have contributed to a faster recovery of our economies in the aftermath of the crisis. In fact, the suspension of competition rules might in some circumstances have added to the duration of the crisis.[41] Thus, the European Commission is to be praised for not having the competition law rules set aside. The continuity in the application of articles 101, 102 TFEU as well as the successful enforcement of merger control turn to proof that overall rigidity in the application of the EU competition policy was correct. Some flexibility that was shown in particular in the enforcement of Article 101 TFEU (INP) shows that the Union knew how to react to possible risks of bankruptcies of financially distressed firms as a result of fines imposed. Last but not least, the new instruments adopted recently by the Union in the field of competition policy might help with the exit from the crisis while contributing at the same time to the attainment of the Europe 2020 strategy objectives.

40 *Ibidem,* p. 2.

41 J. Fingelton, *op. cit.*, p. 4.

OLGA SZCZEPAŃSKA

REGULATORY AND INSTITUTIONAL CHANGES IN THE EU FINANCIAL SYSTEM FOLLOWING THE OUTBREAK OF THE GLOBAL CRISIS

INTRODUCTION

The lessons learned from the recent financial crisis have induced comprehensive regulatory and institutional reforms in the European financial system. The aim of this article is to give a brief overview of those reforms, drawing special attention to three priority areas: financial supervision, deposit guarantee schemes and crisis management. The article describes the general objectives of the regulatory overhaul in the European Union. At the same time it highlights the limitations to further improvements in institutional and regulatory arrangements for financial stability in Europe.

DIAGNOSIS

The recent financial crisis has posed extremely difficult challenges, both for pan-European and local authorities responsible for safeguarding financial stability. During the first stage of the crisis, public authorities in Europe had to respond directly to the shock by implementing unconventional support measures necessary to restore confidence in the financial system. The European Central Bank (ECB) conducted standard and non-standard liquidity supplying operations and interventions in bond markets, including covered bonds.[42] When the crisis moved into an acute phase, and high credit losses started to have a harmful impact on the solvency position of banks, governments stepped in to stabilize the situation and restore confidence in the financial system. Total state aid granted to the financial sector in the context of the financial crisis in 2009 alone represents €351.7 billion, or 2.98% of EU27 GDP.[43] The crisis also had second-round effects leading to economic slowdown and increasing sovereign debt risk.

When the situation in the financial system started to stabilize slightly, a discussion on the lessons learned from the crisis was initiated. The prevailing opinion is that the European Union was institutionally

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42 J.C. Trichet, *Lessons from the crisis*, European American Press Club, Paris, 3 December 2010.

43 Aid Scoreboard Report on State aid granted by the EU Member States—Autumn 2010 Update, SEC(2010) 1462 final, p. 10.

unprepared to manage the crisis effectively.[44] The weaknesses that are usually pointed out are:
– a lack of effective crisis management arrangements;
– a lack of leading institutions at the EU level to coordinate policy and actions of national authorities given that financial firms are active across borders;
– a lack of clear arrangements for the resolution of cross-border banks;
– a lack of a fiscal burden-sharing mechanism; and,
– a lack of clear guidelines for the EU lender-of-the-last-resort function.

The above diagnosis motivated EU authorities and policy makers to work out solutions for improving the regulatory and institutional arrangements in Europe to safeguard financial stability in the future.

REGULATORY AND INSTITUTIONAL REFORMS

After a thorough analysis of the major causes of the recent financial crisis, a comprehensive package of reforms dedicated to regulatory and institutional arrangements in the EU financial system was introduced. At the outset, the European Commission focused on the following priorities:
– financial supervisory architecture,
– deposit protection schemes (DGS), and,
– crisis management arrangements.

FINANCIAL SUPERVISORY ARCHITECTURE

As far as financial supervisory architecture is concerned, the main loopholes that have been identified, contributing to the recent crisis, were the following:
– regulators and supervisors focused on individual financial institutions (micro-prudential supervision) and not sufficiently on macro-systemic risks; and,
– ineffective cross-border cooperation between national supervisors from home and host countries.

In November 2008, the European Commission mandated a High-Level Group chaired by Jacques de Larosiere to work out recommendations on how to strengthen the EU supervisory system. The Group presented its final Report with conclusions in February 2009. After the necessary legal procedures, the new European System of Financial Supervision (ESFS) came into force in January 2011. It is built on two pillars:

44 J. Pisani-Ferry, A. Sapir, "Banking crisis management in the EU: An interim assessment," *Bruegel Working Paper* 2009/07.

– a macro-prudential pillar represented by a newly created authority, the European Systemic Risk Board (ESRB); and,
– a micro-prudential pillar represented by 27 competent national supervisory authorities and three European Supervisory Authorities (ESAs), for each of the different sectors of the EU financial system, including:

the European Banking Authority (EBA),

the European Insurance and Occupational Pensions Authority (EIOPA) and

the European Securities and Markets Authority (ESMA).

The reform is definitely not ground-breaking but it makes a big step forward towards improving the quality and harmonization of financial supervision across countries in the EU.

Pillar 1—Macro-prudential Supervision

The most profound part of the reform was the creation of a new authority responsible for macro-prudential oversight of the EU financial system: the European Systemic Risk Board (ESRB). The main value added by the macro-prudential pillar of financial supervision is its focus on detecting, assessing and addressing vulnerabilities that arise from the interconnections between financial institutions and markets, as well as from macroeconomic and structural developments, including financial innovation.[45]

The task of the ESRB is to identify risks to financial stability in the EU and then to assess and prioritize those risks. The ESRB is also equipped with tools to address those threats, when necessary. The tools the ESRB may use are risk warnings and recommendations, which may be addressed to the Union as a whole, to one or more Member States, to one or more ESAs or to one or more national supervisory authorities. An important mechanism is the *act-or-explain principle,* which means that the addressee must comply with the ESRB recommendation or provide adequate justification for their inaction. The apparent limitation to ESRB effectiveness is the character of its instruments. Recommendations and warnings are rather indirect tools. In addition, the ESRB would probably try to avoid issuing recommendations addressed to a particular country or authority. Therefore, building the reputation and credibility of the ESRB from the outset is a precondition for effective policy-making in the future. Only a credible institution can achieve its goal without any direct administrative tools.

The primacy in EU macro-prudential policy is given to central banks. The rationale behind this is the central banks' expertise as well as their current responsibilities in the field of financial stability. Historically,

[45] V. Constancio, *The establishment of the European Systemic Risk Board - challenges and opportunities*, 2010.

central banks have been deeply involved in analyzing the stability of the financial system and its interactions with the real economy.

The European Central Bank and respective central banks from the EU Member States play a decisive role in the ESRB organisation. The ECB President, the Vice-President and Governors of national central banks are members with voting rights. The ESRB is chaired by the President of the ECB and the ECB ensures the Secretariat for the ESRB.

Pillar 2—Micro-prudential Supervision

With respect to micro-prudential supervision, it is worth underlining the fact that responsibility for supervision and risk-controlling of domestic financial systems in EU countries still rests with competent national authorities. Additionally, the heads of national supervisory authorities are present in the Board of Supervisors —the main decision-making body of the ESAs. This means that national supervisors retain a significant impact on supervisory processes in the EU.

However, cooperation among home and host authorities will be considerably improved due to strengthened coordination competences of the new EU supervisory authorities. The main tasks of ESAs are to:
– contribute to the establishment of high-quality, consistent regulatory and supervisory standards (issue guidelines, recommendations, and draft regulatory and implementing standards);
– create "a single rule book for Europe," reducing inconsistencies between national regulations and fostering cooperation across Europe's national borders;
– contribute to consistent application of EU law (mediation role in case of disagreements between home and host supervisors); and,
– cooperate with the ESRB.

DEPOSIT PROTECTION SCHEMES (DGS)

The recent crisis highlighted the deficiencies embodied in the system of deposit protection in the EU. Despite the minimum level of harmonisation introduced by Directive 94/19/EC, deposit guarantee schemes in the EU were loosely harmonised among countries as to coverage levels, payout delays and procedures to ensure the continuity of banking services. As a result, an insufficient and unequal level of security was offered to customers of banks around the Europe.

As long as the financial system was stable there was no need to implement any changes. However, in the second half of 2008, just after the collapse of Lehman Brothers, confidence in the financial systems deteriorated considerably. The risk of massive deposit withdrawals increased substantially and there was a danger of the domino effect occurring in the banking system. The case of Northern Rock in the UK in

2007 proved that a bank run is a real threat. In these extreme circumstances, some countries decided to adopt extraordinary measures to protect their depositors and prevent deposit withdrawals in their respective jurisdictions. In September 2008, Ireland was the first EU Member State to introduce blanket guarantees for banks' liabilities. This move was widely criticised, especially by the UK over concerns regarding a possible outflow of deposits from UK to Irish banks. Other countries followed Ireland's example and in the following days Denmark, Iceland, Germany, Austria, Slovakia and Slovenia also announced full guarantees.

In response to the uncoordinated actions of individual countries, ECOFIN promptly decided to temporarily increase the minimum coverage level from €20,000 to €50,000. In the next step, amendments to Directive 94/19/EC on Deposit Guarantee Schemes were soon introduced. The main changes included:

– better coverage through a permanent increase in the coverage level from €20,000 to €100,000,
– elimination of co-insurance,[46] and,
– a shortened payout period from three months to 20 working days (with a possible extension of another 10 days).

The main goal of DGS reform in the EU was to enhance the confidence of depositors in all Members States, harmonize the conditions of protection and safeguard a level playing field in this respect.

CRISIS MANAGEMENT ARRANGEMENTS

One of the specific features of the European financial landscape is the presence of large pan-European financial institutions and groups. The ECB (2006) identified 46 systemically important banking groups that accounted for 68% of EU banking assets, of which about half had significant cross-border activity.[47] At the same time, the main responsibility for financial stability in the EU rests with national authorities. Fiscal policy also remains in the national domain, which means that any use of taxpayer money would be considered from the perspective of domestic markets. Such a structural feature poses a big challenge for crisis management in the EU. The question arises who would be responsible for managing the crisis of a cross-border group: home country authorities where the parent company is headquartered or host country authorities where subsidiaries or branches of the banking group are located. What cooperation mechanisms should be applied in case of a crisis in a cross-border group? Who should bear the costs of a rescue operation? There had

[46] Co-insurance means that bank account holders are not fully repaid, but are to bear a certain percentage of their lost sum—even when the lost amount would be lower than the coverage limit.

[47] J. Pisani-Ferry, A. Sapir, *op. cit.*

been a long-lasting discussion concerning burden sharing before the crisis but no conclusion had been reached. The recent crisis demonstrated the difficulty regarding cooperation and the coordination of decisions when a multinational bank is at risk of failure. The lack of coordination and burden-sharing mechanisms creates the risk of a deadlock or non-optimal decision.

In response to these shortcomings, the European Commission introduced a comprehensive package of reforms in relation to crisis management in the EU. The package had the following goals:

– to ensure that each Member State would implement a sound crisis management framework in their jurisdictions;

– to harmonize national frameworks within the EU to the maximum possible extent; and,

– to ensure effective mechanisms for coordination and cooperation among national jurisdictions at the cross-border level.

Resolution Mechanism

At the EU level there is a need to develop a crisis management framework dedicated to cross–border banking groups. In many Member States, the banking sector asset size is from three to five times higher than the level of GDP. Assets of the three largest banking groups are higher than the GDP of Germany, France, Ireland, Spain, the UK, Belgium and the Netherlands. These banks are not only too big to fail but they are also too big to be saved by local governments. The concept of "too big to fail" distorts competition, creates moral hazard and threatens public finances, which is the reason why considerable efforts are being undertaken to address the problem.[48]

That is why much focus in the EU was placed on developing a resolution framework, which was proposed by the European Commission in May 2010. The overriding policy objective of the proposed resolution mechanism is that all insolvent financial institutions can in effect fail, but in a way that would not impair the stability of the EU financial system as a whole, minimizing public costs and ensuring the continuity of essential financial services and avoiding economic disruption. That would allow governments to resolve institutions promptly without recourse to taxpayer funds, and at the same time minimize the social disruption that could occur from widespread interruption to deposit, insurance and/or securities accounts.[49]

According to the framework proposed by the Commission, bank resolution authorities (resolution funds) should be established in each

[48] P. Tucker, *Developing an EU cross-border crisis management framework*, Eurofi Financial Forum, Brussels, 30 September 2010.

[49] T. Huertas, *The road to better resolution: From bail-out to bail-in,* The Euro and the Financial Crisis Conference, The Bank of Slovakia on 6 September 2010.

jurisdiction in the EU.[50] The goal of resolution funds is to organize and provide financing to the resolution process. They should be equipped with resolution tools such as a (i) transfer of certain assets or liabilities to a bridge bank; or, (ii) to a private sector purchaser; or, (iii) the partial transfer of assets to a "bad bank" or "good bank." Implementing those tools will require comprehensive legal adjustments. The resolution funds should be financed on an *ex ante* basis by levies imposed on banks. In order to reduce the risk of moral hazard, the use of resolution funds and tools should exclude any form of bail-out of the shareholders and be based on clear, stringent and properly communicated conditions. The national resolution funds should be harmonized and create a network within the EU.

CONCLUSIONS

The recent financial crisis unveiled many deficiencies in the crisis prevention and crisis management framework in the EU. The institutional and regulatory response to the crisis was prompt and comprehensive. It covered the whole process of safeguarding financial stability. At the prevention stage, the establishment of the ESRB should be judged as the most important and promising part of the supervisory reform. It is a completely new body with responsibility for macro-prudential supervision in the EU. Building credibility at the outset will likely be the greatest challenge for the ESRB.

At the crisis management stage, addressing the TBTF problem is the most challenging issue. Extensive and comprehensive legal changes at the national and cross-border levels are required to make resolution mechanism operational. In particular, the winding-up regulations in each Member State will have to undergo major amendments.

Although wide-ranging reforms in the EU have already been initiated or implemented, some underlying impediments to cross-border cooperation remain unresolved. As long as banks operate across borders and responsibility for financial stability and fiscal policy remains in the national domain, conflicts of interest among different jurisdictions are inevitable. However, one should be aware that solving this dilemma would require the deepening of EU integration. As long as these goals are not on the agenda, it will not be possible to avoid all potential conflicts of interest between home and host authorities responsible for financial stability in the EU. Establishing credible burden-sharing rules on an *ex ante* basis is not an achievable goal at this stage of European integration. The only possible way of proceeding now is strengthening cooperation and harmonization of rules for crisis prevention and crisis management in

50 European Commission Communication. Bank Resolution Funds, COM(2010) 254.

the EU. This is exactly what the recent financial regulatory overhaul in the EU aims to achieve.

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* *The views expressed herein should be attributed to the author and not to the NBP, its Executive Board, or its management.*

BENEDICTA MARZINOTTO

ASSESSMENT OF THE EU'S RESPONSE TO THE GREEK CRISIS AND SITUATION IN THE EURO AREA

The aim of this short article is to assess the EU response to the Greek crisis and describe the state of the art. At the centre of the analysis is the rescue package that was agreed on 9 May 2010. The article is divided into three parts. First, I will look at the Greek case and explain in what respect the Greek crisis has been different from those in other Southern European countries. Second, I will list the macro-objectives of the May 2010 rescue package and their rationale. Third, I will assess the extent to which these objectives have been achieved.

The EU rescue package was agreed on 9 May 2010 under extraordinary circumstances. The situation was rapidly deteriorating. Greek spreads were widening. Moreover, Greece had a huge debt refinancing need due on 19 May 2010. The package consisted of four main components. The first one is the European Financial Stabilisation Mechanism (EFSM) and consists of the extension to euro-zone countries of an already existing lending facility normally used to support balance-of-payment crises in non euro-zone countries, which is known as Medium-Term Financial Assistance (MTFA). The original MTFA sees the European Commission collecting capital on financial markets for up to €60 billion under an implicit EU Budget guarantee. The second lending instrument foreseen in the rescue package is the European Financial Stability Facility (EFSF), whereby a new authority is empowered to collect capital for up to €440 billion under a euro-zone member states' guarantee. The third element of the May package is the €110 billion loan agreement conceded to Greece by the EU and the IMF that served the primary purpose of supporting the refinancing needs. The loan to Greece strongly builds on conditionality. The country has committed to a substantial fiscal consolidation effort, bringing the public deficit down to 2.6% of GDP in 2014 from 13.6% of GDP in 2009. The Greek fiscal adjustment plan includes some frontloading and thus has a significant and immediate contractionary potential. Such a large fiscal adjustment is not unprecedented in economic history. In the 1980s, Sweden went through a similar experiment but it softened the recessionary impact of fiscal consolidation by using the exchange rate and boosting exports through depreciation, a measure that is not available to Greece. The fourth type of intervention agreed in May 2010 is probably the most incisive one and involves the European Central Bank (ECB). The ECB in fact came into the picture and started buying

bonds from crisis countries, provided the latter maintained their commitment to fiscal consolidation. The central bank did so through sterilization measures, namely by preserving the monetary policy stance in the euro zone. At present, the estimate is that the ECB has bought about €74 billion in bonds, of which 55% consists of Greek bonds. The intervention of the ECB is important in one specific respect. Policy-makers always react with a time lag and financial markets are inevitably always ahead of politicians. This is a structural problem that cannot be directly overcome. Against this background, the importance of the ECB's move consists in the fact that its actions had the effect of reducing somehow the costs from time lags between financial market reactions and policy decisions.

The rescue package had three main macro-objectives. First, it was meant to postpone the possibility of a Greek default. Second, it aimed to solve financing needs in the banking sector since the latter owned a large amount of Greek and other crisis countries' government debt. Third, it attempted to control the risk of contagion from Greece to Ireland, Portugal and Spain.

The magnitude of the debt problem in the South of Europe is non-trivial. In Greece, the debt is a public sector issue with both domestic and international banks owning large amounts of government debt. At the same time, bank-to-bank exposure is very limited. Ireland is at the other extreme, as here the country's main vulnerability is indeed bank-to-bank exposure. The Greek fiscal problem is not a consequence of the financial and economic crisis. Public deficits have been accumulated over time on the back of excessive spending and weak fiscal planning capacity. By contrast, Spain has not had a fiscal problem to start with. The country even posted fiscal surpluses over the years. It also succeeded in pushing through important institutional reforms in the fiscal arena and was fiscally virtuous at least until the government agreed to the stimulus package in response to the economic crisis. Nevertheless, this is not to say that financial markets have been irrational in targeting countries such as Spain and Portugal. High levels of private indebtedness justified financial market unrest. Both firms and households in these countries have been borrowing to support investment and consumption respectively. In Spain over-investment is especially problematic because it was concentrated in low-productivity sectors like construction, implying that for Spain to grow out of its own debt, it is necessary that resources move from the non-tradable to the tradable sector so as to improve productivity and thus repay the existing debt by means of exports. For this to happen, both Spain and Portugal need but to go through a harsh structural adjustment. In Ireland, as mentioned, the problem is mainly financial and concerns bank-to-bank exposure. Foreign banks are exposed to Irish banks for an amount of around €140 billion. This makes the case of Ireland especially problematic from a systemic perspective. Given strong financial

inter-linkages, an Irish default would come with strong consequences for the European banking system.

In a nutshell, the crisis had very different origins and symptoms in the different countries. In this respect, it would be more accurate to talk of crises in Europe. To the extent that the problems are different from one country to the other, such should be also the solutions.

Ireland is the first country that accessed the new lending facilities. It obtained loans both from the European Financial Stabilisation Mechanism and the Financial Stability Facility. It is a welcome development that the loan agreement with Ireland contains specific indications as to how the loan should be used. For example, there is a requirement for using a certain amount of the money received to fix the banking sector. This country-specific or case-by-case approach has been often criticised, but it is in fact recognition of the existence of specific, diversified problems.

The challenges ahead mostly concern the EFSF. In the short term, the question is whether the liquidity that it is providing is sufficient to respond to different vulnerabilities in different countries (e.g., Portugal and Spain). The second question concerns the most appropriate way of operating the EFSF after 2013 when it will be permanent. Until there is certainty about the new institutional framework, EU institutions and the new authorities have no other option but to provide liquidity to countries in need. The third challenge concerns the banking sector. The creation of the European Systemic Risk Board is a welcome institutional change. It is difficult to predict whether the new Board will operate efficiently. Whether it will operate efficiently or not, the real question is to devise new stress tests that allow a map of the health of European banking systems to be created. The fourth challenge is macroeconomic and concerns fiscal consolidation. It is uncertain whether countries under conditionality will be able to deliver on their fiscal adjustments. It would require a long period of tough adjustment. The EU Budget has a role to play in this context. The EU Budget has a potential not only for delivering structural reforms, but also in compensating for the unavoidable recessionary impact of fiscal adjustment.

PART II

Reform of Economic Governance in the EU: Subsequent Steps and Final Results

CINZIA ALCIDI

MACRO IMBALANCES AND MACRO ADJUSTMENT. THE EXPERIENCE OF TWO PERIPHERIES: EU VERSUS EURO ZONE

INTRODUCTION

The euro zone crisis is essentially a debt crisis resulting from a combination of factors and dynamics of macroeconomic, regulatory and institutional natures. However, one single factor contributes crucially to explain how a crisis that started in a small member state, like Greece, could spread to Ireland and Portugal and become a systemic euro zone crisis. In fact, the systematic nature of the crisis could only emerge from the vulnerability of a highly integrated European financial system. Had the Greek and Irish crisis occurred when euro zone banks were strong and/or not very inter-connected, the euro zone crisis would not have happened. But the European financial system was (and still is) fragile because of the high level of leverage accumulated over the credit boom of the first decade of the 2000s.[51] Excessive leverage is an essential ingredient in any major financial crisis, and the present one is no exception. Data on debt show that over the last decade in the euro zone, private debt relative to GDP increased by about 100 percentage points (more than it did in the U.S.) and that the financial sector was the segment of the economy with the highest increase.[52] The first question is why and how this could actually have happened.

Excess leverage in the banking sector was probably encouraged by scant financial regulation but its main driver was of an economic nature and tightly linked to large capital flows flying from core euro-zone countries into the periphery after the creation of the euro. The peripheral euro-zone economies (mainly Greece, Ireland and Spain) in their catching-up phase appeared to core European Member States with large savings and little domestic investment prospects as a great investment opportunity: They seemed to offer the opportunities of emerging economies but without the exchange rate risk.

51 I leave aside the question why the build-up of the credit boom was ignored. Inflation-targeting by central banks was probably one key reason. According to Borio and Lowe (2002), a low-inflation environment increases the likelihood that excess demand pressures show up in the form of credit growth and asset prices bubble rather than in goods price inflation. If this is the case, inflation-targeting central banks with a "myopic behaviour" could contribute to financial instability (see de Grauwe, 2009, and de Grauwe and Gros, 2009).

52 See Alcidi and Gros (2011b) for more details.

The flows quickly generated their own fundamentals: high growth rates driven by strong demand for consumption and construction investment, supported by easy credit fed from abroad. In all this, the financial system and banks in particular played a crucial role. They intermediated the flows and magnified the availability of credit through leverage by generating a tight network of intra-sector exposures. In this sense, capital flows (and leverage) were the "financial manifestation" of the macroeconomic imbalances.

Similar trends had emerged also in the north periphery of the EU. Between 2003 and 2007, large amounts of capital flew from surplus countries, especially Nordic countries (e.g., Sweden), towards the Baltic States.

When the financial crisis broke in late 2007, the risk perception changed dramatically and resulted in a sudden-stop of private capital flows both towards the Baltic States and the periphery of the euro zone.

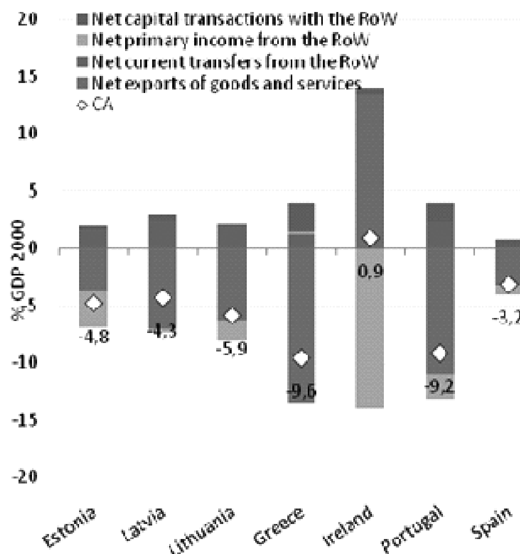
A second question is why the possible negative impact of those flows was not anticipated. When the euro was created in the late 1990s, one of the purposes of having a single currency was exactly to stimulate capital flows and movements of resources from countries with excess savings towards countries with scarce financial resources to promote faster growth. This is in fact what happened on a very large scale. Until before the financial crisis, the dominant view was that flows, and therefore macroeconomic imbalances, within a monetary union do not matter by definition. The crisis brought about a new reality. We discovered that there are two main reasons why imbalances matter. The first one is that large and persisting inflows fundamentally mean accumulation of external debt in the receiving country; the second is that capital inflows do not necessarily finance productive investment able to ensure future growth and hence creation of new resources to repay the debt. In some cases, as it happened, inflows finance consumption and contribute to inflating bubbles, which produced temporary, but unsustainable nominal growth.

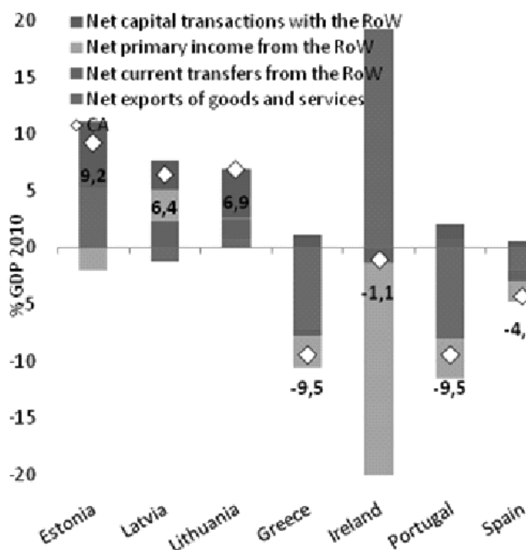
Put it this way, moving towards a solution to the crisis fundamentally requires expenditure adjustment for governments and/or the private sector, depending on where the problem of excessive borrowing lays. Except Greece, where the problem was concentrated almost exclusively in the public sector and hence fiscal correction is the first necessary step, for other countries in difficulties the external adjustment is the needed way out. In general terms, the adjustment should take place by reducing or eliminating further external borrowing, i.e., achieving a balanced or positive current account, and possibly by attacking stocks, i.e., deleveraging.

THE ADJUSTMENT

Countries with large external debts and deficits need large adjustments in demand and, in particular, consumption if the debt is mostly private. Until now, this has happened only partially and in a very heterogeneous way across Europe. In this perspective the experience of the Baltic countries is exceptional. When in late 2007 the large capital flows that had fuelled growth during the previous five years stopped, growth also did and the sustainability analysis of the external position of those countries changed radically. International investors that had financed consumption and construction investment (similar to what happened in Greece, Portugal, Spain and Ireland) suddenly assessed the risk associated with further lending to these countries as too high and turned off the tab. Since the Baltic economies decided to keep intact their parity with the euro, the only way forward for them was internal devaluation: falls in prices and wages. This resulted in a decline in wages on the order of 50% and a huge contraction in spending. To get a sense of the overall correction, Figure 1 (CA data appear in the chart) displays the drastic change in the current account balance between 2007 and 2010 in the ELL (Estonia, Lithuania and Latvia) and compares it with the data in the GIPS (Greece, Ireland, Portugal and Spain). The figure seems to suggest that in GIPS the adjustment in spending has happened only on a small scale; with the exception of Ireland, the current account is negative and is expected to stay so next year. What explains the difference?

Figure 1. Current Account Balance and its Decomposition in 2000 and 2010 as % of GDP





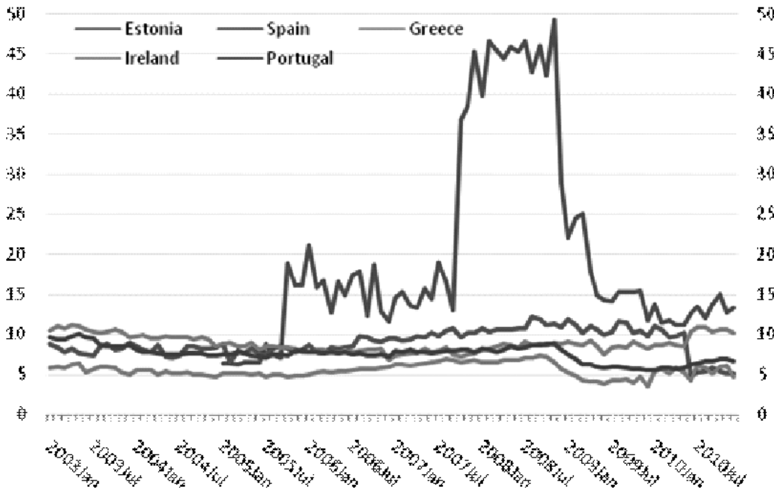
Source: European Commission Services (AMECO)

It should be said that the current account contains elements other than the simple balance of the spending of the country with respect to the rest of the world (that is the trade balance), hence a country that experiences an improvement in its spending (goods and services) position does not necessarily exhibit an improvement in the current account. In this respect, the decomposition shown in Figure 1 suggests that interest payments on domestic securities (negative net primary income from the rest of the world) account for an important portion of the deficits of the GIPS. Interestingly, this is a measure of the transfer made each year by the country to non-residents holding domestic debt.

However, the decomposition also highlights that with the exception of Ireland, imports have continued to exceed exports in all the GIPS countries despite a general reduction in its size.

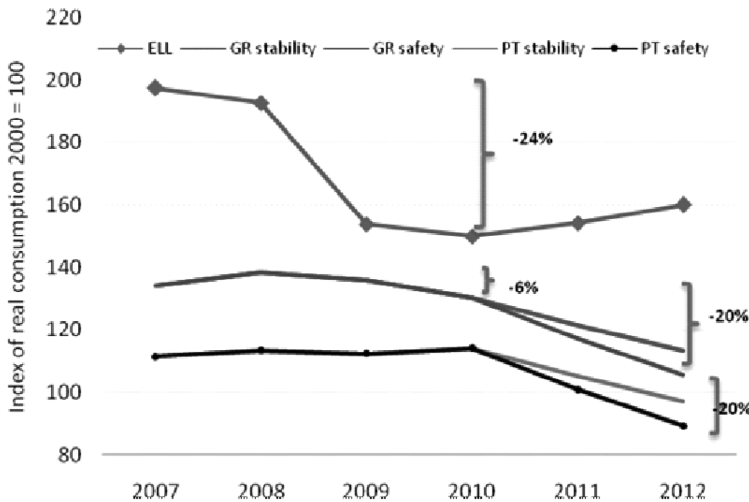
The crucial element to explain the difference in spending adjustments between the periphery of the euro zone and the EU is the ECB. Banks of the countries belonging to the monetary union, notably Greece and Ireland and, to a less extent, Portugal and Spain have resorted significantly to ECB financing, which has permitted them to lower, or keep unchanged, their interest rates against increasing levels that working market mechanisms would have implied. This contributes to explaining why private demand and, in particular, consumption has not adjusted significantly in these countries despite the magnitude of the crisis. Figure 2 shows the effect of a "sudden stop" of capital in GIPS and in Estonia, which was not a member of the euro area before 2011, on the interest rates on consumption credit.

Figure 2. Interest Rates on Loans for Consumption



Source: ECB statistical warehouse, [A21-A2Z], Loans excluding revolving loans and overdrafts, convenience and extended credit card debt (up to 1 year) to Households and non-profit institutions (New business).

Figure 3. Consumption Adjustment



Note: Greece's need for stability is calculated as the real consumption associated to a balanced current account, while Greece's need for safety and the level of real consumption associated with a current account surplus of 2.5%
Source: European Commission Services (Ameco) and authors' calculations.

The "sudden stop" is visible only in the Estonian data where the interest rate had increased at prohibitive levels between 2007 and 2010: a clear manifestation of the credit crunch with severe consequences on consumption, which over that period has fallen by more than 20%.

Similar adjustments have taken place also in Latvia and Lithuania. Figure 3 shows the average correction in consumption in the Baltic States and compares it with the path of consumption in Greece and Portugal and the adjustment after 2010 that would ensure "stability" and "safety." Stability is defined as consumption associated with a balanced current account and safety as consumption associated with a current account surplus.

The chart suggests that Portugal and Greece should put in place a deep correction of about 20%, similar to that experienced by the Baltic countries. This estimation may be exaggerated and likely to be politically unacceptable in those countries, but this simple exercise suggests that if the ECB were to change its policy and withdraw its exceptional measures, a credit crunch of the kind experienced in the north periphery of the EU could materialise, with all its painful consequences on GDP. But even assuming that private flows continue to be replaced by official flows, the question is how the lack of adjustment can be reconciled with debt sustainability: until the current account does not turn to zero, debt will keep accumulating and appear every day less sustainable.

POLICY IMPLICATIONS AND CONCLUSIONS

The key issue facing the euro periphery today is that the large inflows of private capital that built up over the first decade of the EMU have suddenly stopped. These inflows had fuelled a consumption boom in Greece and Portugal, and housing booms in Ireland and Spain. The short analysis presented above suggests that while fiscal adjustment in some countries is necessary, it will not be sufficient by itself to restore access to financial markets. External adjustment is necessary and painful because a "sudden stop" requires ultimately a sharp compression of consumption (investment is already low).

This earlier analysis points also to another important implication. The large debate about the loss of competitiveness in the periphery of the euro zone that has led to the Commission package on economic governance and the pact for the euro (plus) seems not to address the real problem but rather focus on a symptom of it. The increase in unit labour cost experienced in the euro zone periphery are nothing but the reflection of sustained growth and demand until 2007 driven by capital flows. Treating the symptom will not cure the illness and will not solve the crisis.

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* *This short paper based on my contribution to the conference The EU Economy: Response to the Crisis and Prospects of the New Decade held in Warsaw on 18 January, 2011 draws largely on a longer paper I wrote with Daniel Gros "Adjustment difficulties and debt overhang in the periphery of the euro zone," CEPS Working Document (forthcoming).*

TOMASZ SKURZEWSKI

REFORM OF ECONOMIC GOVERNANCE IN THE EU: SUBSEQUENT STEPS AND FINAL RESULTS —A POLISH PERSPECTIVE

In order to consider the issue of economic governance, one needs to go back in time and show the sequence of events that followed the recent economic and financial crisis. The crisis not only damaged the effects of decade-long gains in economic growth and job creation but also exposed some fundamental weaknesses in the European economy. It was further amplified by the macroeconomic imbalances gradually building-up in the years before the crisis.

In the early stage of the crisis, actions were taken to stabilize the financial system through various measures including state guarantees, capital injections and liquidity support. They were mostly successful, but while financial stability had been brought under control, the fiscal situation worsened in many Member States. It resulted from the automatic effects of slower growth (thus lower revenues and higher spending as share of GDP) and from discretionary support measures applied to support recovery. In 2009, the government deficit increased sharply in both the euro area and in the EU as a whole and went above the 3% benchmark. The government debt ratio increased to some 73% of GDP in the EU and nearly 79% of GDP in the euro area. Moreover, debt continued to rise in most EU countries in 2010 and beyond, despite a phasing out of the stimulus measures. According to Eurostat's forecast, total EU debt was expected to rise above 81% of GDP in 2011.

Under these circumstances Poland also acted to safeguard its own financial system and stood ready to assist if necessary. Our banking sector, however, turned out to be remarkably healthy and did not in fact require any financial assistance from the state treasury. So the authorities turned their focus to the fiscal side. First, in the stimulus stage certain tax incentives introduced by the previous government were continued. Then, when the fiscal exit phase was announced and recommended by the EU, cost-cutting measures on the spending side were implemented. Apart from the EU's Stability and Growth Pact requirements this was driven by the continued commitment to meet the fiscal criteria required for the ultimate euro adoption (even though the initially mentioned date of 2012 was subsequently postponed, without setting the new target).

Recovery from the economic crisis coincided with finalizing the Europe 2020, the European strategy for growth and jobs. It followed the Lisbon Agenda, which has just expired. The new strategy set an over-

arching goal of boosting Europe's competitiveness, productivity, growth potential and economic convergence. It was designed to focus on the key areas where action is needed: knowledge and innovation (R&D), a more sustainable economy, high employment and social inclusion. The new approach, however, was adopted to combine macroeconomic, structural and competitiveness developments into simultaneous consideration, together with the assessment of overall financial stability—based on input from the newly established European Systemic Risk Board.

Analysis of the sources of crisis and the desire to avoid or limit the occurrence of a similar development in the future has led to the call for changes in the overall economic governance in the EU. It was not a new idea. Already in 2008 the Commission emphasized that "EMU is a solid construction and a remarkable achievement" but further measures are needed "to keep improving the economic governance of the euro area through strong and binding political commitments. Over the last three years we have revised the instruments of coordination, the Stability and Growth Pact and the euro area dimension of the Lisbon process. We now need to strengthen our coordination of budgetary and economic policies." Two years later, in May 2010, concrete proposals were submitted by the European Commission in its Communication on reinforcing economic governance in the European Union. The European Council mandated the special task force to work on measures to improve the crisis-resolution framework and ensure better budgetary discipline. The task force concluded that a "quantum leap" in terms of more effective economic governance in the EU was needed. It identified five main pillars for action:

– fiscal discipline (stronger Stability and Growth Pact, SGP);
– a broadening of economic surveillance to encompass macro imbalances and competitiveness;
– deeper and broader coordination;
– a robust framework for crisis management; and,
– stronger institutions and more effective and rules-based decision making.

Poland participated in the work of the task force and obviously supported the directions of the planned changes. In particular, Poland remained committed to sound and responsible fiscal policy and thus welcomed the intention to strengthen the preventive arm of the SGP in order to enhance the budgetary surveillance framework. Poland is among the few countries that already have a strong fiscal rule in place. It has been included in our Constitution since 1997 and it sets a limit for gross public debt at 60% of GDP, so that government borrowing in a given year cannot lead to exceeding this threshold. We also introduced a temporary expenditure rule limiting the growth rate of discretionary expenditures and all new fixed expenditures to the level of the consumer price index increased by one percentage point annually (CPI+1%). A permanent

fiscal rule is being designed, which shall replace the above-mentioned one and shall apply to a wide range of general government expenditures and follow the objective of stabilising public finances and respecting the treaty and SGP provisions.

Turning to the package of six regulatory legislative proposals proposed by the Commission, Poland focused mostly on measures related to strengthening the Stability and Growth Pact. On the corrective side of SGP surveillance, Polish authorities' intention was to put more weight on debt criterion and the long-term debt sustainability. That is why we proposed, supported by several other Member States, to have a special treatment for the cost of pension reforms under the excessive deficit procedure. We suggested that countries that introduced pension reform (with diversion of some social contributions to newly established mandatory private pensions funds) and thus worsened their short-term fiscal balance but at the same time improved their long term fiscal sustainability, should not be penalized for it. Hence, in our view, such costs should be taken into consideration when assessing debt and deficit under the SGP. This discussion has reached the level of the European Council in December 2010, which in principle acknowledged our arguments. However, deliberations on some practical aspects of its implementation continued through March 2011. Poland insisted that costs of pension reform be treated symmetrically at both launching and abrogating the excessive deficit procedure. Poland thus proposed that the excessive deficit procedure should be abrogated if the deficit has declined substantially and continuously and has reached a level that does not significantly exceed a level that can be considered as close to the reference value and, in case of non-fulfilment of the requirements of the debt criterion, the debt has been put on a declining path that comes close to the reference value. Such a proposal did not gain adequate support at the Ecofin Council meeting, but the discussion may continue on the definition of the excessive deficit under the Treaty. Other elements of the governance package, i.e., application of financial sanctions (fines or non-interest-bearing deposits) for breaching the SGP and measures aimed at prevention and correction of macroeconomic imbalances were supported by Poland without any significant reservations.

While the work on the governance legislative package continued, a new drive for changes emerged in the form of a French-German initiative, announced as a Pact for Competitiveness. It subsequently gained support of the euro area Member States and was endorsed by the European Council in March 2011. The Pact was named "The Euro Plus Pact" to indicate its application not only to euro area countries. Bulgaria, Denmark, Latvia, Lithuania, Poland and Romania immediately joined the Pact and may be followed by more Member States. Poland was an active advocate of not limiting the design and operation of this framework to euro countries only. Poland's main objective was to support the EU's

global competitiveness and to facilitate the strengthening of all EU economies. The Pact will further enhance the economic pillar of EMU and achieve a new quality of economic policy coordination, with the objective of improving competitiveness and thereby leading to a higher degree of convergence reinforcing European social market economy. The Pact foresees announcing and implementing concrete commitments by participating countries and a monitoring of their implementation.

A similar approach was taken by Poland towards the European Stability Mechanism. It was designed to safeguard the financial stability of the euro area as a whole. The ESM will assume the role of the European Financial Stability Facility (EFSF) and the European Financial Stabilisation Mechanism (EFSM) in providing external financial assistance to troubled euro-area Member States after June 2013. In the case of this initiative, Poland accepted the assumption that the new mechanism would rightly focus on the euro-area and shall be established on the basis of an intergovernmental agreement. It will, however, remain open to non-euro area Member States, which may participate in it (as contributors) on an ad hoc basis.

In both cases, Poland acted in the interest of the whole European Union, aiming to avoid or limit measures involving only the euro area countries. Poland recognizes that Member States whose currency is the euro have a particular interest and responsibility to conduct economic policies that promote the proper functioning of Economic and Monetary Union and to avoid policies that jeopardise it. At the same time, Poland would like to avoid the establishment of a so called "two-speed" Europe in the field of economic policy. Therefore, we promote and support initiatives that are discussed and decided by all Member States, and which allow for the participation of the EU27.

The new European governance structure is nearing its completion, although its final shape remains to be seen. The legislative acts are now discussed by the European Parliament and may possibly be agreed with the Council by the end of June, 2011. The Parliament seems to be generally supportive of these initiatives but may also introduce its own ideas. It was reported that almost 2,000 amendments have been tabled. Some political groups differ primarily on issues such as the nature of sanctions and the rate at which excessive debt should be reduced per year. If delayed, this process may be prolonged into the second half of 2011 and in such a case would be tackled under the Polish presidency in the Council.

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* *This article follows the author's presentation made at the PISM conference on 18 January 2011. It was updated to take into account recent developments in the area of EU's economic governance. The author aimed at presenting the Polish position on the relevant issues, however, it cannot be treated as an official position of the government.*

PART III

The Key Levers of the Europe 2020 Strategy: Prospect for Success?

THE EU BUDGET
AS A TOOL OF EU 2020 IMPLEMENTATION

Besides the internal market and the trade policy, the EU budget is presented as one of the EU 2020 pillars.[53] The main objectives of the Strategy are: smart growth (developing the economy based on innovation), sustainable growth (promoting a more efficient agreement and more competitive economy) and inclusive growth (fostering, growth, employment and delivering social and territorial cohesion). Additionally there are five headline targets that make it possible to assess the progress of the Strategy, and also seven flagship initiatives. How all of these ambitious but rather general goals could be supported by the EU funding?

Going back to the past, the cornerstone of the EU's long-term financial programming in the EU was the first Delors package from 1988. Together with subsequent periods of funding, it contributed to better stability and predictability of EU finances. The former financial perspective 2000–2006 had a tiny correlation with the Lisbon Strategy because it was concluded earlier than the Strategy itself. This was changed with the negotiations of the subsequent financial perspective. The Lisbon Strategy revision in 2005 had an influence on budgetary negotiations 2007–2013 by a desire to "Lisbonise" the EU finances. For example, it was decided to introduce the earmarking rule, which meant concentrating a large part of EU funds on Lisbon objectives. Currently, it is highly expected that the next multi-annual financial framework will be better linked with the EU 2020 Strategy. It was expressed clearly by the Commission in the recent EU budget review.[54]

Trying to evaluate the possible role of the EU budget in the implementation of EU 2020, it seems necessary to start with the question of the overall size of the EU budget. It should be taken into account that the EU level spending is quite limited; it accounts for something about 1% of EU GDP. This share is not impressive when compared with U.S. federal government spending which accounts for about 25% of the U.S. GDP. The figure becomes even more impressive when compared to the Member States' public spending, which averages between 45% and 50% of EU GDP, and it gives a proper impression of the EU budget's size.

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53 Communication From The Commission, "Europe 2020: A strategy for smart, sustainable and inclusive growth," Brussels, 3.3.2010, COM(2010) 2020 final, http://eur-lex.europa.eu/LexUriServ/ LexUriServ.do?uri=COM:2010:2020:FIN:EN:PDF.

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Therefore, knowing the modest size of EU spending, the resources should be allocated where it could bring the highest added value.

The question of the size of the EU budget has been debated for the long time. For example, the well-known MacDougal report from 1977 stated that if the European Communities would be transformed into some kind of federation, it would need a federal expenditure of around 5–7%, or 7.5–10% if that included defence spending.[55] By the end of the 1970s, before the accession of Greece and Spain, the economic differences of the Member States were not as high as now. Currently a kind of federal budget share now would be much higher than the figures presented in the McDougal report as the EU-12 GDP per capita is considerably lower than in the EU-15. The same as it was in the '70s, presently the issue of supra-national spending triggers dynamic political debate. During the European Council summits in the second half of 2010, the UK tried twice to form a coalition of Member States that were against the increase of the EU spending level.

At the same time it seems important to mention that the scope of the EU level of activity is limited and large areas of the EU 2020 Strategy depend in fact on the spending of the Member States. For example, in fields such as education, research and development or social services, the EU has limited competences, so the quantity and quality of spending depends mostly on national priorities. Additionally, the role of the private sector cannot also be omitted, as it is crucial for example for research and development investment. Therefore the success of the EU 2020 will depend on political will to follow its objectives and to define the tasks of difference governance levels: EU, national, regional and local. The EU budget can have here a supporting role.

Knowing the limited size of EU budgetary resources, it seems important to answer the question of what kind of added value the EU budget could have as the EU should finance the objectives, which cannot be better achieved at the national or local levels. An interesting proposal was included in the Sapir Report from 2003 where it was suggested that research and development, convergence and restructuring of the labour market should be the main goals of EU funds instead of financing Common Agricultural Policy (CAP).[56] Other priorities are enumerated, for example, in the European Parliament Reflection Paper from October 2010, which suggests that research, innovation, the Galileo Project,

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55 Commission of the European Communities (1977), "Report of the study group on the role of public finance in European integration," Volume I, General Report, Brussels April 1977, pp. 13–14, http://ec.europa.eu/economy_finance/emu_history/documentation/chapter8/1977 0401en73 macdougallrepvol1.pdf.

56 "An Agenda For A Growing Europe. Making the EU Economic System Deliver," Report of an Independent High-Level Study Group established on the initiative of the President of the European Commission, Chairman of the Group: André Sapir, www.euractiv.com/ndbtext/innovation/sapirreport.pdf.

transport, and energy education should be the special focus of EU spending.[57] This document also shed some light as to how the current EU budget reflects the EU 2020 priorities. When we compare the main EU budget headings with the EU 2020 priorities, it can be seen that one does not necessarily fit to another, for example the heading number 1A, competitiveness, is around 9% of the 2011 budget. From this heading we can finance most of the EU 2020 objectives. According to the working paper of the European Parliament the heading number 1A, for example, is in 86% related to the flagship initiatives of the EU 2020 strategy. As another example, heading number 2B (rural development) reflects in 70% the content of the flagship initiatives of the EU 2020.[58] As imagining a separate budget for the Strategy belongs is political fiction thinking, the only feasible step seems to be a structural change of the EU budget headings to better reflect the EU 2020 objectives. Another necessary tool is a increased conditionality of EU spending, however it would be difficult to introduce due to legal obstacles (for example in Common Agricultural Policy).

Looking at the expenditure structure, how it was changing with time, we can see that there were large shifts, for example, in spending on the common agricultural policy. In 1988 it was somewhat around 60%, and in 2013 it's expected to be only 40%.[59] The share is expected to be further slightly reduced. One has also to take into account the relative size of the EU budget, which is in fact decreasing. In absolute terms the budget is growing, but in the relative terms compared to the growing GNI of all the Member States it's in fact decreasing. This is contrary to the popular statement that the EU budget is growing and raises a question about the importance of this instrument in the Strategy.

In October 2010, the Commission published a long-awaited and important document—the EU mid-term budget review. It was an element of the 2005 agreement concerning the current financial perspective 2007–2013. There were some perturbations connected to the publication of this review, because the draft leaked already in 2009, and the whole document was published only one year later. The delay in publishing was due to problems with the ratification of the Lisbon Treaty. J.M. Barroso did not want to make public this document in the end of the former Commission's mandate. The EU budget review suggests better orientation of the budget on the EU 2020 goals, which is in fact in line with the large majority of the Member States, but they very often differ

57 "Reflection Paper on Implications of the EU2020 strategy on the post-2013 Multiannual Financial Framework," Rapporteur: Salvador Garriga Polledo, Special committee on the policy challenges and budgetary resources for a sustainable European Union after 2013, European Parliament, 5 October 2010.

58 *Ibidem.*

59 Source: European Commission.

concerning the priorities that should be supported as they have different objectives due to their level of economic development. The Commission's document also indicates that cohesion policy can increase the competitiveness of the EU as a whole, and is also proposing some changes in the Common Agricultural Policy but they are not as radical as the leaked 2009 draft. The budget review also criticises the logic of *juste* retour, which consists of endeavours to achieve the most favourable net position towards the EU budget by the main contributors. The review also examined potential revenue sources of the EU budget, supported the role of the cohesion policy in the EU 2020 Strategy and also underlined the necessity of CAP.

Looking at the CAP itself, it's composed of two pillars. The first one is focused on direct aid for producers, the second one supports rural development policy, which aims to speed up economic, social and environmental development in the countryside. This pillar can contribute much more to the objectives of the EU 2020 through technological progress, resource efficiency and environmental protection. The CAP, as a budget objective is politically inviolable. It is vital to the French interests, in particular direct payments, because this country is the biggest beneficiary of direct payments. France is less interested in second pillar, because a large share of it is distributed in similar way to cohesion policy, thus France is net payer in this pillar and would not support this part of CAP. The recent British position contributes to this, being less critical towards CAP, which indicates that there could be possibly a preliminary agreement between the UK, France and Germany, consisting of CAP persistence and French agreement for EU budget consolidation. This would mean, that Common Agricultural Policy is maintained at a cost of a magnitude of cohesion policy.

The cohesion policy is some kind of symbolic policy for the EU, being based on the principle of solidarity, in some countries such as Poland contributes to large EU support. After 2006, this policy found itself under the process of the so-called "Lisbonisation," when it was concluded that cohesion and competitiveness are not mutually exclusive. Nevertheless, this policy has also some problems, including slow uptakes of funds, delays in launching programmes, complexity and also the Member States' fiscal problems, which results in problems with funding projects. At the end of 2010, cohesion was also under criticism from the *Financial Times*, which in a series of articles criticised it for management problems, its complexity, slow uptake of funds and also alleged a level of fraud (about 5%), subsequently criticised by the European Commission for attributing this number to errors connected with filling out application forms.[60] The Commission answered these critics, reminding them that a large number

[60] According to the Commission, the real level of fraud in the cohesion policy management was 0.2%.

of programmes of the cohesion policy from the financial perspective 2000-2006 finished in 2009, so this is why there were some delays in taking the money from the new financial perspective, which was adopted with a delay.

In the budget review, the Commission reminded that the cohesion policy can have a positive effect on donor Member States. This is because just simply increasing intra-EU trade. Using the EC QUEST III simulation the Commission reminded that thanks to the cohesion funds from the financial perspective 2000–2006 there was a higher GDP growth in the EU25 in 2009 by 0.7%.[61] Despite the fact that the economic assessment of the cohesion policy in the literature presents a mixed picture, it has to be admitted that the long-term financial programming of the EU is contributing to the realisation of the development goals at a local level—mobilisation of public and private capital and better coordination between the various levels of governance in the Member States, even if recently it became a challenge because of the fiscal consolidation of the national budgets. Currently, in the Commission documents the cohesion policy is at the heart of the EU 2020 Strategy. However it doesn't mean, that this policy will increase its meaning and a level of funding. It is possible, that in new multiannual financial framework, in consequence of several Member States' efforts, the level of funding will be lower.

The current agenda looks very challenging. We are expecting the Commission to publish in June the communication with concrete proposals for the new multi-annual financial framework 2014–2020. Then the discussion starts not only about the spending, but also about the revenue side of the budget, creation of an EU-wide tax, which in fact is not very likely to happen. Member States oppose this tax since it violates their fiscal competences, but also makes more difficult to calculate Member States net position. Currently, 76% of the EU budget comes directly from the Member States, so it makes the negotiation of the EU budget very difficult and increases the logic of juste retour. We will have also discussion concerning the British rebate, the so-called "bloody British question." As the large part of the EU Member States is subjected to the excessive deficit procedure, there is also pressure to limit the EU budget and to correlate it with the consolidation efforts, which was included in the European Council conclusions in October 2010.

Despite its small size, and limited significance, the EU budget can contribute to the realisation of the EU 2020 objectives. Nevertheless it seems that the EU budget will not be the core pillar of the Strategy and its role will only be supportive. The realisation of the EU 2020 objectives will depend to large extent on the Member States' engagement. The EU budget can support the Member States' efforts but cannot replace them.

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61 Communication from the Commission …, "The EU Budget Review," *op. cit.*, p. 6.

FABIAN ZULEEG

THE SINGLE MARKET IN THE NEW DECADE IN THE CONTEXT OF THE EUROPE 2020 STRATEGY

In 2010, the EU finally reached agreement on the Europe 2020 Strategy, the successor to the Lisbon Agenda. Deciding on Europe's new growth strategy took place in the context of a deep economic crisis, making the achievement of the central objective of Europe 2020—smart, sustainable and inclusive growth—even more important. But resources are limited: Europe's public finances are in a precarious state.

Few tools are available to boost Europe's growth potential. But Europe also has underused assets that can be utilized more effectively. First-and-foremost, Europe must use the full potential of the European Single Market to avert a future growth crisis.

EUROPE'S GROWTH CHALLENGE

While the current economic crisis has aggravated the EU's growth crisis, the difficulties Europe faces also lie in pre-crisis trends with growth rates already relatively low due to the long-term challenges Europe faces, such as global competition, resource competition and increasing resource prices, climate change and an aging population.

The situation has become even more difficult now. The crisis has accelerated structural long-term change, making it unlikely that past drivers of economic growth, such as the financial sector or property/real estate and construction will play a similar role in the future. Low value-added activity that can be outsourced, for example in basic manufacturing, has permanently shifted to emerging economies.

At the same time, Europe's governments must consolidate their fiscal position. In the near future, there is a need to take into account the potentially detrimental impact of fiscal consolidation on growth but in the medium-term more sound public finances are inevitable. Public finance difficulties not only aggravate the current situation, they also make it unlikely that the public sector will provide the significant public investments needed to increase Europe's growth potential.

The impact of the crisis is both a reduction in growth and lower long-term growth potential. This will have an ongoing detrimental impact on labour markets, with low growth rates likely to result in a weak recovery. In addition, low growth rates potentially undermine the sustainability of Europe's economic and social models, for example by

reducing public revenues. Weak economic performance also will reduce Europe's importance as a global player.

The situation is not uniform across Europe, but rather than being positive, this is aggravating the situation as increasing divergence within the euro zone is the major driver of the current euro zone crisis. This divergence, for example in current account performance, predates the economic crisis, but the weakest economies are now being left even further behind. Countries such as Germany are rebounding strongly, while Portugal and Greece record low growth and investment rates.

WHAT GROWTH DRIVERS ARE AVAILABLE TO THE EU?

To drive growth, the implementation of Europe 2020 is critical while at the same time better at dealing with risks and potential instability, for example through improvement in financial regulation. Improved macroeconomic coordination and enhanced economic governance, as well as the promotion of structural reform, are crucial. While Europe 2020 still lacks convincing implementation mechanisms, the existing framework in combination with the emerging governance framework on public finances, must be used to the fullest.

Europe also can do more to enable the investment that is needed: There continues to be significant infrastructure needs across the EU, from traditional infrastructure such as roads and rail but also to new infrastructure such as smart grids and next generation broadband. In addition, there is a need to accelerate investment in education and skills to enable Europeans to compete with emerging economies that are investing heavily in this area. This involves better targeting of the EU budget as well as exploring new financial instruments such as EIB loans, Europe 2020 project bonds or European-level PPPs.

Most important, the EU should aim to create a framework for investment, innovation and growth, using instruments such as legislation and standardisation to create a larger market. Aiming to expand the EU's market should include an external dimension, in relation to trade and investment, but the scope for progress, here, is limited by the continuing impasse in global trade negotiations. In contrast, significant potential still lies in the completion of the internal market.

TODAY'S SINGLE MARKET

The Single Market as it stands is the most significant result of European economic integration, but it is far from complete. Much progress has already been made: the 1992 programme ensured that there is a genuine Single Market in goods while progress on services has been more difficult, even with the Services Directive now in force but still

being too limited in nature. Freedom of movement for people has broadly been achieved, even though more needs to be done to encourage mobility rather than simply providing a passive right. Capital is also much freer to move, but for individuals the financial sector is still fragmented along national lines. In addition, to the incompleteness of the Single Market, many of the problems encountered by firms and consumers stem from incomplete or indecisive implementation, with more needing to be done to ensure that rules are applied uniformly and consistently.

THE SINGLE MARKET OF THE FUTURE

The Single Market also needs to continue to adapt to Europe's changing economy. Technology is permeating all sectors of society, transforming the way we work, companies' business models and the nature of our societies, with digital exclusion becoming an important phenomenon. A whole new, "dematerialised" sector is emerging with the expansion of digital products and services and the rise of e-commerce. The combination of globalization with information and communications technologies is having profound impacts, including digital outsourcing, global value chains in cyberspace and the emergence of knowledge (in the form of data, patents, IPR, etc.) as the key factor of production. Increasingly, knowledge/skills will be Europe's only source of competitive advantage.

These developments will increasingly result in the irrelevance of current Single Market rules. There now needs to be a 5th Freedom: the free movement of knowledge in a Digital Single Market. This requires not only passively removing barriers but actively building a Single Market, for example through harmonization. Knowledge must be seen as Europe's key asset (IPR, patents, etc.) with human capital playing an important role. More focus is needed on the non-material economy (e-banking, e-commerce, e-government, etc.). In many areas the existing rules need to be revised or even newly created, be it on consumer protection, digital crime/identity theft, data protection or taxation.

THE DIGITAL SINGLE MARKET

Making the Single Market fit the knowledge economy entails significant economic potential: it could add at least 4% to EU GDP, help create European digital companies of scale, as well as helping to integrate EU labour markets, combating climate change and countering the effects of population aging.[62] It would bring many benefits to consumers, especially for younger generations that expect a free online market where they can, for example, download music anywhere in Europe.

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62 For further details please see www.epc.eu/dsm.

To achieve this, we will need high level leadership in the EU. We need to create an online market place consumers can trust, as well as a business environment fit for the knowledge economy through, for example, the harmonisation of consumer and data protection and common standards for e-invoicing and e-signatures. The legal framework for knowledge assets needs to be updated including, for example, a pan-European patent, IPR and licensing framework. We also need to build the foundations and infrastructure for such a Digital Single Market through, for example, significant investment in hard (broadband) and soft (skills) infrastructure.[63]

PROGRESS—SLOWLY BUT SURELY?

Aiming to create a Digital Single Market was a key priority for Barroso and is contained in Europe 2020:[64] "The aim is to deliver sustainable economic and social benefits from a Digital Single Market." At the EU level, progress is noticeable: the Digital Agenda[65], the Citizenship Report[66] and consultation on the Single Market Act.[67] The latter two followed on directly from the Monti Report,[68] which provided a comprehensive blueprint for the development of the Single Market. However, it remains to be seen exactly how ambitious, integrated and visionary the concrete proposals will be and what, in the end, will be translated from ambition to reality, given the difficult economic and political environment as well as protracted European decision-making mechanisms. While the right policies are being debated, details are still missing, with concrete proposals rarely identified.

A MORE COMPETITIVE, SUSTAINABLE KNOWLEDGE ECONOMY

There has been a good start with political priority on the creation of the Digital Single Market but this emphasis is in danger of being lost in the crisis. There is a risk that the policy agenda will fragment and that there is a lack of overarching vision and direction.

The risk of non-delivery is high but this would mean that the Single Market would increasingly lose relevance for future generations.

63 For details please see www.epc.eu/dsm/6/Policy_recommendations.pdf.

64 Communication from the Commission, "Europe 2020: A European strategy for smart, sustainable and inclusive growth, Brussels, 3.3.2010, COM(2010) 2020 final, p. 12.

65 Communication from the Commission, "A Digital Agenda for Europe," Brussels, 3.3.2010, COM(2010) 245 final/2.

66 EU Citizenship Report 2010: Dismantling the obstacles to EU citizens' rights; COM(2010) 603 final.

67 Communication from the Commission "Towards a Single Market Act," COM(2010) 608 final/2.

68 A New Strategy for the Single Market at the Service of Europe's Economy and Society; http://ec.europa. eu/bepa/pdf/monti_report_final_10_05_2010_en.pdf.

Moreover, in the current economic situation, Europe does not have many opportunities to generate future growth. Realising the full potential of the Single Market is needed to achieve smart growth. The development of a fully functioning Digital Single Market could be a key driver to turn Europe 2020 ambitions into reality. Europe cannot afford to not grasp this opportunity.

TRADE POLICY AND EU 2020

INTRODUCTION

One of the many criticisms of the now-defunct Lisbon agenda was that it never had an "external dimension": a programme that sought to boost innovation and productivity in the EU appeared to be disconnected from trade policy. The Lisbon agenda's successor programme, EU 2020, claims to have tackled this deficiency. EU 2020 has been given an "external dimension" that the Lisbon agenda lacked. Trade policy, by inference, is set to become an instrument of innovation policy. But is it? If trade policy is to play a role that it did not previously, then either it must have changed in some important way, or it must connect differently to EU 2020 than it did to the Lisbon agenda. Is there any evidence for such a change?

THE CASE FOR FREE TRADE

Let us start by reminding ourselves that the economist's case for free trade rests largely on the benefits of imports, rather than exports. Imports contribute to economic welfare in several ways. But two stand out. First, imports raise living standards by improving the way resources are allocated (the so-called "static" gains). Import barriers reduce economic welfare because they divert domestic resources away from the goods and services that countries make relatively efficiently towards those they produce less efficiently and which they could have bought from abroad. Imports, in short, spare countries from wasting resources on things they do not produce efficiently and frees them up to be put to better use.

The second gain from trade is "dynamic." By increasing competition on the domestic market, imports spur companies to innovate and raise productivity. Imports from China are often referred to by politicians as if they were a threat to European prosperity. But they have actually spurred innovation and productivity in the EU, notably by encouraging European firms to invest in new technology and designs. Before China joined the World Trade Organisation (WTO), European firms enjoyed an easier life. China's integration in the world economy forced them to change. One study estimates that since 2001, 15% of technical change within the EU can be directly attributed to the increase in imports from China.[69]

[69] N. Bloom, M. Draca, J. Van Reenen, *Trade induced technical change? The impact of Chinese imports on innovation, diffusion and productivity*, 2009.

The economist's traditional prescription for trade policy is unilateral liberalisation—that is, the lowering of import barriers, regardless of what trading partners do. This is not, of course, how trade policy is ordinarily set. In the "real world," trade policy tends to follow the logic of arms reduction talks: one side agrees to lower its import barriers, in return for the other side doing the same. From an economist's perspective, this logic can seem a bit strange. It is as if one side were to say: "I will not shoot myself in the foot, but only if you do not shoot yourself in the foot either." Not for nothing has the *Financial Times* columnist, Martin Wolf, dubbed international trade agreements "disarmament treaties for mercantilists."

Why is there such a gulf between the economic case for free trade and the conduct of trade policy? The answer is that trade is domestically disruptive and has distributional consequences. Imports benefit society as a whole, but they threaten less efficient firms and their employees. And as the social costs of imports are more concentrated than the economic benefits, forces resistant to competition exert a strong influence on trade policy. Against this backdrop, trade policy is over-determined by producer interests. The economic case for free trade disappears from public debate. And trade policy becomes a matter of countries reluctantly trading favours between various well-organised producer interests.

TRADE POLICY AND EU 2020

What relevance does all of this have to EU 2020? The aim of EU 2020 is to promote "smart, sustainable, and inclusive" growth. To this end, it has been given an "external dimension" that the Lisbon agenda lacked. But which of the objectives can (or should) trade policy help to meet? In the excellent staff working-document that accompanies its Communication on trade, the Commission rightly argues that trade policy should focus on promoting innovation and productivity ("smart growth"), while social objectives ("inclusiveness") should be met by non-trade policy instruments (like education and training).[70] But is this really the way that trade policy is likely to be framed over the next decade?

It seems unlikely. The reason can be summed up in one word: China. The countries that pressed hardest for EU 2020 to be given an "external dimension" were not those excited about how China could contribute to European innovation and growth, but those worried about the social and distributional consequences of trade with emerging economies. It should come as no surprise, therefore, that the Commission's Communication on trade is not just concerned with how trade can boost the allocation of resources and productivity within the EU. It is arguably more concerned

[70] European Commission, "Trade as a driver of prosperity," November 2010.

by the need for trading partners to play fairly—and to be seen doing so. The EU, the Commission states, "should be open but not naïve."

The Commission never quite spells out precisely what this formulation entails, although it appears to suggest that trading partners cannot reasonably expect to be given access to the EU market unless they give European firms reciprocal access to theirs. So the Commission makes much of the need for trading partners to open their markets for services and public procurement to the same degree as the EU—while remaining coy about what it intends to do if key trading partners fail to play by the rules. The way to make progress, it appears to imply, is to use the EU's huge bargaining power by pushing for bilaterally what it cannot achieve multilaterally through the World Trade Organisation (WTO).

In this respect, as in others, there is far more continuity than change between the Commission's new trade strategy and the previous one (known as "Global Europe"). The EU's new trade policy, which was set out by the Commission in a Communication in late 2010,[71] reaffirms the twin track policy it embraced in 2006. It proclaims its commitment to multilateralism and the completion of the Doha round, but makes a strong case for pursuing preferential trade agreements (PTAs) with fast-growing emerging markets. The Commission notes that if it concludes the agreements that it is currently negotiating, the EU will have PTAs with a majority of members of the WTO, covering around half of EU trade.

THE EU AND THE WORLD TRADING SYSTEM

While the Commission remains rhetorically committed to multilateralism, it is hard to shake the impression that this is no longer where the action is. With Doha going nowhere fast, bureaucratic resources within the Commission are increasingly focused on bilateral trade deals with the likes of South Korea and Mercosur. Among other things, regional trade agreements provide the EU with the opportunity to pursue "Singapore issues" by other means. They are seen as a more effective instrument of international proselytization than the traditional multilateral route—a way for the EU to promote its values, export its regulatory standards, and push trading partners to open their markets to EU goods and services.

The Commission's working assumption is that regional trade agreements can co-exist peacefully with the multilateral system administered by the WTO. But the EU needs to take care. The global proliferation of PTAs means that the world is slowly moving away from a multilateral non-discriminatory system towards one based on discriminatory deals. The

71 European Commission, Communication on "Trade, growth and world affairs," November 2010.

resulting "spaghetti bowl" of bilateral agreements potentially reduces the gains from trade (by creating trade diversion) and adds to the fiendish complexity of rules of origin with which firms have to comply. There must also be a risk that the WTO's authority will gradually erode if it is no longer seen as the main arena where world trade is freed up and policed.

The EU cannot, or should not, ignore the state of the multilateral trading system. At the height of the Great Recession (in 2008–09), the international trading system came under acute strain. Trade collapsed, but unlike the 1930s this was not the result of an upsurge in protectionism. The sharp contraction in world trade was the product of falling demand, the evaporation of trade finance and the resulting impact on international supply chains. True, protectionist measures were introduced during this period. But the world did not fall into a damaging round of 1930s-style tit-for-tat protectionism. It is hard to avoid the conclusion that the incidence of protectionism would have been far worse if the WTO did not exist.

Even so, there is no room for complacency. The world trading system is less free than it was before the financial crisis. Most barriers that were introduced in 2008–2009 did not take traditional forms, but were murky "behind the border" measures not covered by the WTO. These measures may be hard to remove. Besides, it would be wrong to conclude that the international trading system is out of the woods. The global macroeconomic imbalances that gave rise to the Great Recession have not gone away, and the G20 has not been able to come up with a formula to reduce them. The result is that we are now in a mercantilist world in which all countries want to run trade surpluses—hardly a condition for peaceful trading relations!

CONCLUSIONS

The Commission has made much of the fact that EU 2020 has been given an "external dimension" that the Lisbon agenda lacked. It is not at all clear, however, that this will make much difference either to the EU 2020 programme or to trade policy. EU 2020 has not spawned a new trade policy. The new trade policy is mostly a continuation of Global Europe (which was launched back in 2006). And it is hard to argue that current trade policy connects with EU 2020 in a way that it did not with the Lisbon agenda. If it did, there would have been a greater focus on the contribution that trade policy can make to the domestic allocation of resources, which might have produced an improved offer on agriculture in Doha.

The two main differences to trade policy compared with the period covered by the Lisbon agenda are arguably contextual and institutional. The contextual difference is economic. Whereas the Lisbon agenda was launched at a time of euphoria (the height of the dotcom bubble in 2000),

EU 2020 was launched at a time of extreme pessimism marked by fears over economic growth, unemployment, competition with China (and others), and the very survival of the euro zone. The return of "euro-pessimism" bodes ill for EU trade policy. It increases the risk of a defensive policy orientation that focuses on containing the social and distributional consequences of trade rather than spurring innovation, productivity and growth.

The second major difference compared with 2000–10 is institutional. The entry into force of the Lisbon treaty has had two consequences for trade policy. First, it has made trade policy an integral part of the EU's "unified external action." (In plain language, trade policy is an instrument to meet non-trade objectives, like promoting democracy, labour standards and sustainable development). Second, it has given the European Parliament a greater influence on trade policy. Combined, these two changes arguably increase the susceptibility of trade policy to "non-economic" influences. To put it bluntly, trade policy seems just as likely to be used to promote political and social objectives abroad as growth at home.

Closing Speech

MACIEJ WITUCKI

HOW TO MAKE THE EU MORE COMPETITIVE?

I remember a year before the crisis I was in New York City. I was staying in a hotel in which the elevators had TVs tuned to BBC, CNN, Bloomberg and the like. I can tell, going up a couple floors could get you seriously depressed. It was like taking the lift to the Great Depression of the 1930's. Looking back at those years, pessimistic signals about what was about to happen were abundant, good news was scarce.

Today, especially in Poland, it seems there is a way out. We all—as Europe, as Europeans—answered the challenges raised by the financial crisis quite well. We passed the exam. Of course there still could be a second wave, but we have learnt something from those past two difficult years and we have opened a debate about our future. We know now we cannot generate much more financial resources and we should not try to resolve the situation by generating new debts. From the business perspective we have had to and still need to take some fundamental strategic decisions, more talk just isn't enough.

When in 2000 European leaders decided to make the Union "the most competitive and dynamic knowledge-based economy in the world" they introduced the Lisbon Strategy. By creating a program of policy initiatives, areas in which the Union was to excel, they defined what we understood by competitiveness. The Union had internalized the view that in order to be competitive on the world stage we had to excel in many if not all of the following fields. We had to build an information society for all, develop a European area for innovation and R&D, liberalize—and thus complete—the Single Market (and strengthen State Aid and Competition Policy), build network industries in telecommunications, utilities and transportation, create efficient and integrated financial services, improve the enterprise environment, increase social inclusion and enhance sustainable development.

Now please keep in mind that we are talking about 27 Member States working together—but also often times against one another—in order to build a socio-economic system that will allow for this continent to be able to compete on the world stage. And looking at the economic, demographic and political situation— fighting against the odds. Taking a step back to March 2000, please keep in mind that the Lisbon Strategy had been signed into being in a world in which China wasn't in the WTO, Bill Clinton was still President of the United States and the Russian Federation was weaker than ever before.

Over the last decade a number of things happened, which should have made us re-evaluate what competitiveness consists of. Today's

competitiveness strategy: “Europe 2020” places an even stronger focus on sustainability; luckily it also continues to stress the development of skills and the digital economy. If I can be frank with you I have mixed feelings about “2020.” Setting up targets like: “increasing the employment rate to 75%” or lifting “20 million people out of poverty” reads and sounds good but isn’t as specific as I would like a plan to boost competitiveness on the world stage to be. The innovation craze that has engulfed policy circles in many environments and countries sometimes strikes me as counter-productive. Spending billions on programs promoting innovation is a way of generating jobs in public administration rather than in high-tech garage start-ups.

On the other hand I applaud the efforts set by the flagship projects such as a Digital Agenda for Europe (to speed up the roll-out of high-speed Internet and build a digital single market for households and companies) or an industrial policy for the globalization era (to improve the business environment, notably for SMEs and to support the development of a strong and sustainable industrial base able to compete globally).

However when we think about what should be done for us to become more competitive in the world, it is clear that it is not enough to write a new strategic document. The people will not buy a new version of the Lisbon Strategy. After the crisis people are much more “operational”—they do not want to hear that we should be more innovative, knowledge-based, and business-oriented. Today, there is a need for constructive actions rather than more hyphenated words.

Moving to my subject area—communication society—I can say that we now have new plans: fibre optic connections for everybody. The last statistics about fibre optic connections in the world show that there are half a billion high-speed Internet connections, but only eighty million in fibre technology, and out of those eighty million, eighty percent are located in Asia (mostly in three countries: China, Japan and South Korea), 10 percent in the U.S., and only 10 percent in the rest of the world. This statistic clearly shows that the name of the strategy is irrelevant, call it the Lisbon strategy or just as well the Wrocław strategy. What matters is practice, actions.

We need to have real, professional, financial and concentrated plans applicable to strategic areas. I think that today, one of these strategic areas for Europe is the e-industry. We must give Nets (not fish, not fishing rods) to our societies, but more importantly, to our industries. We must provide knowledge and new, cheaper ways of working. A good example of the value added by the Internet is telework. This is something that will be accessible once Europe is covered by the Net. We will travel less. Instead of building more roads and more highways to get from the suburbs to city centres, roads for which we have no more space, we will work at home.

This will save us time, it will improve the quality of living and, at the same time, will improve many other industries.

Another key element of a competitive EU—introduced by President Barroso in 2009 is “smart regulation.” Today we are living difficult times in which people tend to believe in the intelligence of their government administrations. We have gone from one extreme according to which the “market is the king” to another which states that “only the state can help us.” The State is smart when it comes to printing money, so the State should also be smart in regulating our lives and protecting us from future crises. Some time ago we would criticize bureaucrats; now, we believe that they will save us.

I think we are on the right track to find a smart balance between the added value of the State (understood as the regulator) and the power of the market (the power of the liberal economy). Here the EU has a lot to do, but also to offer. A famous example is the fabric industry, but also the banking industry. They were supposed to introduce Bassel III, they were supposed to introduce other regulations, but at the same time they are criticized for earning big money, and receiving high bonuses.

I believe that we are at the moment when we should come back to a healthy balance, leave behind all the intellectual policy fetishes of the last years, and select some critical areas. Among those critical areas I would definitely place the e-economy, and energy. These areas are important for Poland, but also important for the whole Central European region.

And beyond these highways of the e-economy and energy please note one other important area—the state-of-mind of our nations. Our patriotic, collective optimism. Look at the parking lots of shopping malls that are full of cars. People are convinced that the situation is not so bad, that the situation is improving. Therefore it is our responsibility to build projects that may be understood by millions of Europeans, to build projects that may be communicated as concrete, future elements of building a competitive business environment, the competitive edge of our continent. If hundreds of millions of Europeans believe in our projects, “buy” the way we communicate them, then consequently their minds will change and as a result they will boost our economy.

In a word, we need good ideas, but we cannot allow ourselves to stop, even at the best of ideas. We need to formulate real, concrete plans. Mid-term plans, which will prepare us for the foreseeable future. We, as citizens, as entrepreneurs, need to be very demanding of our administrations. The European political class has to provide us with plans that should be understandable and offer Europeans motivation for building a better, collective future.

ENDING REMARKS

- Although The EU economy overcame a recession, the crisis in Europe is not over. A debt crisis in the euro area and existing weaknesses in the EU financial sector provide many uncertainties that refer to future prospects. Economic growth in Europe has been very fragile and in some Member States does not provide strong fundamentals to tackling such problems as unemployment. Deep fiscal consolidation that is needed in some EU states can have a negative effect on GDP. However, restoring sustainability of public finances is the inevitable condition for successful implementation of the Europe 2020 strategy. An especially relevant role in creating sustainable economic growth in the EU in this decade can be played by full and effective use of such levers as the EU budget, Single Market or trade policy.
- The EU used all instruments at its disposal in order to tackle the effects of the financial and economic crisis that intensified in September 2008. Public support of the financial institutions has played a crucial role in stabilizing the situation in the European financial system. State aid frameworks for the financial sector and real economy established by the European Commission after the outbreak of the crisis proved its usefulness, prevented the EU Member States from a "subsidy race" that could have distorted competition in the EU banking sector. The European Commission managed to enforce competition rules with respect to merger control and antitrust rules.
- The EU managed to provide an effective framework for conducting stimulus action during the recession. The European Economic Recovery Plan was adopted by the European Council in December 2008 and consisted mainly of national budgetary resources but also with EU funds and EIB loans. Stimulus actions were directed to support the labour market, enterprises and investments. Swift implementation of EERP contributed to restoring moderate growth in the EU. In some Member States (such as Poland), the important role in mitigating the effects of the crisis was provided by the flows of cohesion and structural funds.
- Problems of some members of the euro area (Greece, Ireland, Portugal) have different origins; however, all of these states have been struggling with serious fiscal consequences that have forced them to request external financial assistance. Temporary stability mechanisms that were set up in May 2010 (EFSM and EFSF) gave the EU the necessary instruments to support troubled euro area members. However, there have been some doubts among analysts and experts about whether the

total amount of these facilities is sufficient to safeguard stability of the euro area in case of a further contagion of the sovereign debt crisis. The other issue is whether the euro area members most affected by the crisis (especially Greece) will be able to achieve long-term sustainability of public debt and to avoid restructuring their debt. The factor that has a detrimental impact on financial stability of the euro area is the situation in the EU banking sector. Some problems in the EU banking system (such as undercapitalization of some banks and toxic assets) still have not been solved, which can hinder restoring sustainable economic stability in the euro area. The new round of stress test, which will be finalized in June 2011, probably will give more credible picture of the situation in the banking sector than the previous one (concluded in July 2010), and its outcomes would trigger further recapitalizing and restructuring of banks.

- Regulatory reform that has been conducted in the EU financial market has a very large scope and can bring far-reaching changes in the functioning of this market. The EU approach to financial regulation seems to be comprehensive and based on the premise that no segment of the financial market should be able to opt out from regulation. Undoubtedly, one of the crucial achievements in this process was the adoption of a financial supervisory package in Autumn 2010. Strengthened financial supervisory architecture, especially by setting up the ESRB and a tangible increase in the scope of the competences of the new supervisory authorities at a micro-prudential level can allow for the provision of detailed surveillances of risks for financial stability at the macro and micro level. Establishing the ESRB is also relevant for macroeconomic surveillance.
- Reform of economic governance that embraces improvements in fiscal surveillance, the establishment of macroeconomic surveillance and the introduction of the European Semester can increase the prospects for Member States to operate a more responsible, balanced, sustainable and growth-oriented economic policy in the coming term. However, this reform cannot be treated as panacea for all problems exposed by the sovereign-debt crisis in the euro area. Especially there are some doubts as to whether a creation of the new surveillance framework focusing on macroeconomic imbalances will be sufficient and effective in order to tackle this problem in some euro area Member States. The effectiveness of the entire system of economic governance depends on several factors given the strong positions of EU institutions in the surveillance process, especially the European Commission. Strong political ownership at the European Council level also is essential for ensuring that the new governance system will work effectively.
- The EU Single Market has been facing tangible challenges ahead of its 20th anniversary. The main priorities include a further liberalization of

the services market, the creation of the digital market with increased access to finance for enterprises, especially SME (e.g., venture capital) and the improvement of the quality of new and existing regulations. Concrete actions in this respect were proposed in the Single Market Act adopted by the European Commission, largely based on proposals presented in a report by Mario Monti. Smooth implementation of these initiatives requires full engagement and cooperation at the EU institutional level.

- The external dimension of the Europe 2020 strategy has been more strongly indicated than in the case of the Lisbon agenda. The key postulates, which have been formulated for years, in this respect are: finalizing the Doha round, adopting a new generation of bilateral and regional free-trade agreements, developing regulatory convergence, better enforcing IPR rules in third states and promoting EU standards. However, overall progress on these points has been very slow and disappointing in recent years. In this context the main priority is to speed up these actions, which can require great political capital, both in the EU and external partners. A difficult economic and social situation in many EU states does not create a friendly climate for the promotion of an ambitious approach to trade liberalization.
- The EU budget is presented as one of three pillars of the Europe 2020 strategy. Nevertheless, it's limited in size, accounting for around 1% of the EU GDP. Additionally, a large number of Europe 2020 objectives belong to the exclusive competences of the Member States. The core question is where is the EU added value and how can proper financing of the Europe 2020 be assured if its objectives are spread across different budgetary headings. The issue of the next EU Multiannual Financial Framework 2014–2020 will become the subject of a bruising battle between the European Parliament and the Council not only due to a lack of agreement on the EU budget's size and its financing, but also because of some procedural issues.

Marcin Koczor, Paweł Tokarski

* *The ending remarks express the authors' points of view and are not entirely based on the contributions to this publication, nevertheless the main conclusions are in line with the opinions presented above.*

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