Treaty Constraints, Power and Creativity in the EU's Handling of the Financial and Economic Crisis

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Introduction

The financial and economic crisis of 2008–2010 constituted a unique challenge to the economic-financial governance of the European Union. On the one hand, economic and fiscal policies remain national competencies of the Member States. On the other, the latter exercise these within an EU system of non-discrimination, solidarity and mutual co-ordination, with seventeen of the Member States sharing a common currency and common monetary policy. These central elements of the EU's economic and financial governance were all challenged by the deep crisis of large parts of the financial system, by economic recession and unemployment, and by an exploding public debt in the Member States.

The scale of this crisis gave national political leaders strong incentives to concentrate primarily on battling their economies' slide into recession, and only in the second place on respecting – not to mention deepening – the EU's economic governance. How does one prevent domestic crisis-management from damaging European integration? How do we assess the added value of EU integration and take advantage of it in anti-crisis policy? Can the crisis favour new advances in European Union building? These are questions which merit closer analysis in assessing the EU's reaction to the crisis.

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

It is true that the first waves of policy reactions in the EU in the fall of 2008 and in January 2009 were marked by discord about common approaches and by Member States' preference for differentiated national strategies. As a result, the pessimism about further integration perspectives in EMU appeared to be confirmed. But these were the first waves of policy reactions. At that moment and in the following months, contradictory expectations dominated the public debate. There were voices that warned against the disintegrative dynamics that might result and endanger the cohesion of the single market and even the survival of today's Monetary Union. The euro-sceptics' vision of the 1990s came back to mind, which saw – in a monetary union without the resource transfers of true fiscal federalism – the rigor of a common stability-oriented monetary policy provoking social and political unrest in the less competitive euro-countries, which would in the end drive them out of the euro zone. But other voices maintained that today's integration levels in the EU can no longer be put into real jeopardy and that a further deepening of economic and financial policy integration was in the end much more likely to result from the financial crisis.

How can this question be addressed? Keeping the contrasting scenarios for EU economic governance in mind, as the grand reference frame for answering the question asked in this article's title, the inquiry had nonetheless to be conducted at a more technical level. First, this article focuses on the banks, and especially on cross-border banks in the EU. In Europe there are around 5,000 banks (compared to 8,000 in the United

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States). Of that number, the great majority are small and medium-sized domestic – frequently regional – institutions. They face around forty cross-border groups representing almost 70 percent of the European market. These groups saw dramatic asset growth: in excess of 50 percent between 2001 and 2005 according to de Larosière in a recent speech to the Belgian Financial Forum on 22 January 2010.

Secondly, the article looks at a number of distinct activities which the EU governments and institutions have undertaken at the financial and economic policy level to counteract the detrimental effects of the financial and economic crisis and prevent its repetition. They were inspired by Nobel laureate Paul Krugman, in an approach shared by many of his colleagues. He pointed to *three* necessary and consecutive steps, addressing three distinct, but differently urgent, aspects of the crisis. Governments and EU institutions should:

- end the quasi-freeze of the global credit system and get credit (especially inter-bank credit) flowing again by bailing out banks;
- contain the global slump by applying 'good old Keynesian fiscal stimulus'; and
- reform the weaknesses of the financial system regulation, which made this crisis possible, limiting the measures to the supervision, regulation and restructuring of banks, especially cross-border banks, in Europe.

Given that our analysis deals with the challenge which the financial crisis poses to European integration, a fourth aspect concerns the effects on its monetary centrepiece, the euro system:

- Governments and the ESCB must deal with the threat of the debt crisis or even a state insolvency in one of the euro states. How to react, given the stability-obligation of ESCB-monetary policy and the no-bailout rule of the Treaty?

The overarching question concerns the challenge posed to European integration by the global financial crisis and especially in the banking sector: will the *acquis* be preserved, will integration regress or will it advance and deepen? In January 2011, we can give a provisional first general answer to this question. In sum it is positive: in the process of reacting to the crisis, EU integration tends to preserve its most central *acquis*, its institutions and procedures tend to advance in integration, rather than to regress. Nevertheless, the European strategies for a number of important issues are still not far enough advanced to permit a definite answer to our question.

First phase of reactions to the crisis by the Member States and the EU

After the full outbreak of the crisis with the Lehman Brothers insolvency in the fall of 2008, EU member governments assembled in the Council to reach agreement on a common approach. The European Commission started the debate about an adequate common reaction only after a first series of divergent national measures had already been taken, mainly in the field of bank rescue.

The eurozone member governments took the initiative in a series of Council sessions from September 2008. On 12 October 2008 they met for the first time ever at the European Council level, whereas they normally meet at the ECOFIN ministers' level only. They were the most active and constructive actors at this early moment. this is especially true of the French government that held the Council presidency in the fall of 2008.

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

Strengthening supervision: Insufficient supervision had quickly been identified as an important Achilles heel of the European financial system. This applied especially at the macro level. No dedicated institutions existed which were able to give timely alert to financial market authorities, about the emergence of systemically relevant risks to financial market stability (for instance concerning the growth of 'market bubbles'). Transnational supervision existed at the micro level, as for the business practice of cross-border banks, but with many deficiencies. National supervisors cooperated insufficiently, and the more important the stakes were for the different host states, the less effective this cooperation became.

Confronting the sovereign debt crisis: The first appearance ever, of an open sovereign debt crisis in the EU and in the euro area (Greece in the first three months of 2009), showed the complete absence of any institutional provisions for that kind of case, at the EU level. In a first phase, this crisis only provoked a far flung and already divisive debate about the different approaches *vis-à-vis* affected EU Member States, between more or less explicit, and 'europeanised', solidarity. The possibility of a sovereign 'insolvency' was not yet mentioned officially.

Preserving the level playing field on the internal market: On the other hand, the tools of EU rules on competition, or the control and authorisation of state aid, were ready to be applied when national strategies for the rescue of distressed banks and the stimulation of economic activity violated EU rules for the Internal Market. The Commission quickly started to apply these rules. But soon it had to acquiesce in a rare degree of Member States' participation, pressuring it to establish the 'stability of the financial system' as a first key criterion of its intervention, besides the objective of the level playing field of the Internal Market.

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

These initial reactions to the crisis by the Member States and the European Union are not surprising. In fact, they reflect exactly the distribution of competences at this moment, as fixed by the Nice version of the EC Treaty:[1]

1. For monetary policy in the euro area, full EU level competence lies with the European System of Central Banks. For investment credit at the EU level, the European Investment Bank stands ready.
2. For preserving the level playing field in the Internal Market, it is the European Commission which is vested with a set of established EU level competences for protecting competition and preventing or authorising state aid. The Directorate General for Competition (DG Competition) wields these instruments with authority and effectiveness.
3. An institutional supervision of banks' activity, as to systemic risk at the euro area level, did not exist. In contrast, it does for the compliance with a number of micro-level EU-directives implementing an internal financial market with the freedom of establishment for banks. In principle, the Member States implement these directives, with the Commission supervising adequate implementation. In one of its first strategic actions, in the fall of 2008, the European Commission acknowledged the inadequacy of the system and commissioned a report on the future of European financial regulation and supervisions, from a group headed by Jacques de Larosière.
4. Concerning public debt crises or the insolvency of Euro Member States, the EU Treaty does not mention them expressly. But it does accept the possibility, by explicitly forbidding the bail-out of sovereign debtors in the euro zone by Member States and central banks.
5. For aiding or rescuing distressed banks, on the other hand, the respective home country governments were (and still are) responsible, following different national legislation. EU rules only set up a framework, controlling for compliance with EU competition and state aid rules. The ECB did its part with drastically lowered interest rates and quantitative monetary easing. A minimal set of common criteria was set up by the Council decisions of October 2008.
6. Finally, the stimulation of national economies by *fiscal policy* remains in full national competence, with the Treaty only setting minimal limits to this autonomy with a demand for non-binding participation in a loose co-ordination effort.[2] In the fall of 2008, the Council could only establish a minimum of additional rules, with a short list of criteria to respect. One EU actor, the European Investment Bank, exists for EU sponsored investment credit. In contrast, the instruments of *monetary policy* stimulation are fully 'europeanised', concentrated in the European Central Bank. The ECB could and did act early on with lowering interest rates and with expanding its refinancing operations, according to its assessment of the situation, and its perceived obligations and competences under the Treaty.

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

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

Second phase of reactions to the crisis by Member States and the EU

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

1. Concerning monetary policy in the euro area, the ECB's status was preserved and confirmed and its instruments and their scope further developed.
2. For the control of competition and state aid, directed by the Commission's DG Competition, the powerful status of the latter has been confirmed as well. Even so, important qualifications for its role in this crisis had already been demanded by the Council in October 2008. The Commission quickly implemented them. As a consequence, the DG Competition has had to take a broader approach to its cases, and take issues of financial stability and Member States' economic situations and interests more explicitly into consideration.[3]

> *13 10 2008* – State aid: Commission gives guidance to Member States on measures for banks in crisis (state guarantees), IP/08/1495
>
> *08 12 2008* – State aid: Commission adopts guidance on bank recapitalisation in current financial crisis to boost credit flows to real economy, IP/08/1901
>
> *25 02 2009* – State aid: Commission provides guidance for the treatment of impaired assets in the EU banking sector, IP/09/322
>
> *23 07 2009* – State aid: Commission presents guidelines on restructuring aid to banks, IP/09/1180

3. Supervision of banks at EU level is substantially strengthened, together with the role of the European Central Bank and the Commission. Both play an important part in the construction of the innovative institutions ESRB and ESA, established for a first-ever EU level supervision at the macro-level, and for a more effective supervision at the micro-level of banks and other financial market actors.

> In the words of the regulations, which established these bodies, the main objective of the ESFS shall be to ensure that the rules applicable to the financial sector are adequately implemented to preserve financial stability and to ensure confidence in the financial system as a whole and sufficient protection for the customers of financial services.
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> The ESFS shall comprise the following:
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> (a) the European Systemic Risk Board (ESRB), for the purposes of the tasks as specified in Regulation (EU) No 1092/2010 and this Regulation;
> (b) the European Supervisory Authority (European Banking Authority) established by Regulation (EU) No 1093/2010 of the European Parliament and of the Council;
> (c) the European Supervisory Authority (European Insurance and Occupational Pensions Authority) established by Regulation (EU) No 1094/2010 of the European Parliament and of the Council;
> (d) the European Supervisory Authority (European Securities and Markets Authority) established by Regulation (EU) No 1095/2010 of the European Parliament and of the Council;
> (e) the Joint Committee of the European Supervisory Authorities (Joint Committee) for the purposes of carrying out the tasks as specified in Articles 54 to 57 of this Regulation, of Regulation (EU) No 1094/2010 and of Regulation (EU) No 1095/2010; and
> (f) the competent or supervisory authorities in the Member States as specified in the Union acts referred to in Article 1(2) of this Regulation, of Regulation (EU) No 1094/2010 and of Regulation (EU) No 1095/2010.

4. The first-time threat of sovereign default of an euro Member State *(€-MS)* has provoked the biggest advance of all, towards the uncharted waters of binding fiscal policy intervention *vis-à-vis* over-indebted eurozone members, flanked by the introduction of a gigantic bailout mechanism financed by the EU, its Member States and the IMF. The Greek and Irish bail-outs are the first life-size experiments for this new structure. As yet, these innovations are conceived only as 3-year emergency regimes for resolving the affected eurozone members' public debt crises, to be supplemented by a more robust framework for (sovereign debt) crisis resolution, attached to the existing but re-enforced Stability and Growth Pact (SGP). They may well permanently re-structure the whole set of rules and institutions governing the fiscal policy co-ordination between eurozone members. By the end of 2010 the first drafts for a change in the SGP and a crisis resolution were on the

[3] For the control of state aid by the Commission *vis-à-vis* the Banking Crisis, see Doleys (2010); Gibson-Bolton and Reiss (2010).

Council table.[4] In the context of this change, the European Central Bank has assumed a role as lender and bailer-out of last resort – even though indirectly– for illiquid €-MS governments, effectively dumping the no-bailout rule also on its part.[5] Market pressure against over-indebted governments could be usefully harnessed, but would hopefully not be removed by these new EU-level institutions.

5. The Commission is trying to extend EU competence in banking legislation, especially by creating an *ex-ante* rule book for aiding or rescuing distressed banks, especially cross-border banks. But in the best-case scenario, only limited progress is foreseeable for EU-level procedures or institutions, consisting of further rapprochement and co-ordination of national legislation and of national banking emergency tools. Integration will advance only in small steps. Relative to the market break-up in 2008–09, these steps may well be too small to re-establish the pre-crisis freedom of movement and establishment of banks in the single market.[6] Its most important symbol, the 'single passport', may not survive.
6. Finally, the direction of economic policy formally remains in national competence. Even so, collectively the EU Member States have delivered a very voluminous fiscal policy stimulus. And they have divided it up according to their respective ability, and not according to their GDP shares, a step of further increased *de-facto* intra EU solidarity – as suggested by the common criteria of the fall of 2008. On 6 October 2008 the euro group agreed on common principles for stimuli: they must be timely, temporary and targeted. The European Commission submitted its proposals on 26 November 2008. The European Council, in its session of 11–12 December 2008, accepted this Commission framework called a 'European Economic Recovery Plan (EERP)'. Especially for the activation of the EU's own budgetary and credit facilities, it set binding new quantitative and qualitative objectives. For the vastly more important national measures of the Member States (a) it stipulated a fiscal policy response equal to 1.5 percent of the EU's GDP in 2009–10, (b) all measures were to be timely, temporary and targeted, and (c) the response was to be differentiated in accordance with the availability of fiscal scope.

   Concerning the European Investment Bank, there was a drastic expansion of its credit volume of almost 60 percent in 2008–09, a volume which may in large part remain in place after the crisis situation, and strengthen the EU's funding power.

   In 2010 the wind-down of stimulus measures moved to the fore, and here the established Eurosystem Stability and Growth Pact competences for correcting excessive deficit and debt did give formal co-ordination powers to the EU-level institutions and procedures – but as yet no 'bite'. Even so, these competences have been utilised since early spring 2010. Concerning monetary policy stimulation, competence is concentrated at the ESCB, i.e. at EU level. The ECB has meanwhile started to withdraw liquidity as required by the coming stimulus 'wind-down'.

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

Remaining questions

Even so, important question marks remain. Firstly, concerning policies in the competence of the European Union already before 2008: here the common denominator of many of the advances (and even of the preservation) of the established level of European co-operation and integration has been that supranational institutions were bound more closely into a strategy defined and directed by intergovernmental decision-making at the Council level. The specific rule-sets designed to safeguard the autonomy of supranational institutions and their specific role in the execution of the tasks at hand, appear to have been partly sidelined in this process.

Secondly, concerning the policies in the competence of the Member States before 2008: here, important advances in policy cooperation (or co-ordination) are being made while trying to avoid all transfers of competences from the national to the Community level and to conserve the distribution of powers. The Member States circumvent those institutions and decision-making methods specific to community type integration and in the process renounce the advantages it can confer for effectiveness and speed of common action. Advancing in that manner can, for instance, entail sidelining the European Commission

[4] For the re-enforced SGP, see European Council (2010).
[5] Sinn and Carstensen (2010) give a good summary of the bail-out measures taken by the ECB and of certain modifications of its role to be envisaged for preventing a perpetuation of this practice.
[6] See the very modest advances made between the first communication of the European Commission on the issue (20 October 2009, COM(2009) 561/4), and the second one of October 2010 (COM (2010) 579 final).

or limiting it to a secretarial role, or having to find original new ways of having Member States co-operate to reach a given common objective.

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

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

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

The EU's actors in crisis policy

The principal actors involved in EU reactions to the crisis include:

- Member States (especially those of the euro area) assembled in the European Council
- The European Parliament
- The European Commission
- The European Central Bank
- The European Investment Bank.

Summing up the actors' record in crisis policy at this point is all the more important as roles and the relative influence of the actors have changed during the battle with the crisis. As the crisis is not yet over, these changes have not yet ended either. In fact, the extension of the crisis to that of sovereign debt is affecting actors in different but not less serious manner, and has caused the creation of new EU institutions in its turn.

The relative distribution of powers between the different EU institutions and the principles guiding their work, viz. on the supranational and the intergovernmental levels, has remained formally unchanged. But in fact, new policy co-ordination became urgently necessary in fields which had remained under national competence such as bank rescue and insolvency law, fiscal stimulation and public borrowing. Here, initiatives and first co-ordination steps necessitated a strong investment of Member State initiative at the intergovernmental level.

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

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

Fiscal and economic governance within the Monetary Union

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

Judging by the decisions of 2010 and early 2011, a few preliminary conclusions may be drawn on the outcomes:

1. As to the forum for formulating the proposals, the Member States assumed control by creating the Van Rompuy task force composed mainly of national ministers of finance, with the Commission and the ECB only entitled to 'inputs', alongside the Member States. Even among the members of this limited group there has been a massive difference of influence to the advantage of certain large Member States (France and Germany).
2. As to the respective roles of the actors, clear differences would result depending on the weight of two mechanisms:
   (a) Enhancing the Stability and Growth Pact (SGP): on the one hand, the governments assembled in the Councils and especially the European Council (full and euro group members) have further strengthened their innovative role even in the EMU domain, *vis-à-vis* Commission and ECB, confirming previous developments. This also showed in the negotiations about the reformed SGP. On the other hand, in implementing the reformed SGP (according to the present drafts), the Commission would gain considerable additional power by making more – and more consequential – assessments, and recommendations, on the rule-conformity of Member States' fiscal policies, and on sanctioning their non-compliance.
   (b) Creating an orderly debt restructuring: in case that the orderly debt restructuring became a credible instrument of EU's fiscal-economic governance, the whole procedure of the sharpened SGP with its enhanced Commission competences could lose much of its importance. Governments could well pay more attention to sovereign bond yields than to the preventive and the corrective arm of the SGP. Depending on the relative success of these two components of new financial and economic governance of the euro area, either of the two might lose importance relative to the other. The integration advance resulting out of this governance reform might indeed take very different paths in the future.

A short and anticipatory look at the other policy domains shows the Member States in the driver's seat also elsewhere, like in EU-wide innovations in common economic and financial policy making where it involves the supranational institutions. The Council strove to determine the direction and the guidelines of EU action down to the point of defining the place which the Commission or the ECB should assume in it. The letter and the spirit of the Treaty rules defining the two institutions' role *vis-à-vis* the Member States sometimes took second rank. It is true that in sum this tended to re-define the division of powers between EU institutions, in financial and economic policies, to the advantage of the Council and Member States. This process had not ended by January 2011.

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

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

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

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

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

Finally, the European Central Bank has at once proved itself an adept operator of its monetary policy competences, but also a dramatic innovator. It has gone up to and for many beyond, the limits of what the EU Treaty permits, assuming the role of the euro area's lender of last resort and even of Member States' bail-out. These unquestionable advances in the 'europeanisation' of euro Member States' sovereign risk certainly also constitute advances in European integration. But they also appear to endanger the strong institutional and financial position of the European Central Bank which gives it its dominant monetary policy role in the first place. At the end of 2010 the ECB has appeared to look for an exit from its excessive bail-out engagements.

Here, as for the Commission, a definite assessment of the changes will only be possible in a few years' time.

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