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Ivanka Petkova[1]

ATTEMPTS OF THE EUROPEAN UNION TO CONTAIN THE FINANCIAL CRISIS

This paper centers on how after banks in mature economies worldwide failed to manage risk and allocating capital properly, both single national and joint efforts of the EU (with special focus on the Eurozone) were channeled to control the deepening financial crisis since September 2008.
The paper is analyzing the reasons for the financial crisis, simultaneously reviewing the discussions on the profound changes in the global financial system in recent years focusing on the excess capacities created in the system and their consequences (the more rapid growth in financial assets compared to the growth in global GDP, the new institutional structure, complexity in financial instruments, increased counterparty risks etc.). The evolvement of the crisis is presented.
The challenges to the implementation of the USA bail-out program as a response to the crisis are examined. Investigating the common and individual efforts in the EU to control the crisis the decisions of the emergency summit of euro zones nations, the national rescue plans of euro-zone and non-euro-zone countries are studied. The EU stimulus package is evaluated, creating a greater flexibility of Eurozone countries with the Stability and Growth Pact, showing the big differences in the fiscal stances of individual countries, their impact on the contributions to the plan, and the heterogeneity of measures to be applied. Special attention has been put on the recapitalization schemes, the issue on state aid and their long-term impact within the EU. The outcomes of the meeting of G20 are also considered. On the basis of the study main concluding remarks have been drawn.
JEL: E58, F02, G15, G28

Introduction

The 2007-2008 global financial crisis has thrown up several issues for discussion. As the credit crunch has evolved into one of the most economic downturns in history it turned also to a challenge to policy action both of individual countries and the European Union (EU).

At the beginning of October 2008 the European Commission (EC) recognized the gravity of the economic situation in the United States and affirmed his confidence, that the financial system of the European Union can cope and has the ability to respond (Press Releases, SPEECH/08/479, 2008).

[1] *Ivanka Petkova is PhD, Director of Economic Policy Institute.*

The first "truly European response" to the US financial crisis proposed by the EC, consisted of plans to strengthen the stability of the financial system across the Union. It envisaged amending the EU regulation on capital requirements for banks (Capital Requirements Directives 2006/48/EC and 2006/49/EC) (Press Release, IP/08/14333, 2008), refining the rules (including accounting rules) on evaluating complex assets; improving the deposit guarantee schemes; increasing the transparency of executive pay; and stressing the EU commitment to increase economic growth and employment rates (Press Releases, SPEECH/08/479, 2008).

This paper deals with the policy reactions towards the crisis, focusing mainly on the European Union's measures (both joint and those of individual member countries) to contain its negative economic implications.

1. Main causes of the crisis

The 2007-2008 global financial crisis reflects dramatic changes in the financial system in recent years and have stimulated an extensive literature on the main reasons and determinants for the brewing of the financial crisis.

Analyzing the causes and putting aside the current forms the crisis is taking, it becomes evident that there is a deeper reason bringing the global financial system into the current crisis. Some authors (Hummler, K. 2008b) suggest that the reason is the long lasting backing of the financial system by implicit state guarantees aimed at avoiding big institutions to fail. According to some assessments (Hummler, K. 2008b), as a result of such subventions overcapacities in the range of 30 to 50% were created or preserved in the financial sector. During the last months these overcapacities have started to be thrown away from the market through new shocks. It became clear that the problem does not stem from the US mortgage market only, but it is a global problem centered in the Western industrialized countries. Currently, this global problem is revealed in the unprecedented lost of trust among banking institutions (Hummler, K. 2008b).

Several problems were manifested as a result of maintaining of excess capacities in the financial sector.

First, the total value of the world's financial assets grew faster in 2006 at 17% to reach $167 trillion from $142 trillion in 2005. In 2006 the growth in global financial assets was "equity driven". The value of the world's equities went up by $9 trillion representing a 20% growth at constant exchange rates, accounting for nearly half the total increase in financial assets. The growth in financial assets outpaced the growth in global GDP. In 2006 world financial depth (ratio of financial assets to global GDP) increased by 350%. (McKinsey Fourth Annual Report, (2008) Even earlier, (end of 2003) foreign bank assets accounted for 130 percent of world GDP (Schertler, A., C. M. Buch and K. Carstensen, 2006). In 2006 cross-border capital flows grew to USD 8.2 trillion with the euro zone accounting half the growth. In the past decade USA, Euro zone and UK accounted for 80% of growth in global capital flows (McKinsey Fourth Annual Report, 2008). There are at least two considerations

as regards such remarkable changes. The first one concerns the behavior of private recipients. Private recipients of capital inflows do not internalize the idea that: a) every capital inflow entails future outflows which could have impacts on the financial system as a whole and b) such outflows lead to a general macroeconomic tightening of liquidity in states of nature when international borrowing constraints are binding (such as during financial crisis). Second, the financial linkages created by these flows are a potential channel through which domestic shocks are transmitted between countries.

Second, the changes centered also in the institutional framework and kinds of activities of the financial system. In the past, financial distress was always a classical banking issue. Only a few decades ago, financial systems were primarily based banking institutions. The key reason for financial distress of such systems was a temporal mismatch between assets (long-term and illiquid) and liabilities (short-term and liquid at par). Thus, crises were frequently driven by (often sudden) losses in confidence in the system. The spreading out of bank runs was the main concern, and new lending tended to stop. These crises would typically take place after a phase of fast and somewhat loose growth in loan books (Fraga, A., 2008) Nowadays, in addition to banks, in the financial systems there are pension funds, endowments, hedge funds, private equity funds and other entities all playing important roles in the movement of capital flows. The big fear was of this new world getting hit by a shock and responding badly as positions are liquidated in disorderly fashion (Fraga, A., 2008).

Third, excess capacities in the global financial markets increased competition, boosted innovation and increased complexity in financial instruments. The intensive use of derivatives, securitization and other risk-transfer mechanisms, increased the complexity of the financial system. In the USA, credit derivatives contracts grew rapidly at a 100% compounded annual growth rate over 2003 to 2007 (OCC's Quarterly Report, 2008). Dealers increasingly used them to structure securities to help meet investor demand for higher yields. Credit default swaps represented the dominant product at 99% of all credit derivatives. It is to be mentioned that derivatives activity in the U.S. banking system is highly concentrated, dominated by a small group of large financial institutions. Five large commercial banks represented 97% of the total industry notional amount and 89% of industry net credit exposure estimations (OCC's Quarterly Report, 2008). Last few years nearly half of the growth in the commercial paper market was due to the expansion of mortgage related asset-backed commercial paper (ABCP) issuance. The issuance of ABCP at short maturities was used by conduits and structured investment vehicles (SIVs) to fund the purchases of collateralized debt obligations (CDOs) and other securitized assets. Within 10 years, the CDOs had become a major force in the derivatives market, in which the value of a derivative is "derived" from the value of other assets. Unlike some fairly straightforward derivatives such as options, calls and credit default swaps, CDOs are more complicated instruments. In a CDO, an investment bank collects a series of assets like high-yield junk bonds, mortgage-backed securities, credit-default swaps and other high-risk, high-yield products from the fixed-income market. The investment bank then creates a corporate structure (special purpose vehicle, SPV) to issue the CDOs and distribute the cash flows from

those assets to investors in the CDO. As the ABCPs need to be rolled over periodically, it put pressure on banks' liquidity after mid 2007. It became evident, that the ABCP market has proved an unreliable source of liquidity to banks. Investors began avoiding the purchase of short-term paper in the capital markets and the ABCP issuance was sharply reduced. In September 2007, all types of asset-backed securities and CDOs suffered a sharp drop in the issuance (Stock Market Investors, Wealth Begins with Better Knowledge, 2008). Investors began to realize that these assets were much riskier than what they originally thought.

Fourth, counterparty risks have been covered by derivatives. The instrument of credit default swaps (CDSs) was extensively applied in order to cover counterparty risks. These instruments grew very fast since 2006:

Estimations on the OTC market in CDSs
(contracts outstanding worldwide)

December 2005	December 2006	June 2007	end of 2007	September 2008
$13.9 trillion	$28.9 trillion	$42.6 trillion	$45 trillion	$58 trillion

Source: BIS, The New York Times, 17 Feb 2008, US SEC.

The insurance for covering default risk using credit default swaps (CDS) became very costly which further made asset backed securities issues more difficult to sell. With the help of these instruments risks were no doubt better distributed, with assets and liabilities better matched and risk factors being decomposed and allocated to those more capable of bearing them. However, at the same time, the ability to detect trouble places has diminished. Most importantly, the main problem with securitization stemming from the fact that it does not provide protection against systematic risk, was neglected. The crisis has shown that banks can not rely on commercial paper for ever to fund structured investment vehicles (SIVs). Banks are not going to accept vehicles with a 20% line of liquidity now. Investors need 100% funding, but no bank is going to offer during the crisis.

As a result of innovation and raising complexity of financial products it became more difficult for regulators and supervisors to make a critical distinction between financial products. This distinction is to be not whether the products promise different types of returns, but how the “delivery failure” impacts upon the survival of the institution (Davis, K., 2000).

Fifth, in an environment of a high demand on assets (because of access liquidity on the market in recent years) many new products were very hard to price (CDOs, CMOs, SPVs and other such instruments and entities). There is a lot of historical experience on how asset prices, in particular residential property prices, can provide a crucial link through which adverse macroeconomic developments can cause financial instability. Episodes of asset price booms are seen by many as raising the risk of a future sharp “correction” of prices, which could have immediate repercussions on the stability of financial institutions. Indeed, many observers have argued that property-price collapses have historically played an important role in episodes of financial instability at the level of individual financial institutions

(Assenmacher-Wesche, K., S. Gerlach, 2008). It became evident, that traditional asset pricing theory fails to take into account the impact of principal-agent problems in even very liquid markets, having been developed in the 1950s and the 1960s when the US equity market was owned largely by individuals.

Sixths, this market feature was accompanied by a less (and less effective) supervision than in the past and almost no room for coordinated action of supervisory authorities. Many of the institutions and markets now under stress are not subject to prudential oversight. It became apparent, that worldwide CDSs market was "completely lacking in transparency and completely unregulated" (Cox, Ch., 2008). Unregulated financial institutions fall into collective misjudgment of risks. They were simply not forced to manage risk exposure on mortgage-backed securities and related financial instruments well and, as a result, have struggled with losses and write-downs. More importantly, it is recommended the equity ratio regulation within the framework of Basel II, which permits banks nominal reductions in required equity for liquid balance sheets positions to be revised (Hummer, K., 2008a). Fare before the crisis emerged academic circles pointed out, that statistical models for forecasting risks (on which Basel II is based) have been proven to give inconsistent and biased forecasts, notably underestimating the joint downside risk of different assets. The Basel Committee has chosen poor quality measures of risk when better risk measures are available (Danielsson, J. a. o., 2001).

2. Evolvement of the crisis

Since mid 2007 central bankers drew the attention of market participants to the crucial role of large asset price in creating conditions for financial crisis. The market turned to a new-style financial flight from risk-taking, and trigger sales of assets started to emphasize price movements. As expected, often market liquidity that participants need to manage portfolio risk dried up, and the correlations among asset prices that went into calculations of risk management strategies shifted in unexpected ways that increased vulnerability (Kohn, D. L., 2007). Central bank’s room for maneuver was also severely restricted.

Remarkable signs of the global financial crisis began with financial market events dating from July, 2007. The actual crisis evolved with failures of large financial institutions in the United States in March 2008. The credit crisis that began in the United States with the sub-prime mortgage crisis has affected Europe and the Asia/Pacific region.

The crisis quickly evolved into a global crisis. The global financial crisis of 2007-2008 became more and more evident expanding into a global economic crisis of 2008, as all major sectors of the global economy are affected. In recent time, some researchers are speaking about a disruption of the system of international payments pointing out that the system of Letters of Credit as well as international shipping, which constitute the lifeline of the international trading system, are potentially in jeopardy (Chossudovsky, M., 2008)

Before the crisis it was typical for financial institution (or individual investors) to borrow in order to invest more, using the effects of leveraging. As it came out, by using credits in order to invest the respective institution could potentially earn more from its investment, but it could also lose more than all it has. Therefore leverage magnified the potential returns from investment, but also created a risk of bankruptcy. More and more institutions failed to honor all their promised payments to others, which spilled over financial troubles from one financial institution to another. The average degree of leverage increased prior to the financial crisis. The crisis has led to a liquidity problem and the de-leveraging of financial institutions especially in the United States and Europe, which further accelerated the liquidity crisis. The credit crisis has made funding a problem.

In the EU the financial crisis resulted in a number of European bank failures and declines in various stock indexes, and large reductions in the market value of equities. Many banks in the EU countries had to be rescued. Great Britain announced a plan of nationalization of mortgage lender Bradford & Bingley Plc. Banking. Simultaneously, the Dutch-Belgian banking and insurance group Fortis was prevented from bankruptcy as the governments of Belgium, the Netherlands and Luxembourg agreed to invest a total of11.2 billion euros in return for a minority stake in the group. End of September, 2008 the British Prime Minister Gordon Brown announced that his government will do "whatever it takes "to protect people's savings in the face of the ongoing global financial crisis." On 1st October Belgium, France and Luxembourg rushed to provide nearly 6.4 billion euros to save Franco-Belgian bank Dexia, the latest victim of the global credit crunch in Europe.

Investors reacted with apprehension to uncoordinated efforts by regulators in the EU and continued bank failures. Credit tightening has begun to affect businesses and consumers, slowing the growth rate of economies worldwide and tipping some of them into outright recession. The crisis contagion occurred in October 2008, when a systemic and simultaneous breakdown of money and bank markets leads to generalized risk aversion and the shedding of all assets that fail to carry public guarantees (Reisen, H., 2008).

3. The USA response to the crisis

The crisis became notably evident in September 2008 with the failure, merger or government protection of several large United States-based financial institutions. The US financial sector has seen huge turmoil in September, 2008, with Lehman Brothers folding and Merrill Lynch being bought by Bank of America. Morgan Stanley and Goldman Sachs (for decades independent investment banking firms) requested to change their status that will see them regulated by the Fed. The move, which means they will expand into the commercial banking sector, arguably marked an end of an era on Wall Street.

Thus the crisis posed new challenges to central bankers and policy makers taking them well beyond the national framework they used to address previous crisis. The kind the crisis was evolving complicated efforts to respond to. Nowadays, financial

systems are no longer predominantly bank-based. In the past the response to banking crises almost always included as its key component a cut in interest rates by the central bank, and could also include direct lending by the central bank (acting as a lender of last resort) as well as emergency mergers and acquisitions (to support weak lenders) and concerted lending (to support weak borrowers). Underlying these actions stood a deep concern to keep the payment system functioning.

Bail-outs are not new and there are plenty of examples of successful and unsuccessful bail-outs, both inside and outside the financial sector. At the end of September, 2008 a bank bailout has been proposed under the so-called Troubled Asset Relief Program (TARP) of the US Treasury. Capital infusions or other relief were rather included under the $700 billion bailout plan. The plan aimed to restore confidence by moving the most troubled assets off the balance sheets of banks into the TARP. By removing uncertainty about impending mortgage-related losses the program was expected to pave the way for banks to keep lending and get new infusions of private capital (Paulson, H.(2008). As the plan foresaw reimbursement by financial companies to the government, this effectively means that this plan does not envisage recapitalisation of the banking sector.

One of the big challenges to the program was how to find prices for the assets it wants to buy. It has to pay a high enough price that banks come forward to sell them. But overpaying imposes high costs on the taxpayer. In addition, the assets are complex, which makes a fair price hard to determine. According to the Treasury, the program will pursue "reverse auctions" in which sellers provide offer prices for the securities.

Some bond experts are optimistic that the Treasury's plan will not only ease financial stress but also make a profit for taxpayers (Trumbull, M., 2008). Other observers stress that the "bailout" contributes to a further process of destabilization of the financial architecture. It transfers large amounts of public money, at taxpayers expense, into the hands of private financiers. It leads to a spiraling public debt and an unprecedented centralization of banking power (Chossudovsky, M., 2008)

The Group of Seven (G7) welcomed the US move and reaffirmed its strong commitment to "protect the integrity of the international financial system".

4. The common and individual efforts in the EU

The reluctance of banks to lend out their money was at the center of the current financial crisis, which started to plunge European economies into recession. In the first part of October, 2008, money markets have ground to a halt because banks have been refusing to lend each other money. The European Central Bank, the Fed, the Bank of Japan and other central banks made cash injections into the system.

Liquidity problems and capital injections became key to containing the crisis. The rescue measures started outside of the Euro-system. The four largest UK banks (HBOS, Royal Bank of Scotland, Lloyds TSB and Barclays) asked for a combined

$60.5bn support. The unprecedented move made the UK government the biggest shareholder in two banks, HBOS and Royal Bank of Scotland. An UK €630 billion plan was created to part-nationalize the country's banking sector by buying preference shares in banks, to invest in short-term loans and to guarantee loans between banks. After announcing the plan the UK Prime Minister Gordon Brown wrote to EU leaders encouraging the creation of a "Europe-wide funding plan" to tackle the worsening financial crisis. He added that a "concerted international approach" was needed. Simultaneously, the German Hypo Real Estate, Europe's largest mortgage bank, received a last minute credit facility.

Actually, the UK government, together with other national governments, has rushed to bail-out banks without first getting the confirmation from EU regulators. Only on 8 October, 2008 alone, five EU member states, Britain, France, Italy, Spain and Austria announced measures or the intention to give state support to national banking sectors.

4.1. Emergency summit of euro zones nations (12 October 2008)

A summit meeting of the leaders of the 15 member countries of the Eurozone was held (on 12 October 2008) in Paris. The meeting has been attended by the Presidents of the European Commission and the European Central Bank. The Paris meeting was arranged by French President Nicolas Sarkozy after a financial summit by the Group of Seven leading industrial nations in Washington that promised to do whatever was needed to unfreeze credit markets. Britain's Prime Minister Brown also attended the meeting, but was not involved in formal decision-making (because his country is not member of the Euro-zone).

At the summit the following has been agreed: a) no major financial institution to be allowed to collapse; b) a pledge to guarantee new bank debt issuance on a temporary basis, until the end of 2009; c) loans between banks in the inter-bank market to be State guaranteed; d) to inject capital to unfreeze money markets and restore confidence in the financial system. The European Central Bank took the responsibility to create an unsecured lending facility to buy commercial paper from banks, similar to the move by the US Federal Reserve at the beginning of October 2008 providing, in effect, guaranteed funding for banks.

At the core of the decision package on the summit were the consensus governments to be allowed to support banks by buying preferred shares, and the commitment to recapitalize any "systemically" critical banks in distress. Leaders of the Euro-zone countries pledged to help or directly subscribe to debt-raising by banks for periods of up to five years. Actually, the participants in the meeting agreed to follow the main points of a plan launched by British Prime Minister Gordon Brown a week before the meeting to buy up big stakes in troubled banks, and to guarantee inter-bank lending.

The aim was to take the pressure off the blocked inter-bank money market and also off bank balance sheets in trouble and to restore confidence in the financial system. This agreement showed the unpreparedness of the Eurozone for financial crisis.

Desperate, European governments have pledged about two trillion euros to prop up troubled banks and underwrite loans between financial players. The lesson from the events and the process to come to a joint response in the EU was that banking crisis of that magnitude require quick political agreements, as those of the US. This political agreement was postponed because the misjudgment of the crisis. The Eurozone countries estimated the crisis to be only an US financial crisis. After the US investment bank Lehman Brothers went bankrupt high officials of Germany judged the resulting global financial turbulence to have limited impact on Germany. The losses to be suffered by the German financial sector were described as "bearableHigh German officials pointed out that although the United States was experiencing its worst financial crisis in decades, it would not likely trigger a domino effect in Europe-especially not in Germany." (Kucharz, Ch., 2008). French officials also expected the crisis would have limited impact on the French financial sector. This excessive optimism prevented European countries from taking early action against potential financial turmoil at home.

On 23 December 2008 the European Union approved bank rescue measures for many of the EU member countries, clearing the way for cash injections and loan guarantees expected to help lenders through the financial crisis.

4.2. National rescue plans of euro-zone and non-euro-zone countries

After the summit individual countries (Germany, France, Britain, Italy) prepared plans for recapitalization of their principal banks. The EU Directorate on Competition Policies approved bank rescue measures for Germany, Britain, Spain and Italy. The sanction came after the EC revised its rules for approving state bailouts of banks after a pressure from member states for holding up vital rescues. The EC had to be assured that competition would not be distorted as a result of the bailouts.

The German government unveiled a €500 billion rescue plan to shore up the banking system. It included a €400 billion financial market stabilization fund to guarantee loans and €80 billion to recapitalize the banking sector through the government taking stakes in banks. An additional sum of €20 billion was also foreseen as a provision to cover losses. As a result of the rescue package, the German government abandoned its plan to balance the federal budget by 2011. France and other euro zone countries announced similar bailout plans to halt the crisis. The EC expected the German_government to present its proposed bank rescue plans, which should pave the way for EU approval of a massive injection of state capital into Commerzbank. Germany was in conflict with the EC for going too slow in considering whether or not to approve the aid to Commerzbank. In Germany, the EU approved a guarantee package for the NordLB regional bank to cover its midterm refinancing needs.

In early December 2008 the European Commission approved a French plan to rescue its embattled banks. The French government has offered up to 40 billion euros to banks, with 10.5 billion euros already set aside for the country's six biggest banks. France had to tighten the terms under which banks must pay back aid. Details

of the agreement with France showed a compromise over the terms of the support. The EC required the repayment rate to be fixed for the first five years and variable after that. The remuneration, which will average about 8 percent, will reflect the degree of solvency of each beneficiary bank. Eight percent was in line with the rate sought by France. In return, France offered improved incentives for the early repayment of state capital and extra safeguards to ensure that bank lending went to the real economy.

Italy decided to shore up the country's financial system in October, 2008. Italy passed a decree supporting the country's banks through a part-nationalization, although no explicit amount of funds has been mentioned. Cash will be offered to banks in exchange for non-voting preference shares in the institutions. The move however, did not amount to a rescue fund, and, as in France, banks would be offered the money on a case-by-case basis. The Italian government also guaranteed deposits up to €103,000. End of December, the Italian authorities won permission from the EC for an aid package for their banks. EC officials underlined that the scheme was in line with EU guidance on state aid to overcome the financial crisis. This means the program is limited in time and scope while, interest paid to the state is priced according to market. There are also incentives for the banks to redeem the state participation over time. The measures allow Italy to subscribe subordinated debt instruments, which will be counted as bank core tier 1 capital, (a standard of capital held against risky assets). The scheme's budget will be up to €20 billion and only fundamentally sound banks are eligible. Capital endowment for the banks is to be within 2% of their weighted assets and in principle within a level of 8% of tier 1 capital. The banks taking advantage of the program will also have caps on dividends, management pay and an ethical code. The Bank of Italy will monitor how the banks' new funds will be put to use to sustain lending to the real economy. Italy will have to report to the Commission every sixth month on how the scheme functions.

The Austrian measures offer financial support in the amount of €100 billion, of which €75 billion is provided in the form of guarantees to support the interbank market, €15 billion is available for direct recapitalization measures of individual banks and €10 billion is reserved to secure the abolishment of the prior limitation of guaranteed bank deposits of natural persons as well as raising the amount of guaranteed deposits of SMEs. The Austrian Federal Minister of Finance is empowered to provide guarantees to a special purpose vehicle which will be set up and work as a "clearing institute". This clearing institute will, in its own name and for its own account, borrow financial funds via the interbank market from credit institutions and insurance companies and lend financial funds via the interbank market to other credit institutions and insurance companies against payment in line with the market. The company can be owned only by credit institutions, insurance companies or various industrial associations of corporations that act as legal representatives of such companies.

Spain's economy has stumbled badly in 2008, due largely to a collapse in its key construction industry and tighter credit policies at banks. In October, the Spanish government said it would guarantee up to euro100 billion in bank bond issuance in

2008. The E C approved the scheme considering it to be nondiscriminatory and limited in time.

In November, the Latvian government was forced to nationalize Parex Bank – the country's second-largest financial institution in terms of assets – after the bank ran out of cash. The government bought a 51 percent stake in Parex and then injected some 200 million lats (euro280 million, $390 million) into the bank to keep it afloat. Latvia prepared a state plan to stabilize its banking markets.

For Great Britain the EC approved the latest modifications to a British scheme, which had already obtained EU backing.

Denmark (a non-euro-zone country) announced a bank support plan aimed at allaying the credit crunch after some banks were finding it almost impossible to obtain new financing because of the turmoil on international markets. Denmark, however was not considering any move to nationalize financial institutions.

It is clear, that (except for Denmark) de-leveraging (to take equity in order to substitute debt) is in the heard of the plans of individual countries. On this way plans are threatening not the reason for the emerging of the problem, but the outcome of the problem, which lies in the breaking of the credit creation value chain. (Rona, P., 2008). In addition, using public equity to de-leverage financial institutions creates new problems centered on the role of the state and state aid within the EU.

4.3. EU stimulus package and the meeting of G20

It was important to find an adequate way to avoid distortion within the single market that could give rise to unilateral action leading to a spiral of protectionism. In mid October, 2008 the EC adopted guidance to specify how it will apply EC Treaty state aid rules to state support schemes and individual assistance for financial institutions in the current crisis. The EC has adopted more than 20 decisions in order to contribute to quickly restore confidence in the market (Kroes, N., 2008). The EC approved three basic schemes to help restore confidence in credit markets: guarantee schemes (to be applied in Denmark, Finland, Portugal, Ireland, the Netherlands, Sweden, France and Italy); asset purchase schemes (for Estonia) and holistic schemes with all of the above (for Germany, United Kingdom and Greece).

Special attention has been put on how to design recapitalization schemes. First, the core issue concerned the reason for fundamentally sound banks to receive state capital. One of the explanations of the EC was to prevent de-leveraging of such banks in order for them to start lending to the rest of the economy. Second, at the same time distortions of competition had to be avoided, and national approaches had to be coordinated. Third, in addition, the EC had to assure, that the recapitalization provided by the state will not become a permanent feature of the financial institutions within the EU. The recapitalization had on one side to provide effective means of strengthening confidence in the markets and, on the other hand to bring banks to financing the real economy in a period of crisis.

In practice it became soon evident, that incurring into pressure from EU governments, the EC compromised the strict EU aid rules. The Directorate General for Competition had to make the bailout rules more flexible. A major point of contention was the rate at which fundamentally healthy banks would pay for any state aid. The EC required banks to pay a risk premium for the state aid based on their health rather than a fixed rate for all. So, state capital injections should be priced at central bank base rates plus a premium reflecting the level of risk of each case.

In November, 2008 the countries of the 15-member euro zone officially entered a recession, recording a 0.2% decline in GDP for the second quarter in a row. For this reason on EU heads of state and government agreed on the necessity to "look beyond the financial crisis" and take measures to address the worsening economic situation. The EC was mandated to submit proposals in that direction (ahead of the EU summit on 11-12 December). The plan proposed a fiscal stimulus of around 1.5% of EU GDP or €200 billion, higher than the €130 billion that had been floated earlier. The idea was most of the funds to be drawn from national budgets, with EU countries asked to contribute €170 billion or 1.2% of the EU's GDP. The rest – around €30 billion or 0.3% of GDP – would come from the EU's own budget and the European Investment Bank (EIB).

The plan was aimed at boosting consumer confidence and stimulating spending. It included at least five billion euros to help the car industry develop green technologies and a total of euro 2.2 bn to improve the energy efficiency of homes and factories. Aid prepared to small and medium sized businesses over the next two years increased from 10 to 30 billion euros. Easier access to 1.8bn euros worth of EU funding for job training would be ensured. The bigger part of the package would be implemented in 2009, while some measures would continue into 2010.

EU countries were invited to draw from a "toolbox" that includes measures already adopted by some governments. Some countries have already announced fiscal stimulus plans, including Germany and the UK that will be taken into account in the EU plan.

Measures listed in the EU's 'toolbox' include:

- Increased support for the unemployed and the poorest households, which have been hit hardest by the economic slowdown;

- Funding large infrastructure projects such as energy networks and broadband internet;

- Temporary VAT cuts across the whole economy, similar to the one adopted in the UK, and;

- Lowering taxes on labour, in particular VAT on 'labour-intensive' sectors such as hairdressers and restaurants, a proposal which has been on the table for some time. (EurActiv, 27 November 2008).

In assessing the package three points call attention. First, one of the main characteristics of the package was to allow countries greater flexibility with the Stability and Growth Pact, which limits public deficits to 3% of GDP. Periods longer than usual to bring the deficit back under the 3% ceiling were considered. The EC warned about disproportionate use of the flexibility, which would result in "a downward spiral of debt" that would only jeopardize growth in the future. The EC made clear that it "will always prepare a report" if the 3% of GDP deficit threshold is breached "unless the excess is not exceptional, temporary and close to the threshold". However, al these warnings can be considered a reassurance rather on the side of the EC than on the countries to follow strictly the eased rules.

Second, while all countries were asked to contribute, the EC insisted that "a one-size-fits-all approach could not work given member states' different starting points" in terms of their budget deficits and overall economic situation. For 2009, the EC forecasts that budget deficits will vary from nearly 7% in Ireland to a surplus of 3.6% in Finland. In the EU's biggest member states, the UK is predicted to run a 5.6% deficit, France 3.5%, Italy and Spain just under 3% and Germany 0.2%. Similarly, there are concerns about deflation in some countries, while there is double digit inflation in others (Estonia, Latvia and Lithuania), highlighting the need for differentiated measures.

Third, as a second 'pillar' of the recovery plan the EC stressed that the measures must be "coherent" with the EU's longer term objectives, such as fighting climate change, creating clean growth and more and better jobs in the future. An additional goal was put into the implementation of the package: to can get back on a path of sustainable growth and pay back short-term government borrowing. Thus the package was diluted with other tasks, which if implemented gave countries a bigger room of maneuver for interpretation. The question also arises on which institutions will be involved in monitoring the implementation of the package and who will bear the costs for monitoring.

Fourth, UK and Germany announced initiatives few weeks before the stimulus package was proposed by the EC. The German government underlined that it was operating under the assumption that its existing economic package was enough as it was already putting 50bn euros back into the economy, more than the EC's target of 1.2% of GDP.

Both individual steps and coordinated announcements have been taken before the EU stimulus package was prepared.

Great Britain announced a cut tax on goods and services to 15 percent from 17.5% in a bid to boost the economy. A Franco-German meeting was held just hours before the British government unveiled a stimulus package featuring a cut in taxes on goods and services. Because of different implications of the crisis on their economies

France, Germany and Britain followed different approaches. France was pushing for tax cuts and other targeted measures, concerned that the 20-billion-euro aid plan for US automakers will leave European car manufacturers at a disadvantage. According to Germany' officials spending one's way out of a recession is reckless and will do little to address the main factor behind the troubles of the German economy – the weak demand abroad for its exports.

On 12 December 2008 the German government decided to accept the Brown-Sarkozy plan of 200 billion euros in stimulus. The amount of the package of about 1.5% of GDP, is smaller than the US package. But in view of the fact, that the EU has a larger share of welfare state spending, hence there are more automatic stabilizers available than in the US.

Some EU member countries participated also in a global frame to discuss measures to contain the implications of the financial crisis. Realizing that there is without doubt an economic downturn in many countries and period of slower economic growth for most, perhaps all others, a coordinated response has been looked for to be more effective in limiting the severity and duration of the global recession. On 16 November, 2008 the G20 summit in Washington was held where a presence from developing country leaders was also needed.

The common document (IHT, 2008) expressed the short-term aim of limiting the fallout from the financial crisis. It also stressed on the call for co-operation in economic policy, and for countries to use the government finances to stimulate growth. Other actions agreed upon at the meeting included fiscal incentives to enterprises, and more international cooperation to identify and rapidly respond to signs of national and international crisis. The officials agreed that tax cuts and increased government spending are necessary to avoid a recession. They also pledged increased communication and coordination in the face of the crisis.

Each country will decide what measures to apply. There are risks associated with tax cuts and increase of spending for countries whose government finances are already strained. The longer-term problem is reducing the risks of a re-run of the events that created the current crisis. Changes to financial regulation will be at the heart of that. Because they were considered less urgent, so the summit commissioned the work on it from the G20's finance ministers, with a deadline of the end of March 2009.

Conclusion

First, the crisis has become one of the most radical reshapings of the global banking sector, as governments in industrialized countries started to use public equity to avoid disappearance of independent entities in the sector. The question is whether the strategy holds the banks responsible after turning the governments into owners. The problem goes beyond whether when distressed assets will be sold the profits will flow to taxpayers and the governments would be able to recoup more money later by selling their shares as well. It is the question on preserving the current structure of excess capacities in the financial sectors in industrialized countries.

Because the response to the lack of trust is again state aid. The state activism is connected with more costs than initially expected. Most importantly, state interventions have a crowding out effect, because public funds are starting to compete with and are crowding out the private sector money.

The second question, which rises is about the new EU member countries, where the foreign ownership in bank assets is dominated by foreign banks, most of them from the Euro-zone countries. Since the 1990s the former centrally planned economies made a substantial step towards excluding government participation in the economy. Nowadays they are experiencing a new paradigm (disregarding of the fact how long it will be lasting) of a strong intervention and participation of governments in economic life. They are confronted with the question: are there not sufficient market mechanisms and tools to respond to a crisis or is this an exceptional case, where governments must take the role of the most reliable and strong economic agent? Are the market mechanism threats in countries with advanced economies more serious to have to rely on a strong state to meet a stress? Such questions only seem to have an easy and clear answer. They need a profound analysis.

Third, one of the important questions now is how to terminate the various temporary assistance programs adopted in this crisis and restore the private market incentives. Which are the devices to be embedded in order to reestablish the market environment and responsibility of financial institutions now in trouble. This makes regulators to think about the fact that one of the main factor creating distortions in the financial system is the perception of a government guarantee of products and institutions. What is the scope and authority of prudential supervision designed to control institutional arrangements in these sphere. In addition, as a result of competition and financial innovation many of the distinctions between financial institutions and products are disappearing, thus complicating the possibility of effective supervision.

Fourth, the measures envisaging the entering of public equity into financial institutions raises the question on to what extent assistance could put public authorities further into the process of allocating credit and selecting the winners and the losers in the market place. If these interventions were provided solely by national governments the consequences would be not so considerable and long lasting. In the case of the current financial crisis however, the intervention of the government in the credit allocation function is supported by the EC. Putting aside the different interests and conflicts between the countries in accepting the principles and the frame of the stimulus package at the end of the day the common interest was to accept state aid in order to strengthen confidence in the markets. State aid was encouraged by the EC in order to restore confidence in the market, however new insights are needed on the issue on European state aid law in the context of the financial crisis**.** Trust can no longer be placed in implicit state guarantees (Hummler, K., 2008a).

Fifth, at the same time markets are lacking measures to create a different balance between bank-based and market-based financial intermediation. Thus the task of a common regulation within the EU would be rather to create an atmosphere in which

banks could act to overcome this gap. The over-levering has been a major problem during the current financial crisis. It calls for extending some form of leverage standards (a minimum capital-to-asset ratio) to those institutions that suffered from inadequate capital. Such kind of capital standard would also help reinforce the pressure that financial investors and creditors are now putting on firms to raise capital and clean up balance sheets.

Sixth, although the financial integration in the EU is well advanced (Eurosystem, single market for liquid reserves/the money market in euro), there are no workable arrangements for crisis prevention, management and resolution. This crisis is especially revealing the serious shortcomings in the crisis management framework within the Eurozone in particular. A conflict between large, complex cross-border financial intermediaries and supervisory regime, based on home-country control became evident. To concert joint actions the main focus was put on short term issues as financial burden sharing. Most importantly is however, that the reponse to the lack of trust in the financial intermediaries was again government support, state intervention, the use of public money. There is a big question on the exit strategies for how to terminate the numerous temporary assistance programs adopted in this crisis and more importantly – how to restore private market incentives.

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