THE EU AND THE CRISIS

LESSONS LEARNED

No. 68, January 2010

ADVISORY COUNCIL ON INTERNATIONAL AFFAIRS
ADVIESRAAD INTERNATIONALE VRAAGSTUKKEN

AIV

Members of the Advisory Council on International Affairs

Chair	F. Korthals Altes
Vice-chair	Professor W.J.M. van Genugten
Members	Ms S. Borren MA
	Ms L.Y. Gonçalves-Ho Kang You
	Dr P.C. Plooij-van Gorsel
	Professor A. de Ruijter
	Ms M. Sie Dhian Ho
	Professor A. van Staden
	Lt. Gen. M.L.M. Urlings (retd.)
	Ms H.M. Verrijn Stuart
	Professor J.J.C. Voorhoeve
Executive Secretary	T.D.J. Oostenbrink

P.O. Box 20061
2500 EB The Hague
The Netherlands

Telephone + 31 70 348 5108/6060
Fax + 31 70 348 6256
E-mail aiv@minbuza.nl
Internet www.aiv-advice.nl

Members of the Financial Crisis Working Group

Chair	Professor A. van Staden
Members	Dr W.F. van Eekelen Professor P.J.G. Kapteyn Professor L.B.M. Mennes W.L.E. Quaedvlieg Professor J.Q.T. Rood Ms M. Sie Dhian Ho Professor A. Szász C.G. Trojan
Honorary member of the AIV	Dr E.P. Wellenstein
External member	M. Bos (SER)
Corresponding member	Ms M.G. Wezenbeek-Geuke
Executive Secretary	Dr D.E. Comijs

Contents

Foreword

On 20 July 2009 the government asked the Advisory Council on International Affairs (AIV) to produce an advisory report on the European Union (EU) and the financial and economic crisis. The joint committee that drafted this report was chaired by Professor A. van Staden of the European Integration Committee (CEI). The other members of the joint committee were Dr W.F. van Eekelen, Professor P.J.G. Kapteyn, W.L.E. Quaedvlieg, Professor J.Q.T. Rood, Professor A. Szász, C.G. Trojan (all from the CEI), and Professor L.B.M. Mennes of the Development Cooperation Committee (COS), Dr E.P. Wellenstein (honorary member of the AIV) and M. Bos of the Social and Economic Council (SER) (external member). A valuable contribution to the report was made by Ms M.G. Wezenbeek-Geuke (CEI), who took part as a corresponding member. The civil service liaison officer was T. Stoppels of the Internal Affairs Division of the European Integration Department. The committee would like to express particular gratitude to Professor J. Pelkmans (external expert) and Professor F.H.J.J. Andriessen (honorary member of the AIV) for their useful suggestions. The secretariat was headed by Dr D.E. Comijs (executive secretary of the CEI), with the assistance of the following trainees: Ms M. van Seeters, Ms A. de Boer, J.J. van Blaaderen and D.A. Wegen.

In its request for advice (see annexe I), the government posed two questions to the AIV:

- Are the EU's existing legal and other instruments sufficient to deal with the crisis at European level? Are these tools sufficient to prevent free-riding?
- In view of recent economic developments and the corresponding policy response, is improved cooperation within EMU necessary and possible?

In the first chapter of the report, the AIV sets out its views on both questions and touches on the broader themes they raise. It also presents the recommendations that emerged from the study. In this way, the AIV hopes to provide a succinct contribution to the political debate on a number of issues that figure prominently on the European agenda.

Chapters II to IV contain a detailed analysis of the underlying problems: the objectives of Economic and Monetary Union (EMU) and the policy instruments available for attaining these objectives, the causes and effects of the financial and economic crisis and the responses by the EU institutions and individual member states to the crisis. These chapters also examine the EU's position in various global partnerships. The views articulated in these sections underpin the findings and conclusions in chapter I.

The AIV approved the report at its meeting on 29 January 2010.

I Summary of the AIV's findings: conclusions and recommendations

'If politicians refuse to learn from the history of the recent financial crisis, they will condemn all of us to repeat it.'

Paul Krugman[1]

I.1 Performance of the EU

I.1.1 A positive balance

The Dutch government asked the AIV whether the current legal and other policy instruments were sufficient to deal with the crisis at the European level. This question is closely related to the more general issue of whether the EU has responded adequately to the financial and economic crisis, particularly in view of the interplay between the Commission and the member states. Inevitably, there is no simple answer. The Union's response must be judged on its effect in a variety of policy fields (monetary, economic, internal market, financial sector, trade and external action). In these fields, the competences of the EU and the member states fall into different categories (and the involvement of different institutions varies accordingly), and a raft of policy tools, ranging from 'hard' to 'soft', are available.

Nevertheless, the significant achievements of more than 50 years of European integration have proven their value during these exceptionally difficult times. The AIV is convinced that the member states' economies are in better shape than they would have been without the Union, thanks in part to the way in which the EU exercised its powers.

The joint participation of the EU and its member states in the World Trade Organisation (WTO), the existence of the internal market and the euro, and the regulatory powers and coordination mechanisms developed within the EU have prevented a repetition of the ruinous conditions of the 1930s. In other words, the EU has helped erect a dam against the recurrence of the costly errors made at that time: a rapid increase in protectionism and a series of devaluations to create competitive advantages.

Nevertheless, the AIV thinks the EU's response to the crisis has displayed both strengths and weaknesses. The strengths include the way in which the European Central Bank (ECB) has implemented monetary policy (in particular its policy on discount rates and the creation of liquidity to restore interbank lending) and the way in which the Commission has ensured the smooth operation of the internal market and compliance with competition rules.

Although a detailed framework is in place to provide aid to rescue and restructure enterprises, it should be borne in mind that there was no comparable framework in the financial sector for the Commission to provide emergency aid to financial institutions or to nationalise banks. The Commission has since set criteria to assess the emergency aid granted to banks, the recapitalisation of financial institutions, the treatment of toxic assets, and the return to viability and restructuring measures in the financial sector (see section III.4.4 below). To ensure that competition on the internal market is not prevented,

1 In his column 'Disaster and denial', *The New York Times*, 13 December 2009.

restricted or distorted, it has also taken compensatory measures regarding the receipt of state aid. The AIV does not intend to express an opinion on the remedies proposed to restructure a number of banks but, on balance, it thinks the Commission has also succeeded in preventing serious distortion of competition on the financial markets. This is illustrated by the dramatic situation in which Ireland found itself in October 2008. Through timely intervention, the Commission managed to prevent the guarantee scheme hastily introduced by the Irish government, which was open only to Irish banks and not to foreign banks with branches or subsidiaries in Ireland. Without the Commission's intervention, there would have been a substantial run on the foreign banks.

Only a provisional opinion can be given on the Commission's measures in respect of banks. The fact that banks have received state aid to very different degrees, and some have in effect been nationalised, involves a potential threat to the level playing field in the EU.[2] The restructuring of the financial sector triggered by the crisis also represents a new challenge to competition policy.

As noted above, the EU's response displayed weaknesses as well as strengths. The weaknesses related to both crisis prevention, i.e. ensuring in advance that the system is strong enough to withstand a crisis (see section I.1.2), and crisis management, i.e. the ability to control the scale and intensity of a crisis and minimise and mitigate its harmful economic and social consequences (see section I.1.3).

I.1.2 Shortcomings in crisis prevention

The EU proved to be vulnerable in the important area of prudential supervision of banks and other financial institutions. The fact that financial integration has enabled dozens of banks to operate on a European scale while the supervisors that are expected to oversee their operations have remained national in scope can be regarded as a serious shortcoming. This imbalance emerged as a major problem during the crisis. With the benefit of hindsight, it could be said that, owing to the dilution of the Commission's initial proposals, the Financial Services Action Plan (FSAP) was a missed opportunity for an effective system of regulation and supervision. The FSAP did lead to the adoption of a package of no fewer than 43 directives and regulations in 2000-2005 but they provided inadequate guidance on how to prevent the high and excessive risks that financial institutions were taking or on how to overcome their adverse consequences. In particular, there was a failure to comply with capital adequacy rules on the ratio of debt to equity and the formation of financial buffers.

Some have spoken of a 'light touch' approach, and this certainly applies to the FSAP. The AIV shares the opinion that the price paid for the relatively fast introduction of the FSAP was over-familiarity between national supervisors on the one hand and the financial sector they oversaw on the other.[3] The FSAP was biased towards the financial institutions' preference for light supervision and the national supervisors' preference to retain their own sovereignty.

The EU was also ill prepared for the crisis from a macroeconomic perspective. Firstly, the rules of the Stability and Growth Pact (SGP) had been poorly enforced in the preceding years. Even before the crisis broke out, quite a few countries were running

2 See: Professor L.H. Hoogduin, 'Voorbij de crisis', *ESB* 95 (4576), 8 January 2010, pp. 20-21.

3 Professor J. Pelkmans, *De rol van de EU in de financiële en economische crisis*, Netherlands Institute of International Relations Clingendael, The Hague, October 2009, p. 9.

high or excessive budget deficits and debts. This subsequently restricted the scope for budgetary manoeuvre in the form of discretionary policies and the operation of automatic stabilisers.

Secondly, the establishment of EMU was not accompanied by the creation of a robust mechanism for far-reaching budgetary coordination in order to address serious macroeconomic imbalances. To compensate for a substantial drop in macroeconomic demand, the EU relies heavily on the member states' cooperation. The member states, after all, are responsible for their own budget policies subject to the SGP's conditions on the sustainability of the single currency. Not only is the EU's budget far too small to act as a lever to overcome a crisis but it must also always be in balance.

I.1.3 Shortcomings in crisis management

Because the EU was ill prepared for a financial and economic crisis on this scale, its response was largely improvised. It did meet with some success, though; the ECB's monetary policy and the Commission's state aid policy were mentioned above. However, the member states' coordination of appropriate stimulus measures initially left a lot to be desired.

The European Commission was criticised for being too cautious and too deferential to the large member states. However, given that an effective policy response is so highly dependent on the active cooperation of the member states the AIV notes that the euro group of finance ministers kept too low a profile during a decisive phase of the crisis. It would have been the perfect body to coordinate the member states' stimulus measures. The euro group met in October 2008 to agree upon a joint action plan for the financial markets but the initiative was taken by the President of the country that held the EU Presidency at the time, Nicolas Sarkozy. Remarkably, the meeting was attended by heads of government and one of the attendees was Gordon Brown, the Prime Minister of Great Britain, a non-euro country. This illustrates the improvised nature of the EU's response. In other respects, too, it was ultimately due to interventions by the French Presidency of the EU that a European Economic Recovery Plan could be agreed in December 2008 (based in part on proposals by the Commission). When looked at in detail, the plan was little more than a compilation of national policy plans. The conclusion is inescapable: European coordination took place after the event rather than before it.

One of the causes of this was the vague allocation of roles among the various actors. The main players were the European Council, the EU's biannual rotating Presidency, the ECB and the European Commission. But it was chiefly the European Council and especially its then President (President Sarkozy) who took actual responsibility for crisis management.

I.1.4 Measures to eliminate shortcomings

In response to the government's request, the AIV considered the steps that could be taken to eliminate the shortcomings wherever possible. It did so in the knowledge that calls to amend treaties or adapt existing tools would certainly not be heeded in the near future. In view of the difficulty experienced in agreeing on the Treaty of Lisbon, it is unlikely that anyone will venture to propose another treaty amendment in the near future. The best possible use must therefore be made of existing tools, and conditions must be created to encourage member states to seek European instead of national solutions where necessary and beneficial. Some improvements can be made without having to draft new treaty texts. A useful distinction can be made between measures that can be taken immediately or in the short or medium term and proposals and ideas that can succeed only in the longer term.

I.2 Proposed short- and medium-term improvements

I.2.1 Crisis management

The AIV thinks agreements need to be made in the near future to *strengthen crisis management* in the EU. The lesson that can be learned is that during a crisis decisions must be taken at the highest political level. This is necessary principally to restore confidence in the financial system. It is also necessary to mobilise sufficient support among the member states for European action in the form of macroeconomic stimulus measures that are then taken by national governments. The measures should be directed at offsetting a collapse in effective demand, which would also increase activity in the private sector. Only the European Council, which has evolved in the past 10 to 15 years into the most important power centre in the EU, seems to have the political weight to force a breakthrough towards effective EU coordination when individual member states are inclined to turn inwards towards narrowly defined interests. The European Council's political weight would also be increased by, for example, cooperation between heads of state and government in the G20.

To be successful, however, the European Council must enjoy the unwavering support of a strong Commission that initiates action through persuasive analyses and timely proposals. The European Council generally cannot draw on the financial and economic expertise that the Commission can. In short, the two bodies are condemned to each other, as it were. The Treaty of Lisbon has facilitated the necessary interplay because the Commission now deals with a permanent President of the European Council instead of a new one every six months.

The AIV believes this new figure will have an important preparatory and diplomatic role to play. As the permanent President, he will be in a strong position to make timely preparations for one or more extraordinary meetings of the European Council if a crisis is looming. Of equal importance is that he will always be available to help seal the inevitable compromises, especially between the leaders of the large countries. The new Lisbon structure also facilitates the relationship with and the input into the G20, which – as already noted – operates at the level of heads of state and government.

Good interaction between the permanent President of the European Council and the President of the Commission is also of vital importance because the Treaty of Lisbon defines the competences of the institutions and their respective presidents, who are assigned executive power and the power of external representation, only in broad terms.

To this end, it would be advisable to flesh out article 121 of the Treaty on the Functioning of the European Union, which states that the member states regard their economic policies as a matter of common concern. This could be done by giving more political weight to the Commission's periodic assessment of the 'broad guidelines of the economic policies of the member states and the Union' referred to in the same article. Since it is the European Council that can conclude, on a recommendation from the Commission, that the Council should adopt guidelines, it goes without saying that it should also pay ample attention to the outcome of that assessment.

The proposals outlined here should be worked out in the near future and addressed as efficiently as possible in order to strengthen the EU's crisis management.

The AIV recommends that the government raise the proposals presented above on improving the EU's crisis management in the appropriate consultative bodies (European Council, Ecofin and euro group).

Effective European interplay is required not only when introducing and implementing stimulus measures but also when terminating measures that are still in force. This will be relevant when economic activity recovers again in the private sector (see section I.2.6 below).

I.2.2 Maintenance of the internal market

As can be concluded from the above, the AIV attaches great value to *the greatest possible defence of the internal market*. The internal market is of vital importance. It is particularly important to the Netherlands since more than half its national income is earned from foreign transactions. Dutch exports to its EU partners account for about 80% of the country's total exports by value. Forms of state aid that are designed to maintain economic sectors or enterprises that have no long-term future should be vigorously opposed. Where protectionism has crept into the relations among the member states under the pressure of the crisis, this must be corrected. An example of this is the car industry, which is suffering from structural overcapacity.

Above all, the AIV would note that the European Commission must be able to act effectively when implementing its core task of enforcing competition policy. Publicly supporting the Commission's role and the substance of competition law is also of fundamental importance, especially when compliance with the rules restrains local industry.

The AIV applauds the fact that the President of the European Commission, José Manuel Barroso, asked the former competition commissioner, Mario Monti, to issue a study on the future of the internal market. The study must also ask whether competition would be distorted if the member states started a race to reduce corporation tax and capital gains tax rates.[4] Should the report conclude that competition would be distorted, the AIV would favour fiscal harmonisation in the form of standard tax bases and minimum rates. The financial crisis also revealed the unique character of the banking industry and the scale of systemic risks. The AIV thinks the Monti study should also consider the correct application of competition rules in a situation of financial instability.

I.2.3 Back to the SGP criteria

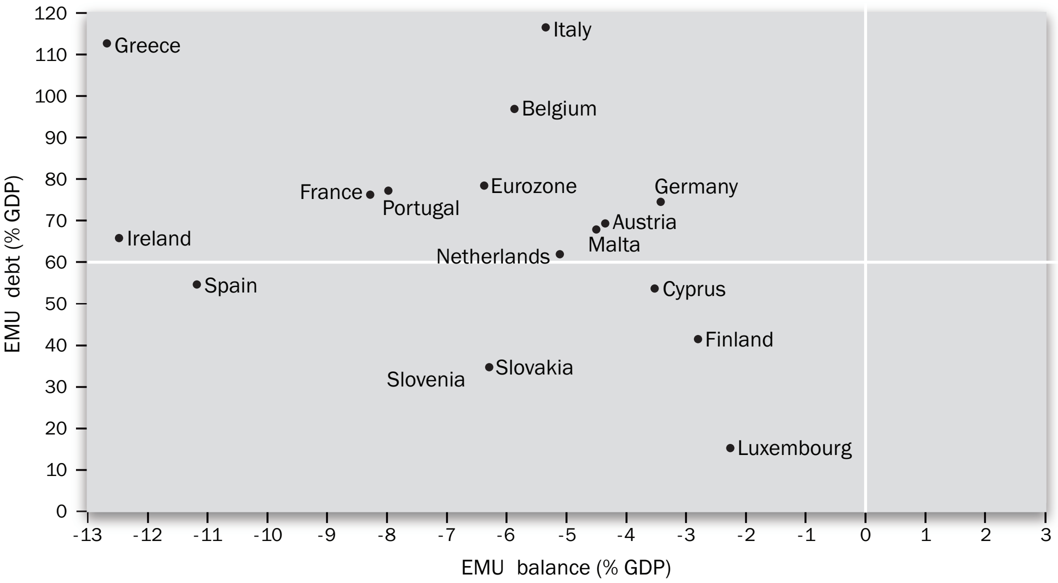
The member states' average budget deficit in 2007 was 0.8% of GDP; in 2008 it was 2.3%. According to the most recent estimates, it will amount to 7% in 2009, 7.5% in 2010 and 7% (again) in 2011.[5] The crisis has forced all countries participating in monetary union to loosen the budgetary reins to such an extent that almost none of them have been able to comply with *the rules of the SGP*, in particular with the budget deficit ceiling of 3% of GDP.[6] The crisis is so serious that use of the SGP's exception clause is certainly justified, but the budget deficits being run up in those member states that were already exceeding the 60% national debt ceiling before the crisis are particularly worrying. The figure below shows the relative size of the budget deficits and the debt positions of the EU member states (2009 expected figures).

4 There is no tax on capital gains in the Netherlands.

5 Figures from the European Commission, referred to in a letter to parliament, *Toekomst van het Stabiliteits- en Groeipact*, 23 November 2009.

6 Only Finland and Luxembourg are expected to remain below 3% in 2009.

Budget situation in the euro area



Source: Autumn Memorandum 2009

There would have been more protection against the tidal wave of the financial crisis if agreements had been better observed in the preceding years. Virtually no member state satisfied the requirement that public finances should be more or less in balance or even in surplus.[7] The AIV found that the euro-area member states had not always satisfied the stability pact's criteria on budgetary policies. There was also a suspicion that the smaller member states (which have to observe the rules) were being treated differently from the larger member states (which can take more liberties).

This is confirmed by a judgment of the European Court of Justice in 2004. The Commission had complained that the Council had failed to follow up its recommendations to take action against the excessive deficits of both France and Germany.[8] Deficits had been incurred in 2002 (Germany) and 2003 (France). The Council had concluded that there had been excessive deficits in both cases but the two countries ignored its recommendations to clear them as quickly as possible. The Commission subsequently recommended that the Council instruct the two countries again to address their excessive deficits. Ecofin could not reach agreement on the Commission's recommendation. The Council then decided to provisionally suspend the excessive deficit procedure. The Court quashed the Council's decision to suspend the excessive deficit procedure on the grounds that it contravened article 104 of the EC Treaty. The Court took no decision, though, on the Commission's claim that the Council was obliged to take a decision if a member state continued to refuse to implement the Commission's recommendation.
In this case, therefore, France and Germany were able to ignore both the Commission's recommendation and the Council's conclusion that there was an excessive deficit.

7 Professor A. Szász, De Euro: Politieke achtergronden van de wording van de munt, Mets & Schilts, 2001, p. 278.

8 Case C-27/04, 13 July 2004, European Commission/Council.

Poor compliance with the SGP has made it considerably more difficult to conduct an appropriate anti-cyclical policy in the exceptional circumstances of the current crisis and even more challenging to implement a well-thought-out exit strategy. Furthermore, by not taking its own obligations seriously, the EU compromises its ability to work credibly with the rest of the world on crisis prevention. It must first set its own house in order.

The AIV believes the lesson learned is that the monetary and, in particular, the economic restraints the EU countries have set themselves must be enforced more strictly. The lack of macroeconomic coordination represents a real risk to the stability of the euro. Sooner or later coordination will have to be tightened. This may not be possible without treaty amendment.

The AIV therefore thinks everything must be done to return the EU countries to the path of balanced budgets. The member states must observe the existing excessive deficit procedures taking into account the medium-term economic and budgetary situation.

According to the AIV, a lesson to be learned from the crisis is that budgetary discipline is a necessary but by itself insufficient condition to ensure a country's financial health. This is illustrated by events in Spain and Ireland. These two countries had balanced budgets before the crisis but were nevertheless hit hard by the collapse of a speculative property market in the former and a banking industry holding completely inadequate capital buffers in the latter.

The AIV therefore favours a widening of the criteria applied to assess a country's financial and economic health. Article 136 of the Treaty on the Functioning of the European Union offers several opportunities to do so. A country's external balance (balance of payments position) and developments in asset markets might also be taken into account. Widening the assessment criteria, however, must not lead to a relaxation in budgetary discipline.

In this context, the AIV would also refer to economist Jacques Pelkmans' opinion that the desirability of a tighter budgetary coordination framework came to the fore in the course of the crisis. Such a framework would be particularly useful in times of serious macroeconomic imbalance.[9] There are currently no binding powers in this area at EU level. Nevertheless, the AIV believes it is a matter of some urgency that the Commission be able to place budgetary coordination of stimulus measures on the Council's agenda during a recession, as Pelkmans has proposed. Without specific Treaty powers, the Commission will remain dependent on the member states' willingness to cooperate.

I.2.4 Financial supervision

Strengthening the EU's supervision of the financial services and capital markets by means of the new European System of Financial Regulators (ESFR) is of no less importance. The AIV considers the Commission's proposals pertaining to the De Larosière report to be just the first step towards true European supervision. The proposals include the establishment of a European Systemic Risk Board (ESRB) for macro-prudential supervision and a European System of Financial Supervisors (ESFS) to supervise individual financial institutions. The ESFS will consist of a network of national supervisors and European supervisory authorities. Since national supervisors will continue to play an important role in the new system, the AIV thinks further centralisation of supervision is as essential as

9 Professor J. Pelkmans, op. cit., p. 23. See also: André Sapir (ed.), *Memos to the new Commission,* Brussels: Bruegel, pp. 23-24.

financial integration and stability. An integrated and stable financial system in the internal market is incompatible, however, with policy and (micro-prudential) supervision that is organised along predominantly national lines.[10]

The new legislation must also be implemented in practice, as must a series of technical proposals made by the Commission on the criteria and their supervision. The AIV would note that a weak compromise, as in the case of the FSAP, would represent a danger. If the relationship between national supervisors and the financial sector remains too close, coordination of the supervision of cross-border banks will be inadequately safeguarded during a crisis. National supervisors will continue to play an important role in the proposed system of European supervision. That there are grounds to be wary of this danger can be seen from decisions taken by the Ecofin Council in early December 2009. At the instigation of Great Britain, the European supervision regulations proposed by the Commission were amended so as to increase the member states' ability to opt out. It is still unknown how the European Parliament will respond to the amended proposals. Where there are signs of economic recovery, the members of the European Parliament rapidly seem to lose their sense of urgency. They are taking their time by appointing no fewer than five rapporteurs. A debate is not expected before June 2010.

As noted above, the AIV considers the current proposals to strengthen the supervision of financial institutions a necessary but insufficient first step. Further integration of EU-wide supervision is necessary to keep pace with the cross-border integration of financial institutions and markets. The AIV thinks it would be inappropriate for the development of supervisory mechanisms in the EU to lag behind developments the United States, where far-reaching proposals in the field of financial regulation have already been made.[11] To achieve the goal of effective prudential supervision, however, several obstacles must be overcome: political resistance to the transfer of powers to the EU, too narrow an interpretation of the Meroni doctrine, and burden sharing when emergency aid is provided to banks. These points are considered below.

The UK is not expected to abandon its very reluctant stance on stricter supervision of financial institutions in the immediate future. Germany, too, will remain firmly opposed to the transfer of national supervisory powers to European supervisors, if only because of a recent decision by the Federal Constitutional Court, the *Bundesverfassungsgericht*.[12] Spain fears that its strict national supervision, which has proven more crisis resilient than that of some other countries, will be weakened.

Another obstacle to the strengthening of supervision is the European Court of Justice's Meroni doctrine, which limits the ability to transfer discretionary powers[13] to private-law institutions. In the notes to the current proposals the Commission refers to a recent judgment by the Court (case C-217/04) that, under article 95 TEC, an agency or

10 Schoenmaker D., Toekomst van de financiële sector in Europa, *ESB*, volume 94, no. 4563S, pp. 69-74.

11 See: Karel Lannoo, Comparing EU and US Responses to the Financial Crisis, *ECMI Policy Brief*, Brussels, CEPS, 2010.

12 BVerfG, 2 BvE 2/08 of 30.6.2009, Leitsätze zum Urteil des Zweiten Senats vom 30 Juni 2009. See: <http://www.bundesverfassungsgericht.de/entscheidungen/es20090630_2bve000208.html>.

13 Powers that can be exercised as thought fit.

institution with power to approximate national laws can be established on condition that the activities are closely related to the subject-matter of approximation.
In the AIV's opinion, the development of the law in recent decades has shown that there is more scope to delegate such powers than assumed by policymakers, who are usually interested parties. The AIV notes that the Meroni judgments of 1958 comprise an opinion, in the context of the ECSC Treaty, on the former High Authority's delegation of discretionary powers to private-law institutions. Partly in the light of the subsequent development of the law, these judgments can no longer be interpreted, in the context of EMU, as meaning that powers may be delegated in individual cases only. Regulatory powers may also be delegated provided they are clearly defined and the exercise of the powers is subject to strict review in the light of objective criteria set by the Council and/or the Commission.[14] Where powers are delegated to a supervisor which works at some distance from the political institutions, it is not automatically appropriate to consider applying case law whose rationale was based largely on the entirely different institutional relations of the ECSC.

Transfer of powers is unacceptable only if an institution not provided for in the Treaty is granted discretionary powers, and policy choices have to be made on the basis of political value judgments. The AIV advises the government to adopt this opinion in its stance on the matter.

Another obstacle is the allocation of the cost of future cross-border rescue measures. Without a European safety net, the supervision of financial institutions and crisis management will remain a predominantly national prerogative. Effective and coherent EU supervision to prevent a future crisis will thus remain out of reach. (We return to this subject in section I.3.2).

I.2.5 Free-riding

The measures required in the short term include *actions to prevent free-riding*. As can be seen from the sections below, there has been free-riding in several areas in the EU, both in the member states' budgetary policies and in the way in which advantage has been taken of the benefits of the internal market. The scope offered by the Treaty to take action against free-riding varies from case to case.

This means that a general and unambiguous answer cannot be given to the government's question of whether the available tools are sufficient to prevent free-riding.

As guardian of the Treaties and as supervisor, the Commission is in a relatively strong, independent position to take measures against member states making unjustified use of state aid or otherwise breaching competition rules. As noted above, the AIV believes the Commission deserves the Dutch government's unqualified support in this respect. Countries that succumb to the temptation of protectionism, usually under pressure from domestic interest groups, benefit from unimpeded access to the internal market without being subject to the discipline of participating in the necessary reallocation of factors of production and maintaining a level economic playing field. The Commission must therefore be able to take measures against all forms of protectionism in the internal market. In accordance with the policy rules laid down in the Commission communication on the return to viability and the assessment of restructuring measures in the financial

14 For a formulation in this sense, see: paragraph 90, judgment in case C-154-155/04, *Alliance for natural health*, Jur. 2005, I-6541.

sector,[15] it must also oversee the termination of state aid to banks in order to return to fair competition.

The Commission and the Council (in this case Ecofin) are on relatively weak ground where member states are unwilling or unable to satisfy the requirement of balancing their budgets throughout the entire economic cycle (see section I.2.3 above). These countries have profited in recent years from the discipline exercised by countries with tight budgetary policies while indulging in higher public expenditure or lower taxes, often to ward off the perceived risk of an election defeat.

Discipline brought peace on the monetary front and kept inflation close to the target of 2%. After the introduction of the euro, countries with relatively high budget deficits initially hitched a free ride on the good reputation of financially sound member states and accordingly did not need to pay higher interest rates on government loans. This is a second example of free-riding.

When the financial markets reacted, countries that were guilty of running excessive deficits were forced to pay higher interest rates. Following the publication of alarming figures on its budget deficit, which it had partially concealed, Greece entered the financial danger zone again at the end of 2009.[16]

Figures published by the European Commission[17] also reveal significant differences in the fiscal stimuli that individual member states have administered to their economies to overcome the crisis. This might represent a third form of free-riding. In general, the EU institutions are relatively powerless if some member states let other member states bear the brunt of economic recovery measures yet profit from the leakage of such measures across national borders.

In those cases in which the EU institutions cannot impose formal sanctions against certain forms of free-riding, maximum use should be made of informal forms of influence, such as peer pressure, peer review, publication of rankings and blacklists, and naming, shaming and praising. Publicity is of key importance. The AIV therefore recommends that the Netherlands insist on ample use being made of the Treaty of Lisbon's provisions on the publication of Council meetings.

I.2.6 Exit strategy

An exit strategy is understood to mean a policy proposal to reverse the monetary and budgetary consequences of the credit crisis.

In monetary policy, this means withdrawing the temporary special facilities that the ECB introduced in response to the crisis, raising interest rates to a more customary level and reducing liquidity facilities to what is necessary in normal circumstances.

15 See: <http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=OJ:C:2009:195:0009:0020:EN:PDF>.

16 See: 'Greece faces ratings downgrade over its spiralling budget deficit', Financial Times, 8 December 2009. The President of Germany's Bundesbank, Axel Weber, has already hinted that the ECB might refuse Greek government bonds as security for loans to commercial banks.

17 European Commission, 2009, op. cit., p. 67ff.

In budgetary policy, this means adjusting the sharply higher government deficits and debts. Some of the increased budget deficit will automatically disappear when growth returns. But this will not be the case where deficits are the result of government measures or of negative growth that cannot be recouped in a recovery. The question is how, when and at what pace the adjustments have to be made. If they are made too early, economic recovery might be inhibited. If they are delayed too long, loss of confidence in government intentions might also endanger economic recovery.

The AIV thinks the Council of Ministers should adopt *a common exit strategy,* based on Commission proposals, that enables the member states to return to the SGP agreements. The strategy could build on the excessive deficit procedure. With the aid of the broad economic policy guidelines, account must be taken of the consequences for the EU as a whole of the policies pursued by individual member states. The guidelines should also ensure that the necessary budgetary consolidation is accompanied wherever possible by structure-strengthening policy or is achieved through the return of sustainable growth.[18] The new Lisbon Strategy for 2010-2020 provides a good framework for such a policy.

The Social and Economic Council (SER) has indicated in an extensive and thorough advisory report[19] what issues the Lisbon Strategy should address.[20] It argues that the EU's main goal should be to increase labour participation and labour productivity. Innovation and entrepreneurship should be encouraged through the efficient operation of the internal market and a further reduction in the administrative burden on entrepreneurs. The European Knowledge Area should also be strengthened. The SER's call to release more funds through transfers in the EU budget in order to invest in education and research is consistent with recommendations the AIV has made in the recent past.[21] As part of a forward-looking structural economic policy, government subsidies would also be acceptable if they enabled or encouraged entrepreneurs to contribute to 'greening' the economy.[22]

The AIV recommends that the government should seek to link, within the framework of the Lisbon Strategy, the exit strategy to new stimuli for structural economic policies that are conducted primarily at national level. Particular attention should be paid to the structural imbalances in the euro area and the corresponding risks to the sustainability of the internal market/euro. In particular, the weaker south European countries (the 'Club Med' countries) must face the challenge of radically reforming their economies (labour market, productivity, etc.). If they succeed, they, and the EU as a whole, will be in a much stronger

18 See also: *European Sustainability Programme*, in Memos to the New Commission, p. 23.

19 SER advisory report, Europe 2020, The New Lisbon Strategy, The Hague, 2009.

20 The Social and Economic Council is an advisory body to the Dutch government and Parliament, in which both employers, employees and independent members appointed by the Crown are represented.

21 See AIV, *The Finances of the European Union*, report number 58, The Hague, December 2007. The second recommendation was: 'The single market needs to be supplemented with a European research area. This requires more money to be spent on knowledge and innovation', p. 43.

22 Also according to Lord Peter Mandelson in a speech to the Bruegel think-tank, Brussels, 6 November 2009.

position to withstand a following crisis. Increased scope for budgetary manoeuvre and a more flexible economy should be seen as necessary conditions for a successful strategy on crisis prevention and crisis management.

1.2.7 External representation

In the short term, high priority should be given to coordination of the EU and the euro member states within international financial and economic organisations and forums. Ineffective coordination of the member states' positions weakens European input as a whole. Coordination should take place *within* the EU ahead of international consultation. The AIV thinks the Presidents of Ecofin and the euro group, in close consultation with the permanent President of the European Council and the President of the European Commission (and the President of the ECB), have a special responsibility to encourage the convergence of positions and actions. A first step towards streamlining the external representation of the EU and its member states in the longer term would be to have them act as representatives of the EU in those bodies that most closely correspond to their duties.

The AIV recommends that the government make maximum use of its influence in the IMF, World Bank, FSF/FSB, G20, etc. to increase the consistency of the Union's external actions.

I.3 Long-term vision

I.3.1 The viability of EMU

The AIV's answer to the government's question of whether improved cooperation within the EMU is necessary and possible in view of the recent economic developments and corresponding policy responses is set out below. It may be appropriate to recall the famous words of John Maynard Keynes, which have frequently been quoted in recent times: 'in the long run we are all dead'. Nonetheless, the AIV thinks the government should not neglect to develop a long-term vision as well as working on short- and medium-term measures.

In the AIV's opinion, a considerable strengthening of the economic governance system is unavoidable to ensure the viability of the EMU in the longer term.

Since the EMU project is far from consolidated, the absence of legislation to strengthen it may entail unforeseeable risks. In other words, there is a real *need* to improve cooperation. A comparison with the 'unsinkable' *Titanic* is not entirely out of place given EMU's current situation. The precarious financial positions of Greece and also of Portugal and Spain come to mind. Many of the weaknesses that have emerged are attributable to the nature of the chosen legal structure: a currency union with a minimum of binding restrictions on the member states' budgetary policies and an open-ended commitment to economic policy coordination.

A slightly different matter is whether it is actually *possible* to improve cooperation within EMU. Again, the AIV is aware that radical proposals requiring near-term treaty amendments will not be heeded at a time when national sovereignty in Europe is being vigilantly guarded under the pressure of public opinion. It would nonetheless like to make some suggestions to advance the discussion. It is encouraged by the programme of the current Spanish Presidency, which is seeking ways to strengthen the member states' commitment to European policy.

I.3.2 The idea of an EU emergency facility

In the longer term, the prospect of a more centralised policy on the financial sector would be improved by concrete discussion in the EU of the creation of an EU financial facility for use in emergencies. The facility could mobilise funds in an acute crisis to prevent the collapse of banks that could bring down the entire financial system. Against the background of a financial trilemma – the incompatibility of financial stability, an integrated financial system as part of the internal market and the continued existence of national policy and supervision – the AIV is in favour of such a facility. Without it, effective European supervision is inconceivable. Such a facility is also necessary to prevent a recurrence of the detrimental events of the current crisis: national governments eagerly rescued their 'own' banks using taxpayers' money and only later were their actions tested against European rules, resulting in painful decisions to restructure certain banks in order not to distort competition. The EU facility would be outside the EU budget and could be financed through the European Investment Bank (EIB) or by means of special EU bonds guaranteed by the member states.[23] To prevent squabbling between the member states, the facility should be managed wherever possible by independent experts. They could be provided, for example, by the ECB.

The AIV recommends that the government study the practicalities of establishing an EU emergency facility to bail out major banks during a crisis.

I.3.3 The idea of central financing of budget deficits

A long-term measure to strengthen the EU's grip on the member states' budgetary policies would be the establishment of an EMU fund for the central financing of budget deficits.[24] The underlying reasoning is that the market often responds inadequately or too slowly to differences in the member states' debt positions. As a result, differences in interest rates are not infrequently too small to entice governments, in the face of high financing costs, to clear or at least significantly reduce their budget deficits. The establishment of an EMU fund to finance budget deficits would probably lead to a reduction in the transaction costs of government bonds. The fund could finance itself by issuing euro bonds and other debt paper on the capital market.

Member states that respect the European budgetary rules rather than just pay lip service to them would be eligible for financing from the fund. The ability to borrow from the fund on more favourable conditions than elsewhere would be an incentive for responsible budgetary policies that a fragmented government bond market cannot always provide. The fund would not compromise the member states' autonomy to set budgetary policies but it would increase the cost of poor performance. One requirement, however, is that the parameters and sanctions must be set in advance.

The AIV commends the idea of establishing an EMU fund for the central financing of budget deficits to the government.

I.3.4 Decision-making rules

Finally, the AIV would suggest another means to strengthen the common budget regime. It is debatable whether decision-making rules on the excessive deficit procedure and, in

23 The AIV is indebted here to the ideas of Professor J. Pelkmans.

24 W.W. Boonstra also came to this conclusion in his article 'Het EMU-fonds: institutionele versterking door centrale financiering van overheidstekorten', *Internationale Spectator*, September 2009, pp. 422-425.

particular, the imposition of sanctions on defaulting member states should be changed in the long term. The AIV is inclined to think they should. At present, the Council can decide whether an excessive deficit exists and impose corresponding punitive measures only by qualified majority (pursuant to article 126 Treaty on the Functioning of the EU).

It could be proposed that the Council should automatically adopt the Commission's proposals unless a qualified majority opposes them.

An intermediate step would be to replace the requirement for a qualified majority with a requirement for a simple majority. Other forms of sanction could in any event be considered instead of fines, for example temporary exclusion from the structural funds, framework programmes and agricultural subsidies. This would make it more difficult for member states that do not take the budgetary rules seriously to ignore them.

The AIV is not blind to the fact that deep-seated political problems cannot be resolved by techniques or rule changes alone. If necessary, governments must be named and shamed to emphasise that they are damaging the long-term interests of their own countries by placing themselves outside the frameworks agreed within the EU. As the well-known American columnist Thomas Friedman recently wrote, 'People do not change when we tell them they should; they change when their context tells them they must.'[25]

I.4 The EU in the world

The crisis also made the EU aware of the shortcomings in the international architecture, especially in financial matters. Thanks in part to the French Presidency of the EU, the irrelevant G8 was in effect replaced with the G20 at the end of 2008. All the major emerging countries are represented in the G20, which, with more than 20 members, including the Netherlands, holds meetings at head of state and government level. The emerging countries are also demanding a greater say in the IMF (which is growing in importance again) and the World Bank. This will eventually require that the Western participants, including the European and North American members, take a step back. The IMF has played a very welcome stabilising role by providing emergency loans, often to smaller countries, and is still doing so, sometimes in collaboration with the EIB and the European Bank for Recovery and Development (EBRD). It will remain an indispensable institution in the longer term, too.

In the field of monetary policy, global imbalances have been a cause of serious concern. They were at the root of the financial crisis and culminated in persistent high deficits on the current account of the balance of payments of one country (US) and ever-higher dollar reserves in another (China). This problem can only be addressed by lower consumption and a higher savings ratio in the US and a corresponding but opposite turnaround in China. The value of the US dollar and the Asian currencies pegged to it is a particular concern to Europe. The Asian countries will become even more competitive than they already are if the dollar depreciates further against the euro. This is very likely given the structural deficit on the US balance of payments (which has already been referred to elsewhere) and the fact that the US still has no trouble financing its deficit because the dollar is an international reserve currency. As a result, the United States is not subject to the same policy discipline as other countries. Should countries with balance of payment surpluses become even more reluctant to increase their dollar

25 Thomas Friedman, 'This I believe', *The New York Times*, 2 December 2009, p. A35.

reserves, a depreciation of the dollar (hard landing) and an international crisis cannot be ruled out. The EU would not be spared the consequences.

The AIV therefore recommends that the Netherlands, together with the other EU member states, initiate a debate within the framework of the IMF on the restructuring of the international monetary system. The objective would be to increase the policy discipline applicable to all countries, including the US. All countries should be made to realise that more balanced global monetary relations are in their own interests.

The euro's potential to become an international reserve currency might be a means to exert pressure on the US. This might lead to the development of a multicurrency system,[26] in which the IMF carries out its current task of supervising the member states' exchange rate policies more effectively than in the past.

Apart from the question of exchange rates, attention should also be paid to developments in world trade. Although there was some recovery in 2009, the volume of world trade in October 2009 was still 13.2% lower than in April 2008.[27] This sharp downturn was the outcome of the recession in combination with the credit crunch. In this respect, worldwide anti-protectionism measures are of eminent importance to the EU as a whole and especially to the Netherlands, whose economy is highly dependent on exports. Trade restrictions have increased since the outbreak of the crisis but with less intensity than might have been feared, thanks in part to WTO rules and G20 agreements. But there is certainly no cause for self-satisfaction. The global political forces pressing for protectionism on their home markets are usually well organised.

According to the AIV, incipient protectionism should continue to be combated through effective enforcement of the WTO rules. The AIV thinks the most effective political signal would be the rapid completion of the protracted Doha Round negotiations.

Finally, the AIV would again underline the unique value of the G20 as a global forum. In the first instance it is the most appropriate body to debate the coordination of the main economic players' policies, for example with regard to bank supervision in order to prevent irresponsible banking activities. Attention should also be paid to the timely management of bubbles. It is hoped that the G20 will successfully address the most fundamental problem of global imbalances. The problems of the poor countries, which in many respects are being hit the hardest by the economic crisis, must not be disregarded. Decisions in the G20 must be worked out and implemented in existing multilateral institutions: the IMF, World Bank, WTO and also the OECD if it is enlarged to include emerging nations. If the EU, a major economic and financial player, does not want to run the risk of being marginalised, it must organise itself so as to speak with one clear voice in the global debate on such issues.

26 See: C. Fred Bergsten, 'The dollar and the deficits', *Foreign Affairs*, November/December 2009.

27 See: <http://www.cpb.nl/nl/research/sector2/data/trademonitor.pdf>.

II EMU as a framework for economic and monetary policy

II.1 Introduction

In this chapter we first consider the EU's objectives as laid down in the EC Treaty.[28] We then look at the parties (member states and EU institutions) involved in policy. What are their competences and what tools do they have? We also consider the changes introduced by the Treaty of Lisbon. The importance of effective policy coordination and open markets is discussed in one of the closing sections.

II.2 The objectives of EMU

The EMU objectives are laid down in Title VII of the Treaty. Article 98 states that member states must conduct their economic policies with a view to contributing to the achievement of the objectives of the Community, as defined in article 2. Article 2 states that the Community's task is to promote throughout the Community a harmonious, balanced and sustainable development of economic activities. This includes a high level of employment, sustainable and non-inflationary growth, a high degree of competitiveness and convergence of economic performance. To achieve this the Community has established a common market and an economic and monetary union and the member states and the Union implement an economic and monetary policy. Article 4 (3) lays down that the activities of the member states and the Community must entail compliance with the principles of stable prices, sound public finances and monetary conditions and a sustainable balance of payments. The member states' obligation to establish sound public finances is laid down in article 104 of the EC Treaty. Paragraph 1 stipulates that the member states must avoid excessive government deficits. The Commission monitors compliance with budgetary discipline. Reference values that the member states must observe are stipulated in the Protocol on the excessive deficit procedure annexed to the Treaty.

EMU comprises two parts. The monetary union part is defined the most clearly. The scope of economic union and its relation to monetary union are far more complex.[29]

Monetary union (articles 105ff of the EC Treaty) comprises:
- a common currency and a single monetary policy, conducted by an independent European Central Bank, whose primary objective is to maintain price stability;
- a framework to manage national public deficits and debts.

Economic union, including budgetary policy (articles 98-104 of the EC Treaty), includes:
- the completion of the internal market including harmonisation of measures to protect employees, consumers and the environment (negative and positive integration);
- the regulated coordination of the member states' budgetary policies – based on the Treaty and the Stability and Growth Pact – necessary for the sustainability of monetary union;

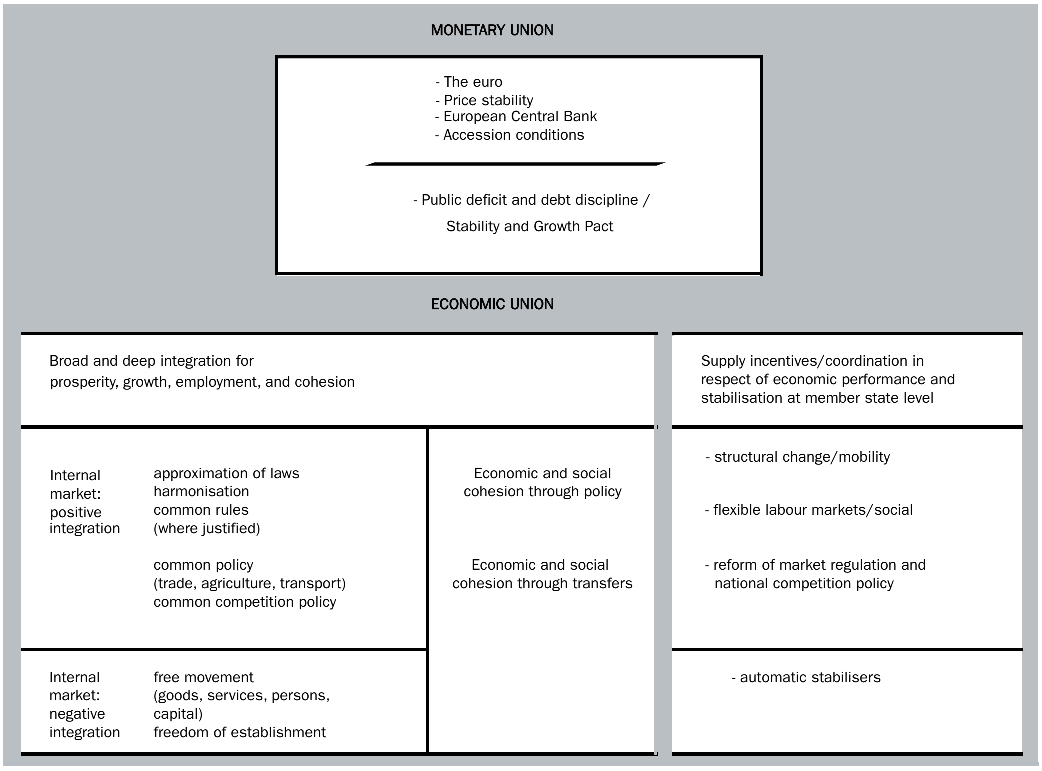
28 This advisory report is based on the Treaty on European Union, including the Treaty establishing the European Community, as in force on the outbreak of the crisis. The Treaty of Lisbon is discussed in section II.4.

29 See: WRR, *Slagvaardigheid in de Europabrede Unie*, report 65, The Hague, 2003, pp. 45-48.

- a common competition policy;
- an external dimension: common trade policy;
- forms of open coordination of national policy in accordance with broad guidelines (pursuant to articles 98 and 99 of the EC Treaty).[30]

The interaction between economic union and monetary union is most evident on the financial markets. The remainder of this report will show just how close the relationship is between monetary and economic policy. Nevertheless, there are significant differences in the division of competences between the monetary and the economic part of EMU at European level and at national level, in particular with regard to the member states' budgetary policies. The figure below shows the main elements of both economic and monetary union.

Economic and Monetary Union



Source: WRR, *Slagvaardigheid in de Europabrede Unie*, report 65, 2003, p. 46.

II.3 The formal position of the parties involved and policy tools

II.3.1 Member states

Title VII of the Treaty is concerned with public finances within the context of economic policy. Budgetary policy is largely a sovereign activity of the member states. The member states themselves may determine the size and composition of government spending and decide on the level of taxation, economy measures, expenditure, etc. within the limits of the SGP. This means that the public deficit must not exceed 3% and public debt must remain below 60% of GDP. The European Commission monitors compliance with these rules. Under article 99, moreover, the member states must regard their economic policies as a matter of common concern.

30 Now article 121 of the Treaty on the Functioning of the European Union (TFEU). See note 36.

The prohibition on excessive deficits is worked out in the SGP. It lays down that public finances must be close to balance or even in surplus. On the outbreak of the crisis, the public finances of several member states were far from sound. Critics note that even before the crisis virtually no country satisfied the requirement of having a balanced budget. Failure to fulfil the requirements is a political problem. On paper, the loss of sovereignty has been accepted, but not the implications. This fundamental problem can only be truly resolved if the member states define their national interests, either under pressure from circumstances or through advances in understanding, so as to eliminate the apparent conflict with the common European interest. Inability to take political steps to ensure EMU compliance is a fundamental threat to monetary union and restricts the EU's ability to work on prevention on a global scale. In other words, the EU cannot act as a global player if it is incapable of keeping to its own agreements.

The crisis also forced the member states to inject substantial amounts of money into the banking system and other economic sectors. Nearly all member state deficits have therefore risen well in excess of the limit set in the SGP. In some countries, the deficits may seriously threaten the sustainability of government expenditure. Greece is currently a striking example of this.

II.3.2 European Council

The European Council was established in 1974 as an informal framework for European summit meetings. It received formal recognition as an EU institution in the Treaty of Maastricht. The European Council has gradually evolved into the most important centre of political power in the EU.[31] It can conclude that the Council must adopt *broad guidelines* for the economic policies of the member states and of the Community (article 99 (2), EC Treaty). The guidelines consist of both macroeconomic and microeconomic guidelines.

The macroeconomic guidelines are concerned chiefly with increasing social prosperity through the pursuit of balanced and sustainable growth.[32] The guidelines are very general in nature and the details have to be worked out elsewhere.

II.3.3 Council

Pursuant to article 99 of the EC Treaty, the Council adopts the broad guidelines of the economic policies of the member states and of the Community. The Council monitors developments in the member states and the consistency of economic policies with the broad guidelines. Where the economic policies of a member state are not consistent with the broad guidelines or risk jeopardising the EMU, the Council may make the necessary 'recommendations' to the member state concerned. It may also decide to make its recommendations public. The Treaty, however, does not provide for the Council to take legally binding measures. Pursuant to article 100 of the Treaty, the Council may grant, under certain conditions, financial assistance to a member state in severe difficulties. Employment guidelines were added to the broad guidelines in 2005. Together, they form the integrated guidelines.[33]

31 This position is supported by Jan Werts in, *The European Council,* London, John Harper Publishing, 2008.

32 SER, op. cit., p. 68.

33 Ibid.

Of all the specialised Council configurations, Ecofin, the council of all 27 EU economics and finance ministers, is of particular importance to the subject of this report. The ministers of the 16 countries participating in EMU together form the euro group. The group's objective is to promote cooperation and in particular to secure the objectives of currency union. The group had no formal status until the Treaty of Lisbon came into force (see section II.4).

II.3.4 The European Commission

In general, the Council can act only on a proposal from the Commission. The granting of aid to a member state in severe difficulties also requires a proposal from the Commission. Article 104 (2) of the EC Treaty lays down that the Commission must monitor the development of the budgetary situation and of the stock of government debt in the member states. It does so in accordance with two criteria:

- whether the ratio of planned or actual government deficit to gross domestic product exceeds a reference value (3% of GDP);
- whether the ratio of government debt to gross domestic product exceeds a reference value (60% of GDP).

The Commission takes action if either of these criteria is not satisfied.

If a member state does not satisfy one or both of the criteria, the Commission prepares a report. The report also takes account of the medium-term economic and budgetary position of the member state. The Commission may also prepare a report if, notwithstanding the fulfilment of the criteria, it is of the opinion that there is a risk of an excessive deficit in a member state. The Economic and Financial Committee (article 134, TFEU) delivers an opinion on the Commission's report. If the Commission considers that an excessive deficit in a member state exists or may occur, it addresses an opinion to the member state concerned and informs the Council thereof. On a proposal from the Commission and having considered any observations which the member state concerned may wish to make, the Council carries out an overall assessment and decides whether an excessive deficit exists.

Where the Council decides that an excessive deficit exists, it makes recommendations, on a proposal from the Commission, to the member state concerned with a view to bringing that situation to an end within a given period. In the first instance, the recommendations are not made public. Only when the Council establishes that there has been no effective action within the period laid down may it make its recommendations public. Article 124 of the EC Treaty also lays down how the Council may act – including the imposition of fines – if a member state persists in failing to put into practice the Council's recommendations. If the member state fails to comply with a Council decision, the Council may apply one or more of the following measures:

1. require the member state to publish additional information, to be specified by the Council, before issuing bonds and securities;
2. invite the European Investment Bank to reconsider its lending policy towards the member state concerned;
3. require the member state concerned to make a non-interest-bearing deposit of an appropriate size with the Community until the excessive deficit has, in the view of the Council, been corrected;
4. impose fines of an appropriate size.

Nearly all EU member states must reduce their deficits in order to restore their public finances to health. In view of the size of the current deficits, five years seems a realistic period. The SGP will be of limited use to get the process going. Its rules are designed to correct individual sinners, not the entire EU. The main provisions are laid down in the Treaty, currently the TFEU. In anticipation of what is to follow in the remainder of this report, the AIV is of the opinion that a credible SGP would require member states to pay a high price if they do not observe the agreed rules. The Netherlands Bureau for Economic Policy Analysis (CPB) has suggested that the European Court of Justice be appointed as arbiter,[34] but the AIV thinks caution should be exercised before referring political questions to judicial authorities. This is why the Treaty does not allow complaints to be made against member states as part of the procedure considered here.

The rules are understandably and correctly concerned with excessive deficits, not with the risks of an unhealthy banking sector. Other rules and forms of oversight are necessary for the latter problems. An arrangement enabling the Commission to set national budgetary goals is required but seems to be a bridge too far.

Despite all the attention given above to the Commission's position in the enforcement of the SGP, it should not be forgotten that economically the Commission's main role is to protect the internal market. The internal market is also a very important factor in strengthening the competitiveness of the EU as a whole. We shall return to this in the remainder of this advisory report.

II.3.5 The European Central Bank

Article 105 (1) of the Treaty lays down that the primary objective of the European System of Central Banks (ESCB) is to maintain price stability. In practice, this objective has been operationalised in a medium-term target of slightly less than but close to 2% inflation per annum. Without prejudice to the objective of price stability, the ESCB supports general economic policy in the Community in order to help achieve the Community's objectives. The ESCB's basic tasks are: to define and implement the monetary policy of the Community, to conduct foreign exchange operations, to hold and manage the official foreign reserves of the member states, and to promote the smooth operation of payment systems.

The ESCB consists of the ECB and the national central banks. The ECB has the exclusive right to authorise the issue of banknotes within the Community. The ECB's independence is assured by the Treaty. Pursuant to article 108, the European Central Bank is not allowed to seek or take instructions from Community institutions or bodies, from any government of a member state or from any other body. Of equal importance is that the latter undertake to respect this principle.

II.3.6 The market as an ally

The market is an important ally that compels member states with excessive deficits to pay higher rates of interest on their state loans (spreads). The CPB, too, believes the market will help the supervisor. The scrutiny exercised by shareholders and bond investors is a source of valuable information for the supervisor. The conditions on which they are willing to grant credit, for example, reflect their evaluation of a bank's creditworthiness. Furthermore, it is often easier for a bank to avoid the supervisor's strictly defined standards than to deceive the market. The market can also use 'soft' information that a supervisor cannot.[35]

34 Casper van Ewijk and Coen Teulings, *De Grote Recessie*, Uitgeverij Balance, 2009, p. 146.

35 *De Grote Recessie*, op. cit. p. 182.

An article by W. Boonstra[36] proposes that the euro should be strengthened through the central financing of government deficits in the EMU. All member states would be free to prepare their own budgets with the exception of deficit financing. Deficit financing would be subject to a number of restrictions:

- government deficits may not be financed monetarily. This is already accepted by all member states;
- government deficits may in future be financed solely through the intervention of a new central financing institution, referred to below as the EMU Fund.

The EMU Fund would finance itself through the issue of bonds and other debt paper on the financial markets. It would charge governments a tariff consisting of its own financing costs plus a margin. This margin would be positive or negative depending on a member state's relative performance with respect to public financing. Countries that break the EMU Fund's rules (for example through monetary financing or defaulting on payments) must be punished firmly and swiftly. Punishments suggested by the author relate to the receipt of funding from the European budget and the loss of political influence on voting rights in the ECB.

The aim is to have the member states themselves bear the cost of poor policy, as evidenced by soaring government deficits, without other member states being affected by lower or even negative interest margins. This will be regulated by the financial markets, which already recognise differences in the quality of public finance from one country to another.

II.4 The entry into force of the Treaty of Lisbon[37]

Since the Treaty on the Functioning of the European Union/the Treaty of Lisbon came into force on 1 December 2009, it is relevant to study the changes it has introduced into the Union's monetary and economic policy.

To begin, the TFEU lays down that the Union has exclusive competence regarding monetary policy for the member states whose currency is the euro (Part 1, Title 1, article 3 (1) (c)). In itself, this is no different from in the past as monetary policy competences had already been transferred in full.

Article 5 (1) of the Treaty lays down that the member states shall coordinate their economic policies within the Union. To this end, the Council sets broad guidelines. This provision goes further than articles 98 and 99 of the EC Treaty, which lay down that the member states must regard their economic policies as a matter of common concern. The formulation chosen for the TFEU can be read as an obligation on the member states to coordinate their economic policies.

This obligation is even stricter for the euro countries. The third sentence of article 5 (1) reads as follows: 'Specific provisions shall apply to those member states whose currency

36 W.W. Boonstra, 'Het EMU-fonds: institutionele versterking door centrale financiering van overheidstekorten', *Internationale Spectator*, 2009, pp. 422-425.

37 Formally, reference should be made to two Treaties: the new version of the Treaty on the European Union (TEU) and the Treaty on the Functioning of the European Union (TFEU), which incorporates – with amendments – the Treaty establishing the European Union.

is the euro.' These specific provisions are laid down in Chapter 4 (in articles 136, 137 and 138). The Council adopts measures for the euro countries in order to strengthen the coordination and surveillance of their budgetary discipline and set out economic policy guidelines for them. The Council takes such decisions by qualified majority. Another important point is that only member states that have introduced the euro may take part in the vote.

The differences with the EC Treaty are that, where measures are adopted for the euro countries, the Council consists of only the euro countries. Secondly, the Council is no longer reliant on a recommendation from the Commission. Furthermore, the new article 136 is framed far more broadly than the old article 99 and provides the Council with far more discretionary power to decide what guidelines are necessary. These new provisions can make it far easier to coordinate the member states' economic and monetary policies than at present. A third difference is that article 100 of the EC Treaty may have given the Council power to decide upon measures appropriate to the economic situation but it could exercise this power only if serious difficulties arose in the supply of certain products. Under the TFEU, the Council may exercise this power solely to strengthen the coordination and surveillance of budgetary discipline and to secure the euro's place in the international monetary system.

The Council has more power to secure the euro's position in the international monetary system. Article 138 (1) requires the Council to adopt a decision establishing common positions within the competent international financial institutions. When adopting such decisions, the Council again consists of euro countries only. It decides by qualified majority after consulting the ECB. At present, coordination of the member states' positions in international financial institutions is not regulated. To some extent, this provision recognises the criticism that the euro is in effect a currency without a state. In a literal sense it still is, of course, but the euro's position is becoming a matter of common concern.

The TFEU also strengthens economic coordination. Article 121 of the Treaty amends the old article 99, which gave the Council, on a recommendation from the Commission, the power to make necessary recommendations to a member state whose economic policy is not consistent with the broad guidelines adopted by the Council.

Article 121 of the TFEU transfers some powers from the Council to the Commission. Where it is established that the economic policies of a member state are not consistent with the broad guidelines or risk jeopardising the proper functioning of economic and monetary union, the Commission may address a warning to the concerned member state. This strengthens the Commission's role as guardian of the Treaty. Moreover, it also goes a step towards the desired depoliticising of economic and monetary policy. It is often assumed that the Commission, far more so than the Council, looks after the interests of the Union rather than the interests of one or more individual member states.

Article 126 of the TFEU lays down, amongst other things, that the member states shall avoid excessive government deficits. In comparison with the provisions of the former article 104 of the TEC, this new article amends one part of the procedure to establish whether or not there is an excessive deficit. The old article 104 (6) TEC laid down that the Council, acting by a qualified majority *on a recommendation* from the Commission, must decide whether an excessive deficit exists, after which measures may be taken if there is an excessive deficit (paragraphs 7 to 12). Pursuant to article 104 (6), the member state concerned took full part in the substantive decision-making procedure regarding the existence of an excessive deficit and its representative was excluded from voting in decisions on subsequent measures. Under the new provisions, however, the member state's vote is no longer taken into account during substantive decision-making on the existence of an excessive deficit and the existence of an excessive deficit is no longer established on a recommendation from the Commission but on a *proposal*. In comparison with the old procedure, therefore, a step has been missed out and the Commission's position is strengthened.[38] This amendment makes it less easy for member states to obstruct decisions on the establishment of an excessive deficit and thus the initiation of appropriate procedures. The AIV considers this to be an improvement.

II.5 Available tools

The EU has a raft of tools to achieve its objectives. They are summarised in the figure below.

The nature of the tools is determined by the extent to which powers are transferred and the associated forms of coordination. The spectrum ranges from policy fields in which the member states have transferred all powers to the EU, as in the case of monetary policy and competition policy, at one extreme, to policy fields that are still national competences, budgetary policy being the most important example, at the other. To overcome the crisis, therefore, the EU must use a variety of tools and accommodate different types of national powers.

Forms of policy coordination and associated tools

Form of coordination	*Relevant socioeconomic policy fields*	*Policy tools*
Full transfer of powers	Monetary policy Competition policy Trade policy	Money market interest rates Supervision, enforcement and sanctions European Commission's mandate
Regulated coordination	Member states' budgetary policies	Benchmarks, instructions to member states, financial fine in excessive deficit procedure
Open coordination	Economic policy and employment Social protection and integration	Broad guidelines, benchmarks, national strategy reports, country-specific recommendations, instructions to member states Common orientations, benchmarks, national strategy reports, Progress programme
External coordination	World economic governance: G20, IMF	Speaking with one voice

Source: adapted from SER report *Advies Europa 2020* (p. 21).

38 The Commission's position is also strengthened under article 121 (4) of the TFEU as it can address a warning to a member state if its economic policy is not consistent with the broad guidelines or risks jeopardising the proper functioning of economic and monetary union.

II.6 Importance of effective coordination and open markets

The figure above identifies various forms of coordination. This justifies separate consideration of this matter. Where the European economies are so closely intertwined with each other, the importance of effective coordination of the member states' economic policies is self-evident. By themselves, national governments are no longer able to achieve the main goals of their economic policies, such as sustainable economic growth, high employment and maintaining internal and external balance. Good coordination is particularly important in an economic crisis. In such a situation, governments are tempted to pass on their own economic problems to other countries (beggar-thy-neighbour policy). They can do so by taking measures that favour or protect their own economies or by devaluing their own currencies. The latter option is of course no longer available in the European monetary union. Elsewhere in this report, we consider the dangers of certain forms of economic protectionism. Suffice to say here that history shows that when one country takes protective measures others follow suit, resulting in a contraction in trade and a loss of prosperity. The importance of an open market is explained in David Ricardo's classic argument that member states can maximise their comparative advantages only if trade restrictions are kept to a minimum. The economies of scale that an open market produces are – alongside technological innovation – an important source of growing prosperity.

Apart from an increase in the EU's external effectiveness (see section IV.7), proper coordination is also required, preferably based on binding agreements, to prevent free-riding. Such behaviour occurs when economic subjects (individuals, groups and countries) profit from collective goods without making a proportionate contribution to the costs that have to be incurred (and are not paid) to produce those goods. Seen from the point of view of political economy, the EU is an alliance that organises collective action. The benefits of collective action are undermined if countries do not stand together and make appropriate contributions. As noted in a number of places in this report, free-riding has occurred in various areas in the EU: in the field of monetary policy, countries with large budget deficits have benefited from stability and low interest rates on state loans; in the field of competition policy, countries that have introduced protective measures have benefited from access to the markets of their partners; and in the field of macroeconomic anti-crisis policy, countries that have not implemented stimulus measures in full have benefited from the external effects of such measures.

II.7 Conclusion

It can be concluded from the above that the euro area is not properly prepared for a crisis. Not enough assurances have been created to enable a rapid response. Member states have a lot of policy freedom and there is no central management. At the heart of the problem is the absence of an authoritative body in the euro area that can take budgetary and financial decisions in difficult times. In this important respect, the Treaty of Lisbon makes no real difference, although stronger obligations on macroeconomic policy coordination can be read into it. It must be clear that there are limits to what can be achieved through ad hoc coordination. In principle, the euro group could be transformed into an effective decision-making body but a lot still needs to be done. When the crisis broke out, the euro group was only an informal body that had just two roles: enforcing the EMU criteria and acting as a meeting place to discuss problems. As will be seen below, since the onset of the crisis the latter role has been seriously neglected and the ECB has become virtually the sole leader of the euro group. The Treaty of Lisbon may have given the euro group formal status in the EU but it does not have the power to impose its decisions on member states. For this reason alone, the euro can be called not only a currency without a state but also a currency without political leadership.

III The financial crisis: causes and effects

III.1 Introduction

This chapter analyses the background to the financial crisis in combination with the aid operations carried out to prevent banks collapsing. It also considers the problems of prudential supervision of the financial system as a whole and of individual banking institutions. After looking at the policy responses in Europe, the consequences of the crisis are summarised, particularly regarding the damage done to economic growth and employment.

III.2 Causes and character of the crisis

The first signs of the crisis were seen in America in 2007. As time progressed the initial mortgage crisis developed into a banking crisis with global repercussions. The crisis culminated in a global economic crisis and its end is still not in sight. There is general agreement in the literature about the causes and development of the crisis. As noted elsewhere in this report, at the root of the problem was the asymmetrical economic relationship between the United States and China. Another important cause was the securitisation of risks by banks, which concealed the risks but did not improve their spread. A short review of the events in the US that led up to the economic crisis is presented below.[39]

III.3 Events in the United States

The US housing market collapsed in August 2007. Many years of low interest rates in the United States had enabled many people to buy a house and house prices had risen to unrealistic levels. In mid-2006 interest rates were increased for a variety of reasons and then rose quickly. As a result, many Americans were no longer able to make their mortgage payments. Owing to the overhang on the housing market, house prices fell. The banks were left holding unpaid and uncollectable debts that were not covered by the mortgage security.

The collapse of the American mortgage market culminated in the present crisis chiefly because the banks had securitised the mortgages. Risks such as interest rate fluctuations or non-payment were sold to other financial parties such as insurers, investment funds and pension funds. Unlike the banks, these parties had sufficient capital to bear the risks but could not provide mortgages. The risks of all manner of good and bad mortgages were packaged into a homogenous financial product with a defined credit risk known as a securitisation.[40] The banks were thus able to issue high volumes of mortgages. Since only a small proportion of the remaining risk on each mortgage remained on their own balance sheets, the banks needed to hold very little capital for each mortgage.[41] The problem was aggravated by the banks also buying

39 European Commission, 'Economic Crisis in Europe, Causes, Consequences and Responses', in *European Economy* 7, 2009, pp. 8-13.

40 *De Grote Recessie*, p. 20.

41 *De Grote Recessie*, p. 25.

securitisations. Although the product was designed to distribute risks, the banks bought back a large proportion of the risks they had sold. Market supervisors required the banks to hold only a minimum amount of capital to insure their subsidiaries (‘shadow banks’).[42]

Despite the high risk, such products were generally given a *Triple A rating*, suggesting that they were extremely reliable products that could be readily repaid. The banks, and other financial institutions in the United States, then got into difficulties. Their share prices fell sharply. The banks lost confidence in each other and were reluctant to lend funds to one another; the interbank market dried up. The banks were uncertain which banks had only temporary liquidity problems and which banks wanted to borrow funds to offset the losses incurred on securitised products. This had a direct impact on the real economy because banks no longer had funds to lend to businesses. Furthermore, banks were forced to sell or terminate existing loans in order to put their balance sheets in order. Only after the collapse of the major American bank Lehman Brothers in September 2008 did the full extent of the crisis become clear and panic spread throughout the world: the global credit crunch was a fact. Governments worldwide have since pumped more than USD 8,900 billion into the financial system, about 15 times the GNP of the Netherlands.[43]

It is of great importance to note that the financial market was inadequately regulated. The lack of effective regulation enabled banks to create all manner of credit instruments without the backing of adequate financial reserves (high leverage).[44] It should also be noted that the collapse of the American housing market was not the sole cause of the present crisis. A larger macroeconomic problem lay at its root: the soaring deficit on the US balance of payments. The US borrowed enormous amounts on the global financial markets, especially from China. At the height of the crisis, the US was absorbing about 70% of the rest of the world’s savings.[45] The US accordingly had enough money to buy products from Asia and thus contribute to the high economic growth of the East Asia region. To redress these global imbalances, the US must save more and countries such as China must spend more. Ultimately, Asian currencies will have to appreciate in value against the dollar.

The global availability of surplus liquidity triggered a rapid increase in share prices.[46] This happened in three ways:
1. the appreciation of the euro against the dollar reduced imported inflation and enabled a relaxation in monetary policy;
2. investors borrowed in currencies with low interest rates and invested in currencies with higher interest rates and ignored the exchange rate risk. This explains the abundance of foreign currencies in European financial markets;

42 *De Grote Recessie*, p. 28.

43 *De Grote Recessie*, p. 13.

44 NATO parliamentary assembly, 029 ESC 08 E, The Global Financial and Commercial Crisis, Implications for the Transatlantic Community of Nations, Simon van Driel (General Rapporteur).

45 Martin Wolf, ‘The seeds of its own destruction’, *Financial Times*, The Future of Capitalism, 2009.

46 European Commission, 2009 op. cit., p. 12.

3. the enormous capital flows generated by the integration of financial markets were channelled to the property markets in a number of countries. Property and share prices accordingly soared without consumers being confronted with high rates of inflation.

III.4 Crisis and policy responses in Europe

The collapse of Lehman Brothers revealed just how closely the banks were intertwined with each other internationally. Worldwide, governments were compelled to support 'their' major banks. This was necessary partly because the banks were holding 'toxic' assets on their books but to a large extent also because banks were refusing to lend to each other. Measures quickly followed each other with conditions changing from day to day.

Specific measures were taken to rescue the banking system, to support the member states' economies, to permit state aid that competition rules normally would not allow and to bolster monetary conditions. During the crisis, the ECB progressively lowered interest rates in small steps to make it as attractive as possible for the banks to continue lending.

III.4.1 Aid operations for the banking system

Banks in various countries had to be propped up by substantial financial injections from the government or were even temporarily or permanently nationalised. On 7 October 2008, the European finance ministers agreed an extensive package of support measures, ranging from participating in the risk-bearing capital of banks and insurers and guaranteeing interbank loans to buying up illiquid loans. In September 2008, major companies and financial institutions withdrew billions of euros from their accounts with Fortis. To prevent Fortis going bankrupt, the Dutch, Belgian and Luxembourg governments agreed to inject €11.2 billion into the bank. The situation changed in the following month, October, when the Dutch State took over all the Fortis Group's banking and insurance activities in the Netherlands for €16.8 billion. Its other activities were taken over by the Belgian State on the understanding that the insurance activities remained listed. Something similar happened in the UK with the Northern Rock mortgage bank. On 14 September 2007, the Bank of England announced that it would provide an emergency loan to Northern Rock after the bank reported a GBP 585 million loss and customers were queuing up to withdraw their savings. Northern Rock was nationalised on 22 February 2008.

The close international ties in the banking system were clearly exposed by the collapse of the Icelandic bank Landsbanki (which was active in the Netherlands through its Icesave subsidiary). On 6 October 2008, the Icelandic government introduced new legislation to enable far-reaching interventions in the operation of new banks. Dutch savers tried to withdraw their deposits from their Icesave accounts en masse. The ministry of finance decided to temporarily increase the bank guarantee scheme for account holders in the Netherlands from €38,000 to €100,000 per person. The Netherlands and Iceland held difficult talks to negotiate an agreement under which the Icelandic government would open up the Icelandic guarantee scheme to Dutch savers with Icesave accounts. The Icelandic president's decision to hold a referendum has jeopardised the implementation of this agreement.

On 10 October 2008 the Dutch government provided €20 billion to strengthen capital positions in the financial sector.[47] In October 2009 several large parties reported that

47 See: <http://www.fd.nl/artikel/10272804/overheid-steunt-financiele-sector-euro-20-mrd>.

they were already repaying loans received from the Dutch government. Insurer Aegon announced on 29 October 2009, for example, that it would repay €1 billion to the government. ING said it would repay €5 billion ahead of schedule. On the other hand, ABN AMRO turned to the Dutch government again in the second half of November 2009 requesting €4.4 billion in support. A substantial proportion of this assistance was earmarked to finance ABN AMRO's integration with Fortis Bank Nederland, a measure imposed by the State. This injection raised the total state aid provided to ABN AMRO and the other companies involved in the operation (Fortis Bank Nederland, ASR en FCI) to approximately €30 billion.

III.4.2 International banks, national supervision

The CPB has noted that banks can operate internationally but if they collapse the consequences are national.[48] This is illustrated by the rescue operation for Fortis. Belgium, the Netherlands and Luxembourg split the bank up along national borders. Owing to the smaller European home market, European banks operate far more internationally than American banks. It is therefore of additional importance to Europe that the banking sector is rescued proactively and at European level. A European solution will also prevent strategic behaviour by national supervisors in which a country trivialises its own banks' problems in the hope of avoiding recovery costs (free-riding).[49]

III.4.3 The European Commission

The European Commission made a series of proposals in September 2009 to improve prudential supervision of financial institutions. It had become increasingly clear that supervisory rules on cross-border financial institutions were inadequate. A High-Level Group chaired by Jacques de Larosière reported on the shortcomings in February 2009.[50]

It also emerged during the crisis that the FSAP was too light.[51] Since a Treaty amendment is not likely in the short term, the AIV hopes the crisis will be seized upon to improve the FSAP in small steps. Above all, the measures must address the problem that financial institutions operate across borders while supervision is chiefly a national affair. In view of the political opposition, the Commission has not suggested a true cross-border supervisor but has proposed that national supervisors work together in a network. Furthermore, the intended European authority (see section III.4.5) could also propose rules to the Commission and force national supervisors to observe the European rules.

III.4.4 State aid in the financial sector

The European Commission was confronted with the state aid the member states provided to financial institutions. In many cases, the aid was very urgent. Since October 2008, the Commission has published four Communications[52] regarding the evaluation

48 *De Grote Recessie,* p. 185.

49 *De Grote Recessie*, p. 187.

50 Report of The High-Level Group on Financial Supervision in the EU, chaired by Jacques de Larosière, Brussels, 25 February 2009.

51 J. Pelkmans, op. cit., p. 7.

52 To avoid misunderstandings, the Communications are interpretative policy rules (legal instruments) rather than informative.

of aid measures during the crisis in the financial sector.[53] The Communications consider a raft of measures, including individual aid, aid in the form of generic programmes, recapitalisations, the treatment of assets written down and the restructuring of financial institutions. In accordance with the principles set out in these Communications, the Commission has taken more than a hundred individual decisions on rescue aid and restructuring aid in the financial sector.

At the start of the crisis, the Irish government announced that only six Irish banks would be allowed to participate in a hastily introduced state guarantee scheme. This led to an immediate outflow of capital from competitors from other member states that would not be protected by the scheme. Under pressure from the Commission, the Irish government reconsidered its announcement and opened up the guarantee scheme to all banks with subsidiaries or branches in Ireland that had an appreciable presence in the Irish economy. This development, amongst others, led to the first Communication on crisis aid, of 25 October 2008. This Communication enabled the Commission to approve aid measures very quickly (sometimes within 24 hours) provided they were well-targeted, proportionate to the aim of stabilising financial markets and satisfied a number of minimum requirements with a view to preventing negative spill-over effects on competitors. In particular, the measures had to:

- be non-discriminatory;
- be limited in time;
- provide for a contribution from the financial institutions;
- impose behavioural constraints to prevent misuse of state aid; and
- provide for an appropriate follow-up to the measures in the form of sectoral recovery measures or, in general, the submission of individual restructuring plans within six months.

The Communication is based on the principles that also underlie the general rules on rescue and restructuring aid.

When the member states increasingly turned to aid in the form of recapitalisation measures, the Commission, after in-depth consultation with the ECB and the member states, published its Communication of 5 December 2008. This Communication states, among other things, that the evaluation of recapitalisation measures should take account of the beneficiary’s risk profile, the risk, exit incentives and an appropriate benchmark risk-free rate of interest. In addition, recapitalisations should be subject to regular review. Six months after the measures are introduced, for example, member states must submit a report to the Commission.

The recapitalisation of banks provided them with a capital buffer but uncertainty about the valuation of impaired or toxic assets led to the banks using a large proportion of the buffer to form provisions against future impairment losses on such assets (such as US sub-prime mortgages). On 25 February 2009, the Commission therefore published a Communication on the treatment of impaired assets. This Communication provides for a Community approach to writing down such assets based in part on transparency, common valuation principles, certification by recognised independent experts and validation by supervisors. The objective is to provide clarity so that banks can use their capital to grant loans instead of holding provisions in anticipation of offsetting specific

53 See OJ EU C 270 of 25 October 2008, OJ EU C 10 of 15 January 2009, OJ EU C 72 of 26 March 2009 and OJ EU C 196 of 19 August 2009 respectively.

losses. The need for in-depth restructuring will be presumed where an appropriate valuation of toxic assets would lead to negative equity or technical insolvency without state intervention. In such cases, the extent of necessary compensatory measures should be examined, for example in the form of downsizing or divestment of profitable business units or subsidiaries, or behavioural commitments to limit commercial expansion fuelled by the benefits received.

In its fourth Communication, of 23 July 2009, the Commission considers the return to viability and the assessment of restructuring measures in the financial sector in the current crisis. The Communication states that banks must subject their activities to a stress test in order to map out sustainable, forward-looking strategies. A diagnosis of a bank's strengths and weaknesses could lead to a review of its business model, the identification and redress of problem assets, the divestment of loss-making activities or even consideration of acquisition by a viable competitor or liquidation.

Banks that receive aid and their shareholders must bear responsibility for their actions in the past and must contribute to the restructuring from their own resources in so far as possible. In particular, the State should receive appropriate remuneration for the aid it grants. Where such burden sharing is not immediately possible due to market circumstances, this should be addressed at a later stage.

Furthermore, the Communication considers the extent to which competition is distorted by state aid provided to banks and presents measures to limit such distortion. Distortion can occur if a bank continues its careless or excessively risky activities and/or maintains its position as a market participant at the expense of its competitors. Structural measures may be necessary in the case of significant state aid, such as divestments (which can be spread out over a series of years in the current crisis) or behavioural measures such as restrictions on acquisitions or aggressive pricing and marketing strategies that are funded with state aid. The analysis should consider national market structures so that the integrity and accessibility of the internal market remain intact.

On the basis of this last Communication, the Commission has already taken a number of decisions on restructurings, for example with regard to ING, KBC and Commerzbank, and is considering others.

In total, the maximum amount of funds subject to the crisis measures approved by the Commission between October 2008 and October 2009 was about €3.632 billion, equal to 29% of the GNP of the EU 27. The measures approved in 2008 were worth €3.361 billion. Between January and March 2009, further rescue and stabilisation measures were approved with a maximum value of €96 billion. Since April 2009, the member states have taken further aid measures totalling up to €175 billion. The take-up rate (the actual amount taken up relative to the amount announced and approved) of the crisis measures (chiefly guarantees) is about 33%. The rate for recapitalisations is about 55%.[54]

54 State Aid Scoreboard: <http://ec.europa.eu/competition/state_aid/studies_reports/2009_autumn_en.pdf>.

III.4.5 Further centralisation of prudential supervision by the ESRB and ESFS

The European Commission proposed a series of draft rules to work out the recommendations made in the De Larosière report:[55]

- the establishment of the European Systemic Risk Board (ESRB) to evaluate the risks of the financial system as a whole (macro-prudential supervision);
- the strengthening of the European System of Financial Supervisors (ESFS) for the supervision of individual financial institutions (micro-prudential supervision); the ESFS will consist of a network of national supervisors working together with the European authorities (together known as the ESAs or European Supervisory Authorities);
- the establishment of the Banking Authority;
- the establishment of the Insurance and Occupational Pensions Authority;
- the establishment of the Securities Markets Authority.

The ESRB can issue warnings and recommendations. The recommendations, however, cannot be made binding because the ESRB does not have legal personality. Instead, a more political obligation was preferred in the form of 'comply or explain'. The proposals can strengthen supervision through the ESRB's risk warnings. The ESRB will have access to the information to make it possible to issue credible warnings.

The ESFS will have the power to propose binding technical rules to the Commission, known as the *single rule book*. It will also have the power to arbitrate between national supervisors when their powers overlap. If a national supervisor does not accept the binding arbitration ruling, the authority can impose direct measures on the party concerned. In addition, if a national supervisor does not seem to be adhering to applicable rules, the ESFS can address a recommendation to the Commission. The Commission can incorporate this recommendation into a binding decision. A board of appeal will be established so that appeals can be lodged against all decisions by the authorities. The authorities will have specific powers during emergencies so that action within the EU is uniform. With the establishment of the ESFS, the 'Level Three' committees will be disbanded. Their tasks will be assumed in full by the ESAs. The Level Two committees will continue on their current terms.

Of no less importance, EU supervision of the financial services and capital markets will be strengthened by the new European System of Financial Regulators. First of all, the new legislation must be implemented. To this end, the Commission has made a series of technical proposals on the practice and standards of supervision. The AIV has already noted in chapter I that in practice the Meroni doctrine tends to frustrate decision-making in the EU regarding the much-needed centralisation of the prudential supervision of financial institutions as a necessary complement to financial integration and stability.

55 Proposal for a Regulation of the European Parliament and of the Council on Community macro prudential oversight of the financial system and establishing a European Systemic Risk Board, COM(2009) 499 final; Proposal for a Council decision entrusting the European Central Bank with specific tasks concerning the functioning of the European Systemic Risk Board, COM(2009) 500 final; Proposal for a Regulation of the European Parliament and of the Council, establishing a European Banking Authority, COM(2009) 501 final; Proposal for a regulation of the European Parliament and of the Council establishing a European Insurance and Occupational Pensions Authority, COM(2009) 502 final; Proposal for a Regulation of the European Parliament and of the Council establishing a European Securities and Markets Authority, COM(2009) 503 final.

III.5 Lasting damage?

In 2008/2009 the global economy suffered the worst recession since the 1930s. Fortunately, the tide seems to be turning, although no-one knows how sustainable or strong the recovery will be. An important question is whether this crisis will cause lasting damage in terms of social prosperity and employment. In this respect, a distinction can be made between three scenarios based on the example of credit crises in the early 1990s:[56]

- Japan provides the worst scenario: the crisis is followed by long-term stagnation;
- the Finnish scenario is grey: it took several years for the economy to resume the growth rate seen before the crisis; several years of economic growth were lost in the intervening years;
- the Swedish scenario gives cause for optimism: at the end of the crisis the rate of economic growth accelerated and the impact of the crisis on per capita national income had been redressed in full within a few years.

Whatever the scenario, the consequences of the credit crunch will be felt for many years to come. A study of a large number of financial crises[57] shows that on average the negative effects are felt for a further nine years.

Gross domestic product
The Dutch economy contracted by about 4% in 2009. The CPB expects the economy to expand by 1,5% in 2010. In comparison with the historical trend of 2% growth per annum, the damage caused by the credit crisis has so far been more than 6% of gross domestic product (GDP). It will be difficult to make up all this loss, chiefly because of the global scope of this credit crisis.

Employment
The consequences of the crisis are particularly painful to those who lose their jobs or cannot find work. Employment tends to lag behind economic developments, in times of both economic downturn and recovery. Unemployment will increase further in 2010, to more than 10% in the EU as a whole, and a recovery in employment will take many years. Even in the ‘sunny’ Swedish scenario, ten years after the crisis broke out unemployment was still 3 percentage points higher than before the crisis. Moreover, a credit crisis, more so than other forms of crisis, will have a lasting impact on employment, chiefly because of the lack of investment – not only in production capacity but also in research and development. In the wake of a credit crisis, banks are even more reluctant to lend.

Public finances
Governments have absorbed most of the shock of the recession by means of stimulus measures and the operation of the automatic stabilisers. Government deficits have accordingly risen sharply. The return of economic growth and the cessation of stimulus measures may reduce the deficits again although persistent high rates of unemployment will place a heavy burden on public finances. In addition, European countries are facing

56 For more information, see: C. v. Ewijk and C. Teulings (2009), *De Grote Recessie: het Centraal Planbureau over de kredietcrisis*, chapter 4: Tijdelijke crisis, blijvende schade?

57 Carmen M. Reinhart and Kenneth S. Rogoff, ‘The Aftermath of Financial Crises’, *American Economic Review*, Vol. 99, 2009, no. 2, pp. 466-472.

increasing costs for pensions and the like on account of the aging population. The combination of additional expenditure owing to the crisis, lower tax revenues and higher pension costs represents a stress test for public finances.[58]

Inflation

Inflation in the EU and the euro zone is expected to remain modest (1-2%). But this assumes that there is a well-timed exit strategy. If monetary and budgetary policy remains expansive and raw material prices rise during the economic recovery, strong inflationary pressures will inevitably arise. Coherent and timely adaptation of monetary and budgetary policy is therefore necessary. An estimate must be made of how the recovery will develop after the crisis. Will it look like a 'V' (fast and powerful recovery) or a 'U' (slower recovery)? It almost goes without saying that a 'W', where economic recovery – as in the 1930s – is interrupted,[59] must be avoided at all costs if only to avoid the negative consequences for poor countries. This is particularly true since the budgetary resources to respond to a second dip have been exhausted during the first dip.

58 Anton Hemerijck, 'The Institutional Legacy of the Crisis of Global Capitalism', in: Aftershocks, AUP 2009, p. 15.

59 See, for example, Loet Mennes, 'Keynes contra het Centraal Planbureau en het kabinet', *ESB* 94 (4574), December 2009.

IV How have the policy tools been applied in the crisis?

IV.1 Introduction

This chapter considers what use has been made of the policy tools available in various EU fields: competition policy, macroeconomic policy and monetary policy. It also looks at the EU's external trade policy, representation in international forums and the importance of effective policy coordination in a global arena. The chapter closes with a discussion of the formulation of an exit strategy.

IV.2 The rules of the internal market and the role of the Commission

IV.2.1 Challenges to competition policy

Governments try to help ailing companies in many ways. Government intervention increases the danger of protectionism. Protectionism can take on many forms, one of them being state aid. Several countries provided support to their key industries in the course of 2008. In the United States, General Motors, Chrysler and Ford turned to the government for help. General Motors and Chrysler were propped up from the end of 2008 with substantial bridging loans from the US government. In Europe, governments wrestled with Opel, Renault and Peugeot-Citroën. The French government ultimately provided €6 billion to support its car manufacturers.[60] Pisani-Ferry and Sapir hit the nail on the head when they write, 'extensive state intervention to assist sectors in distress is creating tensions between the logic of European economic integration and the logic of national political accountability'.[61] National taxpayers insist that state aid is received by companies in their own countries. This can create a major problem if these companies also have branches in other countries. European competition rules do not permit discrimination, even if jobs are at stake.

IV.2.2 State aid for banks

As noted in the previous chapter, governments provided the banks with billions in aid. Owing to the economic consequences of a crisis in the financial system, it is exceedingly important for the government to rescue banks during a crisis. The CPB notes that these guarantees have the disadvantage of encouraging banks to take risks without having to bear the cost if things go wrong. Government guarantees invite banks to take additional risks at the taxpayers' expense.[62] This creates the frequently discussed problem of moral hazard: banks that receive aid might take even more risks. During a crisis, banks can play 'double or nothing' with the government.

IV.2.3 Response of the Commission

The role of the European Commission as 'guardian of the internal market' has been comprehensively put to the test by the state aid provided to financial institutions and other sectors in the member states and by covert forms of protectionism. Rules on

60 *De Grote Recessie,* p. 68.

61 Jean Pisani-Ferry and André Sapir in their article in a publication by the Bruegel think-tank entitled *Europe's economic* priorities 2010-2015, Brussels, September 2009, p. 11.

62 *De Grote Recessie*, p. 173.

state aid to non-financial sectors are laid down in a Regulation.[63] In most cases it is clear when a member state may grant permitted aid. The Commission has also increased the amount of aid that can be granted without having to be notified in advance from €200,000 to €500,000. The conditions on subsidised guarantees have also been relaxed. It has already been noted in the previous chapter (section III.4.1) that the Commission responded to the substantial state aid granted to banks with four Communications that form the framework for evaluating emergency aid measures. The Communications build on existing rules and work out technical components. Criteria are set, for example, on the recapitalisation of financial institutions and the treatment of assets with a high and unknown loss risk.[64]

Although it is difficult to deny that the crisis forced the Commission to relax the conditions under which aid can be granted to banks, it recently intervened more forcefully by making clear that banks that receive aid must divest parts of their business if there is a danger of competition being distorted. The AIV thinks Pelkmans[65] is therefore right when he states that the perception of the Commission does not agree with its actual role. The media seem to present a picture in which the member states are free to do whatever they like to support their own industries. The part played by the Commission is overlooked even though it has been of decisive importance to preserve the proper functioning of the internal market. The Commission ultimately made it perfectly clear that it would not tolerate any preferential treatment of economic sectors in certain member states.

IV.3 The European recovery plan and crisis management

IV.3.1 General

There are significant differences among the economies of the EU and the crisis has accordingly affected them to different degrees and in different sectors. In itself, this is not a bad thing but it does make it difficult to formulate a coordinated policy. Secondly, there are virtually no tools at European level to coordinate the individual economies, a problem that has been raised several times in this report. Coordination is a matter of cooperation among the member states in which the European institutions do not have a decisive say. It should also be borne in mind that the EU budget cannot serve as a stabilisation instrument because it is simply too small relative to the combined gross domestic product of all the member states (just over 1%). With annual funding of about €130 billion, the EU budget is actually considerably smaller than the Dutch budget.[66] Furthermore, the EU is not allowed to run a budget deficit, which further restricts its freedom to take economic stimulus measures during a crisis.

63 Regulation 800/2008, OJ EU L 214 of 9 August 2008.

64 See OJ EU C 270 of 25 October 2008, OJ EU C 10 of 15 January 2009 and OJ EU C 72 of 26 March 2009.

65 J. Pelkmans, op. cit.

66 Government revenue for 2010 is projected at €240 billion and expenditure at €272 billion (including social insurance expenditure, for which the payment of contributions is compulsory).

In the chapter entitled ‘Alle remmen los’ in the frequently cited publication *De Grote Recessie,* the CPB authors[67] look at the stimulus measures taken by a variety of countries. The US government is conducting a classical Keynesian policy to compensate for loss of demand. It will cost USD 787 billion between 2009 and 2012, without counting the money injected into the economy to rescue the financial sector. This is about 5.5% of US GDP.

IV.3.2 The European response
On the basis of proposals from the Commission, the European Council adopted the European Economic Recovery Plan in December 2008. This recovery plan represented about 1.5% of the Union’s GNP.[68] Since the EU member states decide on their own stimulus packages, they differ from country to country. On average they represent 1.8% of national GDP. Germany and the UK are spending 3.6% and 2.6% of GDP respectively. France and Italy are spending barely 1%, far below the EU average. The Netherlands’ discretionary expenditure is also clearly below the average. The Netherlands, however, is one of a large group of European countries that is stimulating its economy by means of automatic stabilisers such as benefit payments. These have a huge impact on the government’s budget.

Subject to the restriction of a relatively small budget that must always be in balance, the EU also took direct measures to overcome the crisis (i.e. not via the member states). It drew up and adopted a recovery package funded from the EU budget to accelerate payments from the structural funds, opened up the globalisation fund to enterprises forced by the recession to dismiss large numbers of employees (with the threshold being lowered to 500 employees) and created a new micro-credit facility. In addition, the EIB increased its lending by about €15 billion in 2009. As noted in section IV.5 below, the EU also granted loans to certain member states outside the euro zone.

IV.3.3 Crisis management
In the AIV’s opinion, the EU’s crisis management in the second half of 2008 did not make a convincing impression. The Commission gave the impression that it was waiting to see how events would unfold. The main cause given for this was the narrow interpretation of the President’s role and a certain degree of deference to the larger member states. The AIV, however, is inclined to attach more significance to the low profile of the euro group and the lack of decisive action by Ecofin, both before and during the crisis. Before the crisis, Ecofin failed to respond when many member states allowed their budget deficits to rise to excessive levels. In the past, the Council had lectured smaller countries, such as Ireland, about their rising budget deficits but several large countries, such as France, entered the present crisis with national debts in excess of 60%. This gave rise to the suspicion that large countries could take more liberties than small countries.

The AIV also notes that the crisis was apparently too big to be tackled by only the euro group finance ministers. It was the European Council that ultimately had to cut the knot as crisis manager. Thanks to the firm action of the French Presidency towards the end of 2008, some coordination of the member states’ additional expenditure was achieved, albeit more in retrospect than in anticipation. As already noted in chapter I of this report, the AIV draws an important conclusion from this experience.

67 See note 56.

68 J. Pelkmans, op. cit., p. 12.

IV.3.4 The toll of a burdened past

The group of euro countries found it difficult to reach agreement during the crisis on the right macroeconomic policy for the euro zone as a whole. It virtually goes without saying that this undermined confidence in the euro.[69] As long as the member states remain within the limits of the SGP, they can insist on retaining their budgetary autonomy. On the other hand, the common guidelines require the member states' macroeconomic policies to take account of the greater good. As noted in chapter II, the Treaty of Lisbon goes a step further in this respect. Regularly reminding the member states of this responsibility should be one of the Council's tasks.

IV.3.5 The Open Method of Coordination

One of the lessons that can be learned from the crisis is that economic policy falls largely within the formal competence of the member states but in difficult circumstances national governments are willing to relinquish only a little of their autonomy. As a result, the Open Method of Coordination (OMC) is effectively the most important tool to achieve at least some policy convergence. The AIV agrees with the SER that there is reason to improve the method.[70] Within the EU, OMC has declined into a rather perfunctory and bureaucratic process. This is regrettable because good European coordination can have better results for the member states. Some of the benefits of national stimulus measures leak across national borders, which encourages free-riding. Since the EU as a whole forms a relatively closed economy, it need not concern itself about such leakage to countries outside the EU. Such concerns may exist, of course, in the relationship between individual member states.

IV.4 The role of the euro

The position of the euro has already been considered above. In its report *Weathering the Storm*[71] the Brussels Bruegel think-tank evaluates the euro's performance before and during the crisis. The picture is mixed.

IV.4.1 The euro before the crisis

Before the crisis, the euro had generally fostered price stability despite the fact that its performance on budgetary discipline was less favourable. There were a number of shortcomings, however. Firstly, despite the extensive mechanisms in place, it was difficult to take action against countries that had excessive budget deficits (such as Greece). This illustrates the limited effectiveness of the stability pact. Secondly, the budgetary framework did not anticipate the conversion of private debts into public debts when governments rescue private institutions. Thirdly, as the SER noted, the macro-guidelines do not consider the external dimension of the euro.[72] This is particularly disadvantageous to countries that use the euro as a reference currency but are not members of the euro group.

69 SER, 2009, op. cit., p. 41.

70 SER, 2009, op. cit., p. 73.

71 Jean Pisani-Ferry and André Sapir, 'Weathering the Storm, Fair-weather versus stormy-weather governance in the euro area',
See: <http://www.bruegel.org/nc/publications/show/category/policy-contributions/page/2.html>.

72 SER, 2009, op. cit., p. 69.

The authors of the Bruegel report also note that Europe has so far been less effective in tackling the causes of economic instability. In comparison with the provisions on budgetary deficits, article 99 of the EC Treaty offers far fewer instruments to coordinate the member states' economies. This is partly because it was incorrectly thought that budgetary stability would automatically lead to macroeconomic stability.

The provisional conclusion is therefore that although the euro has led to price stability several other mechanisms were not functioning properly even before the crisis began.

IV.4.2 The euro during the crisis

When the banking crisis broke out, it seemed that Europe was incapable of coordinating it and that each individual country would try to rescue its own banking industry. On 12 October 2009, however, the French Presidency brought the heads of government of the euro group countries together. This was particularly important because euro group meetings are usually attended by finance ministers. Attendance by the UK prime minister, Gordon Brown, was important as it established a bridge between the euro countries on the one hand and one of the world's leading financial markets on the other. This is of more than just symbolic importance. The euro countries not only have common financial interests but also share interests with the other EU members owing to the internal market for financial services. In total, €2 billion was promised in support for the financial sector.

IV.4.3 The response of the European Central Bank (ECB)

The ECB received universal praise for its response to the crisis. When the banks no longer dared to lend to each other, which immediately caused the crisis to spread to the real economy, the ECB provided the banks with large amounts of liquidity. In doing so, it fulfilled its responsibility as lender of last resort. The banks, however, immediately deposited the funds on their accounts with the ECB instead of investing it in the economy. The ECB also lowered interest rates in order to make investment as attractive as possible. Interest rates fell to their lowest level since the inception of the euro zone. In addition, the ECB took part in intensive coordination with central banks inside and outside Europe and supported several emergency aid operations outside the euro zone, for example in Iceland and Latvia (see next section). Furthermore, the ECB was closely involved in the new financial architecture of the internal market for financial services and capital, and in consultations relating to the G20, in the IMF and in the worldwide stability forum.

The AIV, too, thinks that the ECB made good use of its powers during the crisis. More specifically, the ECB's actions raised its credibility. To start with, before the crisis the ECB resisted pressure from the member states to create too much money and reduce interest rates to irresponsible levels. After the crisis broke out, however, the ECB did not hesitate to create more liquidity when it was necessary to do so. It therefore averted a systemic crisis and ensured that the money markets could continue to function.

It is important for money creation to be reversed in good time as part of the exit strategy. The ECB will increase its credibility further if it makes it clear in advance that it will reverse money creation as soon as feasible, but no sooner. The AIV agrees with the Bruegel think-tank's criticism that considering only the member states' budgetary policies is not enough. The crisis has shown, for example, that bubbles can also occur in the property market. More aspects of monetary and economic stability must be taken into account as well as budgetary policy. The CPB therefore recommends that policy concentrate more on the long-term stability or sustainability of public finances instead of on keeping a rigid grip on short-term compliance with the SGP.[73]

A recent study by the IMF[74] called on the banks to do more than just prevent inflation. The study looked at bubbles in the housing and stock markets in the past 40 years. When a bubble bursts, it is followed by a crisis, like the credit crunch. Central banks have done little if anything to prevent bubbles occurring because there was no danger of inflation. According to the IMF's researchers, the ECB, too, should have taken timely measures to ensure that borrowing remained within limits. The signs that strong growth in lending would lead to economic problems in Europe, they say, were clear for all to see. The ECB's response to such signs should have been to tighten the money market. Higher interest rates would have made loans more expensive and made it more attractive for banks to deposit their funds with a central bank, thus reducing the money supply. The AIV agrees that the ECB should take prompt action against the dangers of excessive lending.

IV.5 The euro zone and the relationship with non-euro countries

Of the ten countries in Central and Eastern Europe that joined the EU in 2004 and 2007, only Slovenia and Slovakia are members of the euro zone. The heady economic growth enjoyed by virtually all these countries following the fall of the communist regimes was brought to an abrupt end by the crisis, although they were not all affected by the financial and economic problems to the same extent. The Baltic states, Hungary and Romania were hit the hardest. The Baltic states and Bulgaria introduced currency boards to try and peg their currencies to the euro. Countries with floating exchange rates had to pay an extra high price for the fact that both private individuals and enterprises borrowed euros on a large scale owing to the low interest rate without concerning themselves with exchange rate risks. The Hungarian forint, for example, lost about a third of its value; other currencies were also affected by exchange rate fluctuations.[75]

The EU has followed a two-track strategy to solve these problems. Firstly, through the Commission it lent billions to countries such as Latvia, Hungary and Romania. Secondly, it supported the IMF's assumption of a new role in the region. This led, for example, to the combination of a €12.5 billion stand-by loan from the IMF to Hungary with phased EU support of €6.5 billion. A complicated arrangement was agreed for Latvia in which the IMF and the EU acted in concert and five EU member states and the World Bank bore part of the burden.[76] It looks as though such international support can soften the far-reaching adjustment measures that have to be taken in the countries of Central and Eastern Europe.

73 *De Grote Recessie*, p. 146.

74 See: World Economic Outlook, *Central Banks Should Move Beyond Price Stability,* Washington, IMF, 22 September 2009.

75 J. Pelkmans, op. cit., p. 23.

76 J. Pelkmans, op. cit., p. 20.

IV.6 External: trade policy

The existing state aid rules have proven their value as a means to prevent protectionism on the internal market. Through their effective and prompt application, both inside and outside the financial sector, the European Commission averted the distortion of competition on the internal market. On the world market, the pressure to take protectionist measures has been high since the beginning of the crisis. In response, the G20 undertook not to introduce any new restrictions on investments and trade in goods and services, not to impose new export barriers and not to apply export support that is inconsistent with the WTO rules (G20 Summit Declaration, The global plan for recovery and reform, London, 2 April 2009). Furthermore, it undertook to report restrictive measures to the WTO, and the WTO and other relevant international organisations were charged with monitoring the situation and publishing quarterly reports. The EU has also published a quarterly report on protectionist measures on the world market since the beginning of 2009. The transparency created by these publications has made it virtually impossible for countries to seek refuge in protectionism. A series of reports has now been published on the matter, including a joint report by the OECD, WTO and UNCTAD[77] and a report by the private Global Trade Alert organisation.[78]

The OECD/WTO/UNCTAD report and the latest Commission report conclude that there is no indication yet of 'high intensity protectionism' comparable with the beggar-thy-neighbour policies seen in the 1930s. There has been some policy slippage, however, and there is still a danger of countries succumbing to protectionist pressure as unemployment rises. Furthermore, the crisis can saddle us with non-viable industries and sectoral overcapacity. The Global Trade Alert report is far less optimistic. It argues that the G20 commitments are being systematically ignored and protectionist measures are causing widespread damage.

Since the beginning of 2009 several hundred protectionist measures have been taken throughout the world. Customs duties have been increased or introduced in many sectors; sanitary and phytosanitary rules[79] and technical trade barriers[80] have also been applied more strictly. The EU and the US have again introduced export subsidies in the dairy product sector, and indemnification and antidumping measures are increasing. Measures taken for the economic crisis may also contain aspects that distort competition such as the policy line taken by banks to grant credit to their own economies. Such measures can also provoke counter-measures.

77 WTO, OECD and UNCTAD, Report on G20 trade and investment measures, 14 September 2009.

78 Global Trade Alert, Broken promises, a G20 Summit report; see also: <http://www.globaltradealert.org/gta-analysis/broken-promises-g20-summit-report-global-trade-alert>.

79 Sanitary and phytosanitary measures are in themselves legitimate plant and animal health requirements but may represent a barrier to trade if they are misused.

80 Technical trade barriers are in themselves legitimate technical product requirements but may represent a barrier to trade if they are misused.

Nonetheless, WTO rules (and G20 agreements!) have placed effective restrictions on governments so that they do not give in to protectionist pressure. Furthermore, many trade restrictions are not by definition incompatible with the WTO. The AIV therefore concludes that a deluge of protectionist measures such as those seen in the 1930s has in any event been prevented. It cannot be denied though that protectionist measures are increasing, that most of them are being taken in the G20 countries and that growing unemployment can aggravate the situation. There is certainly no cause for self-satisfaction. We have to remain alert because the climate could change at any moment.

Protectionism must be nipped in the bud by convincing national politicians that protectionism will always boomerang, by strictly enforcing WTO rules (for example by activating the EU Market Access Strategy), by continuing the various monitoring exercises and by means of peer pressure. The most effective political signal, however, would be to bring the Doha Round to a speedy conclusion. Although the negotiations have now entered their eighth year and the tide is unfavourable, it should not be assumed that this trade round is a lost cause.

IV.7 Worldwide coordination (G20, IMF)

The AIV thinks the current crisis highlights once again just how intertwined the financial and economic markets are. Global agreements and global consultation structures are needed to tackle the crisis and build the capacity needed to prevent future crises. The need is all the more urgent in view of the fundamental imbalances in the world economic system and the realignment taking place in world economic relations with the emergence of the BRICs,[81] and China in particular. Owing to the latter development, the AIV thinks it is significant that the G20 has taken the place of the G7/8 as the leading forum for global economic, monetary and financial issues. The decisions taken during the G20 meetings, particularly those in London and Pittsburgh, on strengthening and reforming the IMF and addressing global economic imbalances are encouraging but they are no more than the first step on the road to structural reform of the international financial and economic architecture (see below).

This problem cannot be seen in isolation from the external representation of the EU/euro zone. It has already been noted that the fragmented external representation of the EU/euro zone weakens the Union's and the member states' voice in global decision-making. In view of the Union's leading position as a financial and economic power, it is vital that it has an appropriate say in decision-making. But the Union must also recognise that it is overrepresented, measured by the number of seats, in the G7/8 and the G20 and in the IMF and World Bank. The AIV therefore thinks a reform of the global financial and economic governance system would entail the EU member states having to take a step back for the benefit of the effectiveness and legitimacy of the system as a whole.[82] Ideally, there would be uniform EU representation in these forums, along the lines of that in the world trade talks, and ultimately a single seat for the EU

81 Common abbreviation for the following combination of emerging countries: Brazil, Russia, India and China.

82 The same is also true of the United States. Its veto in the IMF will not be tenable in the longer term. See, for example: Jeroen J.M. Kremers, 'Van een Amerikaans naar een gedeeld leiderschap bij het IMF en de Wereldbank', in: *Christen Democratische Verkenningen*, volume 29, summer 2009, pp. 275-280.

or the euro zone.[83] The AIV thinks such an arrangement will only be possible in the longer term. In the short and medium term, the aim should be to coordinate the action of the EU and euro member states within the international frameworks for financial and economic consultation. This will require appropriate coordination *within* the EU during preparations for international talks. The AIV thinks the presidents of the euro group and Ecofin, in close consultation with the permanent president of the European Council and the European Commission (and the ECB), have a special responsibility for this. They could also act as spokespersons for the EU at their own level. This would be a first step to 'rationalising' the external representation of the Union and its member states. The Dutch government should make the maximum possible use of its position in the IMF, World Bank, FSF/FSB, G20, etc. to clarify the external representation of the Union.[84] The Netherlands should not give up its own seat before a single EU representative can sit in the forums concerned.

IV.8 Decision: prepare an exit strategy

In a European context, an exit strategy has to be developed that gradually reverses government support for the market and facilitates a transition to a more stable financial sector. In Germany, France and possibly other countries, account must also be taken of other markets (such as the car industry). International cooperation and careful planning will be required to prevent market distortion.

Formulation of an exit strategy should make a distinction between its announcement and its implementation. It must be stated well in advance that the measures – both the member states' aid measures and the measures taken by the ECB – are temporary and will be terminated in due course. The president of the ECB, Jean-Claude Trichet, has already made it clear that facilities will not be renewed when they expire.[85]

Reference is made in the literature to the need to design an exit strategy that enables governments to slowly relax their grip on the economy.[86] Governments must not be allowed to tighten their grip on the financial markets owing to the need for security.[87]

83 See, for example: J. Pelkmans, op. cit.; Willem Molle, 'Effectiever IMF vereist institutionele hervorming', in ESB, volume 94, 26 June 2009, pp. 31-35. This would be consistent with the principle that the Union represents the member states externally in those areas in which it also has internal competence. A complication here is that the Union does not act in all areas or for all member states. The euro zone is an example of the latter as not all member states are part of it.

84 The AIV therefore supports the government's aim of the Netherlands having its own seat in the G20 on condition that it is used to improve coordination of EU action. The same consideration applies to the Dutch position in the global financial institutions. Reconsideration is acceptable only if the outcome is stronger European representation.

85 Jean-Claude Trichet, 'Europe has mapped its monetary exit', *Financial Times*, 3 September 2009. See also: 'ECB to unwind support for banks', *Financial Times*, 3 December 2009.

86 Memos to the new Commission, p. 22.

87 Martin Wolf, 'The seeds of its own destruction', in: The Future of Capitalism, *Financial Times,* 12 May 2009, pp. 6-9.

Excessive government intervention in the banking sector can lead to political considerations replacing financial and economic considerations.

It is essential that the exit strategy is coordinated across Europe, otherwise the negative impact on the economy would be even greater. Since the Treaty of Lisbon does not provide for permanent economic coordination instruments either, such coordination can only take place on an ad hoc basis. Furthermore, conflicts of interest are to be expected if the member states do not set the same priorities and do not agree on the exit strategy.

It is of cardinal importance that member states return *in due course* to the standards of the SGP. For the time being, however, powerful government stimuli will be required until economic recovery becomes visible. Although the AIV recognises the great importance of a credible exit strategy, caution should be exercised to ensure stimulus measures are not stopped before there are clear signs that private sector activity is picking up. The AIV therefore agrees with the head of the IMF, Dominique Strauss-Kahn, that 'exiting too early is costlier than exiting too late'.[88] In no event, however, may this be used as an excuse to postpone necessary restructuring measures indefinitely.

88 See his speech in London on 23 November 2009.

Annexes

Annexe I

Mr F. Korthals Altes
Chairman of the Advisory Council
on International Affairs
Postbus 20061
2500 EB Den Haag

Date 20 July 2009
Re Request for advice on the EU and the financial and economic crisis

Dear Mr Korthals Altes,

I kindly request the advice of the Advisory Council on International Affairs (AIV) on the following subject.

The European economy has been hard hit by the financial and economic crisis. The turbulence in the financial sector in the second half of 2008 and the deep recession in which the EU finds itself in 2009 demand rapid and effective European cooperation. The crisis requires coordinated emergency measures to safeguard the proper functioning of the financial system and restore the confidence of the economic players. To dampen the effects of the credit crisis on the real economy, coordinated measures for economic recovery have been decided at European level (the European Economic Recovery Plan), which are chiefly being implemented by the member states. Bearing all this in mind, I believe that it is time to make a provisional assessment of the functioning of the European institutions in this time of crisis.

The key question is whether the EU has the legal and other instruments it needs to respond adequately to a financial and economic crisis on this scale. How can possible institutional obstacles be circumvented? How effectively have the Commission and the member states interacted? Is there any way to stop individual member states from acting as ‘free-riders’?

The rapid pace of events during the crisis has raised questions about the EU’s effectiveness, and about the relationships between the various EU bodies (e.g. the Council and the Commission). Although it should be noted that the member states have primary responsibility for economic policy, they also regard their economic policies as a matter of common concern (under article 99 of the Treaty establishing the European Community). As guardian of the Treaties, the Commission has a major independent responsibility to monitor compliance with the rules of the internal market.

With regard specifically to cooperation in EMU, we may note that the financial and economic crisis has led to diverging interest rates on public debt. Furthermore, a meeting at heads of state and government level of the euro countries was held for the first time under the French Presidency. I would like to know what lessons the AIV may draw from the cooperation within EMU and what changes and improvements could be made.

With respect to the role of the EU Presidency, President Sarkozy clearly showed leadership in the course of the French Presidency. A strong Presidency seems important as a catalyst for decision-making. The rapid application of the Lisbon Treaty could also facilitate decision-making in the future. There are those however who see the intergovernmental tendencies on financial and economic issues as a downside of the strong French Presidency; the big EU countries did in fact play a more prominent role in the decision-making process.

The government requests that the AIV respond to the following questions.

- Are the EU's existing legal and other instruments sufficient to deal with the crisis at European level? Are these tools sufficient to prevent free-riding?
- In view of recent economic developments and the corresponding policy response, is improved cooperation within EMU necessary and possible?

I look forward to receiving your advisory report.

Yours sincerely,

(signed)

Maxime Verhagen
Minister of Foreign Affairs

List of abbreviations

AIV	Advisory Council on International Affairs
CPB	Netherlands Bureau for Economic Policy Analysis
EBRD	European Bank for Reconstruction and Development
ECB	European Central Bank
Ecofin	EU Economic and Financial Affairs Council
ECSC	European Coal and Steel Community
EIB	European Investment Bank
EMU	Economic and Monetary Union
ESAs	European Supervisory Authorities
ESCB	European System of Central Banks
ESFR	European System of Financial Regulators
ESFS	European System of Financial Supervisors
ESRB	European Systemic Risk Board
EU	European Union
FSAP	Financial Services Action Plan
FSF/FSB	Financial Stability Forum/Financial Stability Board
GDP	Gross Domestic Product
GNP	Gross National Product
IMF	International Monetary Fund
OECD	Organisation for Economic Cooperation and Development
OMC	Open Method of Coordination
SER	Social and Economic Council of the Netherlands
SGP	Stability and Growth Pact
TEC	Treaty establishing the European Community
TFEU	Treaty on the Functioning of the European Union
UK	United Kingdom
UNCTAD	UN Conference on Trade and Development
WTO	World Trade Organisation

Previous reports published by the Advisory Council on International Affairs

1 AN INCLUSIVE EUROPE, *October 1997*
2 CONVENTIONAL ARMS CONTROL: urgent need, limited opportunities, *April 1998*
3 CAPITAL PUNISHMENT AND HUMAN RIGHTS: recent developments, *April 1998*
4 UNIVERSALITY OF HUMAN RIGHTS AND CULTURAL DIVERSITY, *June 1998*
5 AN INCLUSIVE EUROPE II, *November 1998*
6 HUMANITARIAN AID: redefining the limits, *November 1998*
7 COMMENTS ON THE CRITERIA FOR STRUCTURAL BILATERAL AID, *November 1998*
8 ASYLUM INFORMATION AND THE EUROPEAN UNION, *July 1999*
9 TOWARDS CALMER WATERS: a report on relations between Turkey and the European Union, *July 1999*
10 DEVELOPMENTS IN THE INTERNATIONAL SECURITY SITUATION IN THE 1990s: from unsafe security to unsecured safety, *September 1999*
11 THE FUNCTIONING OF THE UNITED NATIONS COMMISSION ON HUMAN RIGHTS, *September 1999*
12 THE IGC AND BEYOND: TOWARDS A EUROPEAN UNION OF THIRTY MEMBER STATES, *January 2000*
13 HUMANITARIAN INTERVENTION, *April 2000**
14 KEY LESSONS FROM THE FINANCIAL CRISES OF 1997 AND 1998, *April 2000*
15 A EUROPEAN CHARTER OF FUNDAMENTAL RIGHTS?, *May 2000*
16 DEFENCE RESEARCH AND PARLIAMENTARY SCRUTINY, *December 2000*
17 AFRICA'S STRUGGLE: security, stability and development, *January 2001*
18 VIOLENCE AGAINST WOMEN: LEGAL DEVELOPMENTS, *February 2001*
19 A MULTI-TIERED EUROPE: the relationship between the European Union and subnational authorities, *May 2001*
20 EUROPEAN MILITARY-INDUSTRIAL COOPERATION, *May 2001*
21 REGISTRATION OF COMMUNITIES BASED ON RELIGION OR BELIEF, *June 2001*
22 THE WORLD CONFERENCE AGAINST RACISM AND THE RIGHT TO REPARATION, *June 2001*
23 COMMENTARY ON THE 2001 MEMORANDUM ON HUMAN RIGHTS POLICY, *September 2001*
24 A CONVENTION, OR CONVENTIONAL PREPARATIONS? The European Union and the ICG 2004, *November 2001*
25 INTEGRATION OF GENDER EQUALITY: a matter of responsibility, commitment and quality, *January 2002*
26 THE NETHERLANDS AND THE ORGANISATION FOR SECURITY AND COOPERATION IN EUROPE IN 2003: role and direction, *May 2002*
27 BRIDGING THE GAP BETWEEN CITIZENS AND BRUSSELS: towards greater legitimacy and effectiveness for the European Union, *May 2002*
28 AN ANALYSIS OF THE US MISSILE DEFENCE PLANS: pros and cons of striving for invulnerability, *August 2002*
29 PRO-POOR GROWTH IN THE BILATERAL PARTNER COUNTRIES IN SUB-SAHARAN AFRICA: an analysis of poverty reduction strategies, *January 2003*
30 A HUMAN RIGHTS BASED APPROACH TO DEVELOPMENT COOPERATION, *April 2003*
31 MILITARY COOPERATION IN EUROPE: possibilities and limitations, *April 2003*
32 BRIDGING THE GAP BETWEEN CITIZENS AND BRUSSELS: towards greater legitimacy and effectiveness for the European Union, *April 2003*
33 THE COUNCIL OF EUROPE: less can be more, *October 2003*
34 THE NETHERLANDS AND CRISIS MANAGEMENT: three issues of current interest, *March 2004*
35 FAILING STATES: a global responsibility, *May 2004**
36 PRE-EMPTIVE ACTION, *July 2004**
37 TURKEY: towards membership of the European Union, *July 2004*
38 THE UNITED NATIONS AND HUMAN RIGHTS, *September 2004*
39 SERVICES LIBERALISATION AND DEVELOPING COUNTRIES: does liberalisation produce deprivation?, *September 2004*
40 THE PARLIAMENTARY ASSEMBLY OF THE COUNCIL OF EUROPE, *February 2005*
41 REFORMING THE UNITED NATIONS: A closer look at the Annan report, *May 2005*
42 THE INFLUENCE OF CULTURE AND RELIGION ON DEVELOPMENT: Stimulus or stagnation?, *June 2005*
43 MIGRATION AND DEVELOPMENT COOPERATION: coherence between two policy areas, *June 2005*
44 THE EUROPEAN UNION'S NEW EASTERN NEIGHBOURS: *July 2005*
45 THE NETHERLANDS IN A CHANGING EU, NATO AND UN, *July 2005*
46 ENERGISED FOREIGN POLICY: security of energy supply as a new key objective, *December 2005***
47 THE NUCLEAR NON-PROLIFERATION REGIME: The importance of an integrated and multilateral approach, *January 2006*

48 SOCIETY AND THE ARMED FORCES, *April 2006*
49 COUNTERTERRORISM FROM AN INTERNATIONAL AND EUROPEAN PERSPECTIVE, *September 2006*
50 PRIVATE SECTOR DEVELOPMENT AND POVERTY REDUCTION, *October 2006*
51 THE ROLE OF NGOS AND THE PRIVATE SECTOR IN INTERNATIONAL RELATIONS, *October 2006*
52 EUROPE A PRIORITY!, *November 2006*
53 THE BENELUX: THE BENEFITS AND NECESSITY OF ENHANCED COOPERATION, *February 2007*
54 THE OECD OF THE FUTURE, *March 2007*
55 CHINA IN THE BALANCE: towards a mature relationship, *April 2007*
56 DEPLOYMENT OF THE ARMED FORCES: interaction between national and international decision-making, *May 2007*
57 THE UN HUMAN RIGHTS TREATY SYSTEM: strengthening the system step by step in a politically charged context, *July 2007*
58 THE FINANCES OF THE EUROPEAN UNION, *December 2007*
59 EMPLOYING PRIVATE MILITARY COMPANIES: a question of responsibility, *December 2007*
60 THE NETHERLANDS AND EUROPEAN DEVELOPMENT POLICY, *May 2008*
61 COOPERATION BETWEEN THE EUROPEAN UNION AND RUSSIA: a matter of mutual interest, *July 2008*
62 CLIMATE, ENERGY AND POVERTY REDUCTION, *November 2008*
63 UNIVERSALITY OF HUMAN RIGHTS: principles, practice and prospects, *November 2008*
64 CRISIS MANAGEMENT OPERATIONS IN FRAGILE STATES: the need for a coherent approach, *March 2009*
65 TRANSITIONAL JUSTICE: justice and peace in situations of transition, *April 2009**
66 DEMOGRAPHIC CHANGES AND DEVELOPMENT COOPERATION, *July 2009*
67 NATO'S NEW STRATEGIC CONCEPT, *January 2010*

Advisory letters issued by the Advisory Council on International Affairs

1 Advisory letter THE ENLARGEMENT OF THE EUROPEAN UNION, *December 1997*
2 Advisory letter THE UN COMMITTEE AGAINST TORTURE, *July 1999*
3 Advisory letter THE CHARTER OF FUNDAMENTAL RIGHTS, *November 2000*
4 Advisory letter ON THE FUTURE OF THE EUROPEAN UNION, *November 2001*
5 Advisory letter THE DUTCH PRESIDENCY OF THE EU IN 2004, *May 2003****
6 Advisory letter THE RESULTS OF THE CONVENTION ON THE FUTURE OF EUROPE, *August 2003*
7 Advisory letter FROM INTERNAL TO EXTERNAL BORDERS. Recommendations for developing a common European asylum and immigration policy by 2009, *March 2004*
8 Advisory letter THE DRAFT DECLARATION ON THE RIGHTS OF INDIGENOUS PEOPLES: from Deadlock to Breakthrough?, *September 2004*
9 Advisory letter OBSERVATIONS ON THE SACHS REPORT: How do we attain the Millennium Development Goals?, *April 2005*
10 Advisory letter THE EUROPEAN UNION AND ITS RELATIONS WITH THE DUTCH CITIZENS, *December 2005*
11 Advisory letter COUNTERTERRORISM IN A EUROPEAN AND INTERNATIONAL PERSPECTIVE: interim report on the prohibition of torture, *December 2005*
12 Advisory letter RESPONSE TO THE 2007 HUMAN RIGHTS STRATEGY, *November 2007*
13 Advisory letter AN OMBUDSMAN FOR DEVELOPMENT COOPERATION, *December 2007*
14 Advisory letter CLIMATE CHANGE AND SECURITY, *January 2009*
15 Advisory letter THE EASTERN PARTNERSHIP, *February 2009*
16 Advisory letter DEVELOPMENT COOPERATION, The benefit of and need for public support, *May 2009*

* Issued jointly by the Advisory Council on International Affairs (AIV) and the Advisory Committee on Issues of Public International Law (CAVV).

** Joint report by the Advisory Council on International Affairs (AIV) and the General Energy Council.

*** Joint report by the Advisory Council on International Affairs (AIV) and the Advisory Committee on Aliens Affairs (ACVZ).