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COMMUNICATION FROM THE COMMISSION

From financial crisis to recovery: A European framework for action

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Acting in a coordinated way at EU level

The unprecedented crisis in international financial markets has created major challenges for the EU. Co-ordinated action at EU level by all 27 Member States has been effective in stabilising Europe's banking system. Implementation of measures has to be rapid so as to put much needed liquidity back into the financial system. But the financial crisis is not yet over and is already feeding into a serious downturn affecting the wider economy, hitting households, businesses and jobs. The shocks hitting the European economy are expected both to reduce the potential growth rate in the medium term and cut actual growth significantly in 2009 and 2010. As investment shies away from risk, productivity will be put under downward pressure and innovation may suffer.

Europe's strength lies in its solidarity and our ability to act together. All Member States will be affected, albeit in different ways and to different degrees, and it is likely that unemployment will increase, demand will fall, and fiscal positions will deteriorate. Acting jointly means a more effective and credible response. In contrast, if each Member State acts alone, their efforts will fall short. There is also a risk of unwelcome spillover effects on other Member States.

The fact that the EU was able to take collective action when the pressure on financial markets was at its most intense was central to the stabilisation of the banking sector. Coordinating national action inside a set of clear EU principles, complemented with direct EU action, proved to be the right approach. It was backed up with decisive, coordinated and effective action: at the EU level by the French Presidency of the Council, the Commission and the European Central Bank, and at the national level by the Member States, with full support and cooperation from the European Parliament.

The EU should build on this success and decide to tackle the next stages of the crisis in a united, co-ordinated manner turning these challenges into opportunities; adding selected short term measures to the Lisbon Strategy for growth and jobs. This paper sets out a three part approach which will be developed into an overall EU recovery action plan/framework:

- *A new financial market architecture at EU level*
- *Dealing with the impact on the real economy*
- *A global response to the financial crisis*

This Communication is presented as a Commission contribution to ongoing debate inside the EU and with our international partners on how best to respond to the current crisis and its aftermath. On 26 November the Commission will propose a more detailed EU recovery framework, under the umbrella of the Lisbon strategy for growth and jobs, bringing together a series of targeted short term initiatives designed to help counter adverse effects on the wider economy and adapting the medium to long term measures of the Lisbon strategy to take account of the crisis.

1. A NEW FINANCIAL MARKET ARCHITECTURE AT EU LEVEL

Steering the European financial sector out of crisis

Working closely together, Member States and the Commission have agreed a series of immediate measures to protect our citizens' savings and rescue banks in difficulty. The initial reaction to the various packages in credit markets has been positive, but they will need to be implemented rapidly and their impact assessed on an ongoing basis. Competition policy provides a vital contribution to a coordinated reaction, whilst preserving the possibility for Member States to intervene where necessary according to national conditions.¹ The Commission will continue to ensure a level playing field among beneficiaries and non-beneficiaries of public sector assistance.

However, conditions in the global financial system remain very fragile and the risk of a severe credit crunch persists. Accordingly, there can be no room for complacency in implementing the strategy to steer the European financial sector out of crisis. The EU needs to continue to act in a co-ordinated manner to maximise the success of its response. In particular there is a need for:

- *Continued strong support for the financial system from the ECB and other central banks.* Central banks have demonstrated impressive flexibility and ingenuity in providing sufficient liquidity to the banking sector and in ensuring that the crisis does not spread to other parts of the financial system.
- *A rapid and consistent implementation on the bank rescue plans established by the Member States.* This is essential to quickly restore confidence in the EU banking sector and so limit the damage to the economy and create the conditions for a strong and sustained recovery. Consistency is necessary to optimise the overall impact of the rescue plans across the EU, to avoid a fragmentation of the Internal Market and to maintain a level playing field among beneficiaries and non-beneficiaries of public sector assistance.
- *Decisive measures to limit the spread of the crisis across Member States.* The financial crisis has now begun to affect the recently acceded Member States of central and eastern Europe. In order to meet this threat, the EU stands ready to provide substantial medium-term financial assistance, together with the IMF, to those Member States experiencing balance of payments pressures or serious financial-stability risks.

Ensuring reinforced regulation and supervision

In parallel to the stabilisation of the crisis, it will be necessary to move on to the phase of restructuring the banking sector and, at some stage in the future, returning banks to the private sector. The Commission will work directly with Member States to ensure that the restructuring of parts of the banking sector is done in a way which will ensure fair and healthy competition in the sector for the future. Private individuals and businesses need to have access to a sound and stable banking system in order to be able to finance their investment plans and society as a whole will benefit from the measures taken to ensure that credit remains available on reasonable terms.

¹ The Commission has adopted a Communication on the application of State aid rules to measures taken in relation to financial institutions in the context of the current global financial crisis (add ref)

The Commission has tabled proposals on deposit guarantees and capital requirements, and on countering the risk of pro-cyclicality in the effects of regulation and accounting standards. It will also soon make proposals on credit ratings agencies and executive pay. Work has also been launched on the adequacy of capital market supervision and risk management, including on derivatives, hedge funds and private equity. The Commission encourages the Council and the European Parliament to give priority to dealing with its proposals so that stronger regulation and supervision can be implemented as soon as possible and play their role in restoring confidence in the system.

These measures will tackle the shortcomings identified and will help to restore confidence in the system as a whole. We need to redefine the regulatory and supervisory model of the EU financial sector, particularly for the large cross border financial institutions. The current national-based organisation of EU supervision limits the scope for effective macro-prudential oversight. The Commission has launched work on the kind of supervisory system which we need for the future through the De Larosière Group².

2. DEALING WITH THE IMPACT ON THE REAL ECONOMY: A FRAMEWORK FOR RECOVERY

The impact of the credit crunch on the wider economy will be felt in rising unemployment levels and reduced demand for the goods and services of companies of all sizes. The policy instruments for dealing with employment and stimulating demand are mainly in the hands of the Member States. However, the EU dimension brings added value to national actions. As the positive results of the Lisbon strategy have shown, where Member States and the Commission work in partnership to create growth and jobs considerable additional benefits can be delivered.

However, in the current crisis the EU needs to adapt the medium to long term measures of the Lisbon strategy to take account of the crisis. It needs to add short term actions to its structural reform agenda, while continuing to invest in the future through:

- Increasing investment in R&D innovation and education;
- promoting flexicurity as way of protecting and equipping people rather than specific jobs;
- freeing up businesses, especially SMEs, to build markets at home and internationally;
- enhancing European competitiveness by continuing to green our economy as a way of creating new jobs and technologies, overcoming our energy security constraints and achieving our environmental goals.

The more Europe can coordinate effectively, the more the positive benefits of these measures will be multiplied. Building on the partnership approach which characterises the Lisbon Strategy, we invite Member States to agree to higher levels of coordination, to face these new challenges.

² The mandate of the group is to consider the organisation of European financial institutions to ensure prudential soundness, the orderly functioning of markets and stronger European co-operation on financial stability oversight, early warning mechanisms and crisis management, including the management of cross border and cross sectoral risks. It will also look at co-operation between the EU and other major jurisdictions to help safeguard financial stability at the global level. Its members are: Jacques de Larosière (Chairman), Leszek Balcerowicz, Otmar Issing, Rainer Masera, Callum McCarthy, Lars Nyberg, José Perez Fernandez, Onno Ruding

The Stability and Growth Pact

Given the EU-wide nature of the shocks and the fact that inflationary pressures are now easing, monetary and fiscal policy can contribute to supporting demand. Government budget positions are likely to deteriorate considerably in coming years reflecting falling revenue. While part of falling revenues is linked to the slowdown, the part linked to the adjustment of some sectors like the oversized housing sector will have some consequences of a more permanent nature for revenues. Forecasts suggest an overall EU budgetary deterioration of above 1 percentage point of GDP over the next year, with large variations from one Member State to another. This might partially cushion the impact of the slowdown in the short-term but at the expense of fiscal deterioration, even before the financial rescue plans are taken into account. However, and largely due to previous implementation of the Stability and Growth Pact, the EU deficit, and in particular that of the Euro area, is currently expected to remain below 3% of GDP.

While the largest share of the announced measures in support of financial stability (guarantees) will not have an immediate impact on the deficit, real fiscal costs will be incurred to the extent that public guarantees are called in. At the same time, measures taken to recapitalise banks are already increasing debt levels. Together with the evidence of an ongoing structural deterioration in budget balances, this may raise concerns about the long-term sustainability of public finances, especially in the most exposed countries.

The Stability and Growth Pact provides the right policy framework, balancing short-term stabilisation needs and long-term structural reform requirements, notably supporting the adjustment process. Implementation of the Pact should ensure that any deterioration of public finances is accompanied by structural reform measures adequate to the situation, while ensuring that sustainable positions are being restored. Budgetary policies should draw fully on the degree of flexibility permitted by the Treaty and the revised Stability and Growth Pact and should take into account the following principles:

- Fiscal policy should be maintained on a sustainable course, anchoring expectations of an ordered resolution of the crisis;
- Country-specific differences in fiscal room for manoeuvre should be considered, conditional on strong and credible national budgetary institutions and medium-term budgetary frameworks;
- The level of ambition of the structural reform agenda should pay particular attention to those reforms that strengthen resilience and enhance sustainability over the long run;
- Reforms supporting demand in the short run should be timely, targeted and temporary.

The excessive deficit procedure should be seen as peer support to overcome current difficulties and ensure long-term sustainability. A clear distinction will be made between budgetary consequences stemming from policy errors and cyclical effects including consequences of the financial crisis rescue package. In particular, increases in debt levels due to rescue plans will be taken into account in the surveillance process.

Accelerating reform and investment

The shocks hitting the European economy are expected both to reduce the potential growth rate and increase unemployment, thereby reducing demand. Structural reforms are therefore essential to sustain demand in the short-term, facilitate transitions within and into the labour market in the short and medium run and increase potential growth in the long-term.

It will be particularly important to ensure that investment is directed to best effect. This means using EU and national public sector support to businesses to have a double impact – offsetting falls in demand in the short term, but doing this in a way that will help reform and modernisation in the longer term. Within the existing reform priorities, identified under the Lisbon Strategy, immediate priority should be given by Member States to key reforms that support innovation and productivity-enhancing investment, which together with bringing down inflation and supporting household incomes through targeted social protection measures will support demand.

Moreover, with the financial system in the grip of a prolonged process of deleveraging, and given the expected changes in the banking sector's appetite for risk, the question of how to fund innovative technologies, preserve the international competitiveness of European industry and finance SMEs will need to be addressed. In addition, a continued focus on opening third country markets for European business, including small and medium sized enterprises will be required.

The Commission will explore with the Member States the following measures:

- Following the informal ECOFIN last month, the European Investment Bank Group put together an overall package of €30bn for loans to small and medium-sized enterprises in Europe granted via commercial banks. This constitutes a substantial increase over its usual lending in this sector but has to be implemented with urgency;
- Working closely with the Commission, the EIB could accelerate its work of financing climate change, energy security and infrastructure projects, in particular those of a cross-border nature. There may be a need to reinforce the capital base of the EIB by for example advancing the date of its next capital increase currently scheduled in the course of 2010;
- The EBRD has been playing a key role in financial sector reform and in financing the private sector in our newer Member States. In the current financing environment its activities in these countries could be strengthened.
- With a financial envelope of over €350 billion for the period 2007-2013, cohesion policy provides considerable support to public investment by the EU's Member States and regions. The Commission will explore with Member States the scope for accelerating investment projects and for bringing forward payments to Member States;
- Finding innovative funding for a wide range of infrastructure projects, including transport, energy and high technology networks, for example through a better use of public-private partnerships;
- Boosting energy efficiency and green technology, for example in buildings and in clean cars, which would provide new opportunities for the economy, including for SMEs, while at the same time helping the EU to meet its climate change aims;
- Increasing demand for energy efficient goods and services through reduced taxation and other targeted fiscal measures;
- Maintaining and creating new export opportunities for EU business, including SMEs, through a pro active market opening agenda, including pursuing trade agreements and our market access strategy;
- Using national and EU competition, as well as consumer, policies to make markets work better, bringing down prices for consumers and taking full advantage of the Single Market.

Acting together in a spirit of partnership and co-ordinating their activities, Member states and European Institutions, can mobilise important funds to accelerate much needed investment and equip the EU to emerge stronger from this crisis.

Addressing the employment and social impact

The economic downturn will affect families, households and the most vulnerable people in our societies. It is already being felt in terms of unemployment. The EU needs to work to minimise the impact on jobs and job losses and to use the levers at its disposal to cushion the social impact. Whereas the main responsibility lies with the Member states, a good coordination between community and national action will be helpful. The Commission will work with the social partners to find the best response to the crisis. Growth areas in terms of job creation should continue to be encouraged – such as personal, health care and social services, in a rich source of job creation which also serves as a tool for access and opportunities.

Europe has suffered in the past from a failure to apply active labour market measures to help people to retrain for the future, to find and to create new jobs. There is now a more urgent need to support transition within and into the labour market, raising and matching supply and demand for labour, and increasing labour productivity. This means applying measures encouraged by the Lisbon strategy including:

Countering the effects of unemployment by offering Member States the possibility of reprogramming funds under the European Social Fund to support measures to quickly reintegrate unemployed into the labour market;

- Reviewing the effectiveness of the Globalisation Adjustment Fund;
- Helping the unemployed to start up a new business quickly and cheaply;
- Monitoring the impact of the crisis on different sectors affected by structural adjustments and using the scope offered by the State Aids regime to enable timely, targeted, and temporary support where appropriate;
- Pursuing flexicurity: in particular active labour market policy measures, tax and benefit reform, and reinforced matching of skills and jobs. The situation is likely to be particularly difficult at the lower end of the labour market, making it particularly important to ease the unavoidable restructuring and provide income and targeted social protection support.

3. A GLOBAL RESPONSE TO THE FINANCIAL CRISIS

Every region of the world has been affected by the crisis and no region working alone will be able to tackle its effects. There are clear signs that the crisis is spreading to emerging markets and will further add to existing pressures on developing countries. It is important that further contagion is contained and the IMF should stand ready to intervene with emergency financing as appropriate. Europe will work together with the IMF and will use its instrument of macro-financial support, particularly to help neighbouring countries. Europe is and will continue to be an active actor in the coordinated global response.

The current financial crisis has underlined more than ever the interaction between macroeconomic policies and financial markets on a global scale. Addressing it will hence require tackling both regulatory and supervisory failures, as well as the macro-economic and exchange rate imbalances that are among the origins of the current crisis.

The financial crisis has raised issues of global governance which go beyond the purely financial sector. The issue of global imbalances has come to the fore, but must also be seen in the broader context of the need to maintain the EU's commitment to open markets in trade and services and deeper multilateral co-operation, fighting against protectionist tendencies and pursuing a positive outcome of the WTO Doha Round. It is also about sharing the benefits of sustainable growth with developing countries, particularly at a time of volatile commodity prices, and tackling challenges like climate change, global prosperity and delivering on the Millennium Development goals.

Following an EU initiative in which the Commission played a full part, the US will host on 15 November the first international summit on the financial crisis. One of the goals of the summit is to begin to improve coordination at global level, review the role of international institutions in financial market surveillance and to adapt global governance structures for the future. The Commission has given active support to international efforts to provide a consistent framework for addressing investment issues at global level, including on the IMF General Agreed Principles and Practices on Sovereign Wealth Funds.

In order to reduce the risk of a recurrence of financial crises in the future, a series of measures to reform the global financial architecture should be pursued. These should relate broadly to the following areas:

- Strengthening the international consistency and quality of regulatory standards, including implement reforms (as reflected in the ECOFIN roadmaps and FSF recommendations) and extend them at global level;
- Strengthening international coordination among financial supervisors;
- Strengthening macroeconomic surveillance and crisis prevention, bringing together macro- and micro-prudential aspects, enhancing financial stability and developing early warning systems; and
- Further developing the capacity to deal with financial crisis and resolution capacities, at the national, regional and multilateral levels.

Ultimately, to deliver financial stability it will be essential to undertake a major overhaul of the relevant institutions. Only in this way we could lock in a sustainable way the results of the series of global financial crisis summits. While the current crisis has revealed some weaknesses in the European regulatory system, Europe is well placed to play an active role in designing the new global architecture and making it work effectively. This should be based on key principles:

- Efficiency: A balance is needed to ensure speed and quality in decisions, without excessive intrusion;
- Transparency and accountability: new or reformed organisations need to be properly accountable, to increase incentives for implementation and enforcement;
- Representation: Global groups should include key emerging countries to improve the legitimacy of the decision making process. The fragmented representation of the European countries and of the euro area should also be addressed to increase the EU's overall effectiveness and influence.

Risks and opportunities

The EU needs to take effective action now to counter the crisis. This action needs to be smart so that it stimulates the right changes in our economy ensuring that we emerge from this crisis ready to take full advantage of the upturn when it comes. It can best do this if we seize opportunities to continue to restructure our economies, train and equip our citizens for new challenges while taking care of the most vulnerable people in our societies in the spirit of Article 2 of the Treaty. We know from past experience that our success is based on moving away from economic nationalism and that the drivers of European growth come from removing barriers between Member States, capitalising on the scale and strength of our Internal Market.

The EU has faced different kinds of crisis in its history and has always managed to emerge from them stronger and more united. We have already shown that when our 27 Member States and the European Institutions decide to act together, we are able to get results and deliver for our citizens. The current crisis can also be an opportunity for Europe and the actions outlined in this paper show how we can work together to put the EU on the road to recovery.