RESHUFFLING COMPETENCES: EUROPEAN UNION'S ACTORS AFTER THE ECONOMIC CRISIS

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Abstract: The economic crisis which begun in the United States of America, with the fall of Lehman Brothers, became a real "euro zone crisis" with the sovereign debts issue. When Greece acknowledged it had given false statistics about its deficit, the entire euro zone became a target for the financial markets, and the structural differences between the states sharing the euro suddenly became apparent. This flow of events triggered changes in the core structure of the European Union, with some actors assuming more competences than the Treaties had provided. In order to do so, the member states used both European law – with the "six-pack" and the "two-pack"- , but also international law, with the intergovernmental Treaty on Stability, Coordination and Governance in the Economic and Monetary Union. The Member states were thus willing to give more powers to the European Commission and the European Central Bank, and even founded a new financial organization – The European Stability Mechanism, in order to save the common currency and, by consequence, the entire project of the European Union.

Keywords: European Union, European Commission, European integration, European economic governance, TSCG.

Just like a "black swan event", as defined by Nassim Nicholas Taleb[1] in his theory, the financial crisis of 2007-2008 was not foreseen by neither the markets, nor the states. Yet, the signs were there. And while the crisis started in the United States of America, once it crossed the Atlantic, it became a "euro-zone crisis", endangering the common currency and, with it, the entire European project (I). The "European debt crisis" determined some significant changes in the structure of the European economic governance, with the key institutions gaining more powers. Thus, the European Council, the European Commission and the European Central Bank acquired more competences than they had been given in the Treaties (II).

I. The economic crisis

The "hindsight effect", known in social psychology, can account for the large number of economic and legal studies explaining *why* the crisis happened, after it happened. After the event had occurred, it becomes far more obvious in hindsight than beforehand. Moreover, "we often do not expect something to happen until it does. *Then* we suddenly see clearly the forces that brought the event about and feel unsurprised", says prof. David G. Myers[2]. Indeed, in the finance world too everything became obvious after the crisis: the high position in subprime-linked securities that banks had accumulated, the real-estate "bubble", with real estate prices pushed up to unsustainable high levels, the AAA rating the rating agencies gave to subprime-linked products, despite the high risks, and the danger of the innovative financial products, which previously had been barely regulated.

[1] TALEB Nassim Nicholas, *The Black Swan: the Impact of the Highly Improbable*, 2007, Penguin Books Ltd, London

[2] MYERS G. David, *Social Psychology*, 11th edition, 2012, McGraw-Hill, New York, cap. 1, page. 14

In the United States, in a continually growing real estate market, the banks started looking for new clients, even if that meant assuming more risks, since these particular borrowers had either no possessions to be used as securities in case of default, excessive debt, lower income, and/or history of missed or late payments. The volume of subprime and non-traditional lending rose sharply: from $105 billion in loans in 2000, to $188 billion in 2002 and then $310 billion in 2003[3]. The subprime mortgages came with higher and adjustable interest rates, but also with higher risks of default. These "toxic mortgages" were afterwards packed into complex financial products, named mortgage-backed securities, which banks sold to investors. The resulting content, mixed with state bonds, prime mortgages or other safer products, were then placed on the financial markets, rated by the rating agencies and re-sold to banks, which needed AAA rated securities to back up its capital requirements, since banks needed to guarantee their stability for the risks taken with loans and other types of investments[4]. Moreover, pension funds or assurance companies invested in these AAA rated products because of their creditworthiness, pushing even further the vulnerability of the system.

When the variable interest rates became too high for the borrowers to afford paying their mortgage and they defaulted in large numbers, the whole system collapsed. The investment banks, such as Merrill Lynch or Lehman Brothers were highly exposed to the flaws of the system. Thus, in September 2008, in the mist of the financial crisis, all five of the largest investment banks had closed down (Lehman Brothers), merged into new entities (Bear Stearns and Merrill Lynch) or converted to bank holding companies, under the supervision of the Federal Reserve (Goldman Sachs and Morgan Stanley)[5].

On the other side of the Atlantic, the European investment banks were also highly exposed to the subprime market in the United States. Moreover, the European commercial banks also had to face the European real estate bubbles. In Europe, from 1997 to 2007, prices in real estate increased in United Kingdom, Spain or Ireland far above those in the United States[6].

In Europe, the real estate bubble, combined with the financial crisis of 2007-2008 and the sharp contraction of the world economy prompted the governments to step up and bailout the banks. The state aids given to the financial institutions, as European governments tried to limit the impact of the crisis[7] led to an increase in the debt as percentage of GDP, shown in Appendix 1. Moreover, the banking crisis in the years 2009-2010 showed that Europe is not well equipped to resolve banking crisis, since the European Commission had to intervene and impose strict restructuring plans on the banks that received state aid[8]. However, in Europe the crisis was not really perceived as a dangerous enough situation. For the public opinion, the difficulties met by the banks in financing each other, in the context of a deep lack of mutual trust, didn't mean much, as the blocking of the interbank exchange market didn't translate

[3] The Financial Crisis Inquiry Commission, *Financial Crisis Inquiry Report. Final report of the National Commission on the causes of the financial and economic crisis in the United States,* January 2011, http://fcic-static.law.stanford.edu/cdn_media/fcic-reports/fcic_final_report_full.pdf , p. 11

[4] Gérard GOURGUECHON, « Les agences de notation », blogue de Jean Gadrey *Alternatives économiques*, p. 3, 17th January 2012, http://alternatives-economiques.fr/blogs/gadrey/files/agences-de-notation26p.pdf

[5] The Financial Crisis Inquiry Commission, *Financial Crisis Inquiry Report. Final report of the National Commission on the causes of the financial and economic crisis in the United States,* p. 154

[6] The Financial Crisis Inquiry Commission, *Financial Crisis Inquiry Report. Final report of the National Commission on the causes of the financial and economic crisis in the United States,* p. 158

[7] Nicolas de Sadeleer, "La gouvernance économique européenne: Léviathan ou colosse aux pieds d'argile?" *Revue Europe*, number 4, April 2012, etude 5

[8] DEWATRIPONT Mathias, NGUYEN Gregory, PRAET Peter and SAPIR Andre, Working Paper The role of state aid control in improving bank resolution in Europe, Bruegel Policy Contribution no. 2010/04

immediately into the real economy. The problems the main media channels rose at the time were linked to governments using public money to save irresponsible banks[9].

Soon enough, the financial markets realized they have been treating asymmetric economies of the euro area wrongfully as being similar. And the starting point to this second and consecutive European crisis was Greece, when the government led by George Papandreou admitted his country has been forging the statistics sent to the European Union and that, in fact, Greece's deficit was 12.7% of its GDP in 2009[10]. Moreover, it seems Greece has been doing this for quite some time, since it masked its growing sovereign debt in 2001, as the country needed to meet European Union requirements to join the euro. Greece used a contract with Goldman Sachs to swap debt issued by Greek government in dollars and yens for euros, using an historical exchange rate, a mechanism that allowed a reduction in debt. These swaps allowed the Greek government to circumvent the reporting rules of Eurostat and show a smaller debt than it really had[11].

The interest rates paid by the European states for 10 years government bonds tended to converge once the euro currency started being used in the years 2000s. In other words, having a common currency was considered enough by the investors as to lend the European governments at similar interest rates. But once Greece revealed its huge country debt and public deficit, the financial markets started treating differently the euro area countries. As a result, the credit rating agencies started a race in downgrading Greece, until the country reached the lower rating mark in 2011, becoming the lowest rated country in the world, according to the rating agency Standard and Poor's[12]. In the meantime, it was clear that Greece could no longer find capital on its own, on the financial markets, since the price it had to pay for the borrowings reached unsustainable levels (Appendix 2).

Furthermore, as rumours about a Greek default started spreading, other European countries became targets for the financial markets and saw their yields spread exploding (Appendix 2). Spain, Ireland[13] and Portugal ware also downgraded in several tranches by the three main rating agencies, Standard and Poor's, Moody's and Fitch[14]. Linked to these downgrades, the financial markets' response was swift: the interest rates asked for government bonds of these countries rose sharply. Soon enough, virtually all "weaker" perceived countries were targeted by the downgrades and thus these countries saw their borrowing costs rising (Appendix 3). Even the third economic power in the euro area, Italy,

[9] Schoutheete Philippe, « La crise et la gouvernance européenne », *Politique étrangère,* 2009/1 Printemps, p. 33-46. DOI : 10.3917/pe.091.0033

[10] The Economist, *A very European Crisis: Greece's sovereign-debt crunch*, February 4th 2010, http://www.economist.com/node/15452594

[11] DUNBAR Nicholas, MARTINUZZI Elisa, *Goldman Secret Greece Loan Shows Two Sinners as Client Unravels*, Bloomberg, March 6th, 2012, http://www.bloomberg.com/news/2012-03-06/goldman-secret-greece-loan-shows-two-sinners-as-client-unravels.html

[12] GEORGIOPOULOS George and BRANDIMARTE Walter, « Greece falls to S&P's lowest rated, default warned», *Reuters*, June 13th 2011, http://www.reuters.com/article/2011/06/13/us-greece-ratings-sandp-idUSN1312685920110613

[13] Le Monde, *Explosion de la dette de du déficit irlandais,* 30th September 2010, http://www.lemonde.fr/europe/article/2010/09/30/l-irlande-s-attend-a-une-explosion-de-son-deficit-public-en-raison-du-sauvetage-de-l-anglo-irish-bank_1417990_3214.html?xtmc=crise_euro&xtcr=140

[14] DONCEL L., ABELLAN L., *La deuda espanola desciende un peldano*, El Pais, le 29 avril 2010, http://elpais.com/diario/2010/04/29/economia/1272492002_850215.html

was downgraded[15] and reached the highest historical rates for its bonds – 7.8% in November 2011[16], a crisis which finally led to the resignation of Berlusconi government.

The crisis then begun its domino evolution, with public debts rising even more, accordingly to the higher prices the targeted European countries had to pay for their borrowings. As a result, with a higher public debt and deficit, these countries were no longer considered trustworthy and the yields rose even more.

II. The European actors after the crisis

As the crisis deepened, it became apparent that a new economic policy framework had to be developed. However, the treaties specifically prohibited the bailout of an European country, member of the euro zone. In the article 125 in the Treaty on the Functioning of the European Union (TFEU) was set the so called "no bailout clause", where it was stated that "the Union shall not be liable for or assume the commitments of central governments, regional, local or other public authorities". Similarly, the member states "shall not be liable for or assume the commitments of central governments, regional, local or other public authorities"[17]. Nevertheless, the interpretation of 125 was different among the authors, some arguing that the prohibition of bailing out another member state was clear[18] and others considering the article 125 as being less constraining. For example, Jean Pisani-Ferry says that "there was never a no-assistance principle, but only (and rightly so) a no-coresponsibility" principle for public debts"[19]. The objective of this article was deterring the member states from excessive spending and keeping always open the option of allowing a member state to default, rather than be provided with financial assistance, in case of budgetary indiscipline.

Regardless of the interpretation of the provisions of the treaties, the member states were in a tough position once the Greece debt crisis aggravated and it became obvious that, without urgent assistance, the country would default. The first solution found was a purely intergovernmental one, by a series of bilateral loans between Greece and the euro are member states. In this particular case, the European Commission was charged with centrally pooling the loans and negotiating, together with the International Monetary Fund and the European Central Bank (the so called "troika"), the programme of structural reforms assumed by the Greek authorities[20].

This, however, was a temporary solution, and since the crisis begun extending to Ireland, Portugal, Spain and even Italy, the European Council entrusted the Council of the European Union (also known as the Council of ministers) with the creation of a European

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[15] Le Monde, *S&P menace de baisser la note de l'Italie,* 24th May 2011 http://www.lemonde.fr/web/recherche_breve/1,13-0,37-1158833,0.html?xtmc=agence_de_notation&xtcr=59

[16] TYMKIW Catherine, *Italian bond yields back in the danger zone*, CNN Money, le 25 novembre 2011, http://money.cnn.com/2011/11/25/markets/bondcenter/italian_bond_yields/index.htm

[17] Official Journal of the European Union, *Consolidated versions of the Treaty on European Union and the Treaty on the Functioning of the European Union*, http://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=OJ:C:2010:083:FULL&from=FR

[18] RUFFERT Matthias, "The European debt crisis and European Union law" (2011) 48 *Common Market Law Review*, Issue 6, pp. 1777–1805

[19] PISANI-FERRY, Jean : Euro-area governance: what went wrong? How to repair it?, *Bruegel policy contribution*, No. 2010/05, http://hdl.handle.net/10419/45515

[20] Council of the European Union, *Statement by the Eurogroup*, 2nd May 2010, Brussels, http://www.consilium.europa.eu/uedocs/cmsUpload/100502-%20Eurogroup_statement-sn02492.en10.pdf

Financial Stability Facility (EFSF)[21]. Based on the article 122 TFEU, stating that financial assistance can be granted, under certain conditions, in case of severe difficulties met by a member state, the EFSF empowered the European Commission, on behalf of the European Union, to contract borrowings on the capital markets or with financial institutions. These funds could be later granted as financial assistance to the member state in need of capital, but only after submitting a draft economic and financial adjustment programme to the Commission.

The EFSF was itself a temporary mechanism, and to prevent further contagion of the crisis, the European Council called for the establishment of European Stability Mechanism (ESM). ESM was set to function as a permanent stability mechanism, similar to the way the International Monetary Fund works. Furthermore, the MES assumed the tasks fulfilled by the EFSF in providing financial assistance to euro area member states[22]. With MES fully functional, it was no longer the job of the European Commission of borrowing on the financial markets, on behalf of the European Union, the funds needed to bail out member states. And although this treaty was signed outside the legal framework of the European Union, as an intergovernmental treaty between the member states of the euro zone, it made use of the European Union institutions, stating that the European Commission and the European Central Bank were in charge with negotiating the economic policy conditionality attached to the financial assistance to the member state concerned. Furthermore, the Court of Justice of the European Union was entrusted with the jurisdiction over the disputes concerning the interpretation and application of this treaty.

However, the risk of contagion was too big to resume the budgetary surveillance only to the member states under financial assistance. As the Greek case showed, even the public deficit of a smaller country, in terms of gross domestic product (GDP) could jeopardize the stability of the entire euro area. And, as Spain case showed, even a sound budgetary policy could prove insufficient to prevent major threats to economic and financial discipline, if it is correlated with strong economic imbalances. Spain, for example, had a two percent GDP budget surplus in 2007 and in 2009 reached a 11% budget deficit. Under the provisions in place before the crisis, the European Commission could not call to attention the real estate credit boom in Spain, which involved budgetary risks, as many macroeconomic dimensions were exclusively in the responsibility of the member state. For this reason, the European Council – behaving again like having the power of legislative initiative, which in fact belongs exclusively to the European Commission – decides the establishment of another treaty, this one on the stability, coordination and governance (TSCG)[23]. And if TSCG is ratified after the same intergovernmental pattern as the MES and it is a treaty outside of the EU's legal framework, the European Union backed the TSCG with a set of five Regulations and one Directive (the "six-pack"), which entered into force in December 2001, and another set of two Regulations (the "two-pack", which entered into force on May 2013).

The "six-pack" and "two-pack" gave even more powers to the European Commission. These legal measures enforced the powers of budgetary surveillance and control. According to the Protocol no 12 TFEU, the reference values for the public deficit is 3%, and for the public debt – 60%. The Commission has to monitor the development of the budgetary

[21] Official Journal of the European Union, *Council Regulation (EU) no 407/2010 of 11 May 2010 establishing a European Financial Stabilisation Mechanism*, http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=OJ:L:2010:118:0001:0004:en:PDF
[22] Treaty establishing the European Stability Mechanism (2012), http://www.european-council.europa.eu/media/582311/05-tesm2.en12.pdf
[23] Treaty on Stability, Coordination and Governance in the Economic and Monetary Union (2012), http://european-council.europa.eu/media/639235/st00tscg26_en12.pdf

situation of the member states and identify the macroeconomic imbalances. In case a state does not fulfil the requirements, the Commission prepares a report, but taking into account the economic context ant the medium-term economic and budgetary position of the member state. If however the Commission considers that an excessive deficit exists, it informs the Council[24]. The reform brought by the "six-pack" is that the recommendations formulated by the Commission are deemed to be adopted by the Council unless it decides to reject the Commission's recommendations by qualified majority[25]. In other words, the "six-pack" fixed a problem of the Stability and Growth Pact, established in 1997, which was made obsolete by the actions of the member states, when they rejected a recommendation of the Commission to sanction Germany, when this country exceeded the deficit limit. However, the Commission can only get to tougher sanctions if the Council decides that the concerned member state didn't take any measure to correct its excessive deficit[26]. The ambiguous formula "the member state did not take effective action to correct its excessive deficit" gives enough space for negotiation to the Commission, whose ultimate objective is reaching consensus, and not inflicting sanctions.

Another change brought by the "six-pack" is that the Commission has even more surveillance powers in the case of the countries under financial assistance. Before the bailout programme starts, it is the Commission and the European Central Bank who evaluate the real needs of the state, even if the final, political decision remains in the responsibility of the Council. After the initiation of the programme, the Commission, together with the ECB, evaluates the implementation of the negotiated conditionality and of the structural reforms by the member state. And in this particular case of the states under a bailout programme, the Commission can send its representatives to carry out in the beneficiary member state "any technical or financial controls or audits that it considers necessary in relation to that assistance".

From the economic coordination perspective, the member states realized that a real monetary union needed more coherence and symmetry. In the European Semester, the member states have to coordinate their economic and budgetary policies. Again, the European Commission has an important role, since it is in charge with the evaluation of the structural reform policies of every member state, provides recommendations and monitors their implementation. And although the "six-pack" provides the procedure of applying sanctions to those member states which fail to take effective measures to correct excessive macroeconomic imbalances, the Commission's recommendations are "discussed" between member states' ministers, giving room for manoeuvre to the Commission, who can adjust its recommendation in correlation with the specific context of each member state. For example, France, although one of the initiators of the TSCG, repeatedly asked the Commission for more time to set its budget within the 3% of the GDP limit.

Conclusion

The member states gave the Commission and the ECB more powers in matters of budgetary surveillance and control. From now on, the Commission can evaluate the reform plans of the member states in the euro zone, and can even formulate recommendations in a country's budgetary plan. Nevertheless, it is the responsibility of each country to carry on the

[24] TFEU, art. 126
[25] **Official Journal of the European Union,** *Regulation (EU) no 1173/2011 of the European Parliament and of the Council of 16 November 2011 on the effective enforcement of budgetary surveillance in the euro area*, art. 4, paragraph 2 and 3 http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=OJ:L:2011:306:0001:0007:en:PDF
[26] *Regulation (EU) no 1173/2011*, article 6, paragraph 1

structural reforms decided within the Council. In other words, even if a supranational institution, such as the Commission, has now more intrusive powers, the final, political decision remains in the hands of the member states, even if that means working together as an entirety. Like Luuk van Middelaar remarked, the states have after the crisis the growing conscience of belonging together, of the need to act together, as an entity[27], even if that means renouncing of some sovereignty prerogatives. And as the banking union is implemented, step by step, it will be interesting to see the evolution of another supranational institution, the European Central Bank, which will have increased powers over the European banking system, and the way the states will cope with this new challenge: another European institution having more powers that the member states intended to give it in the treaties.

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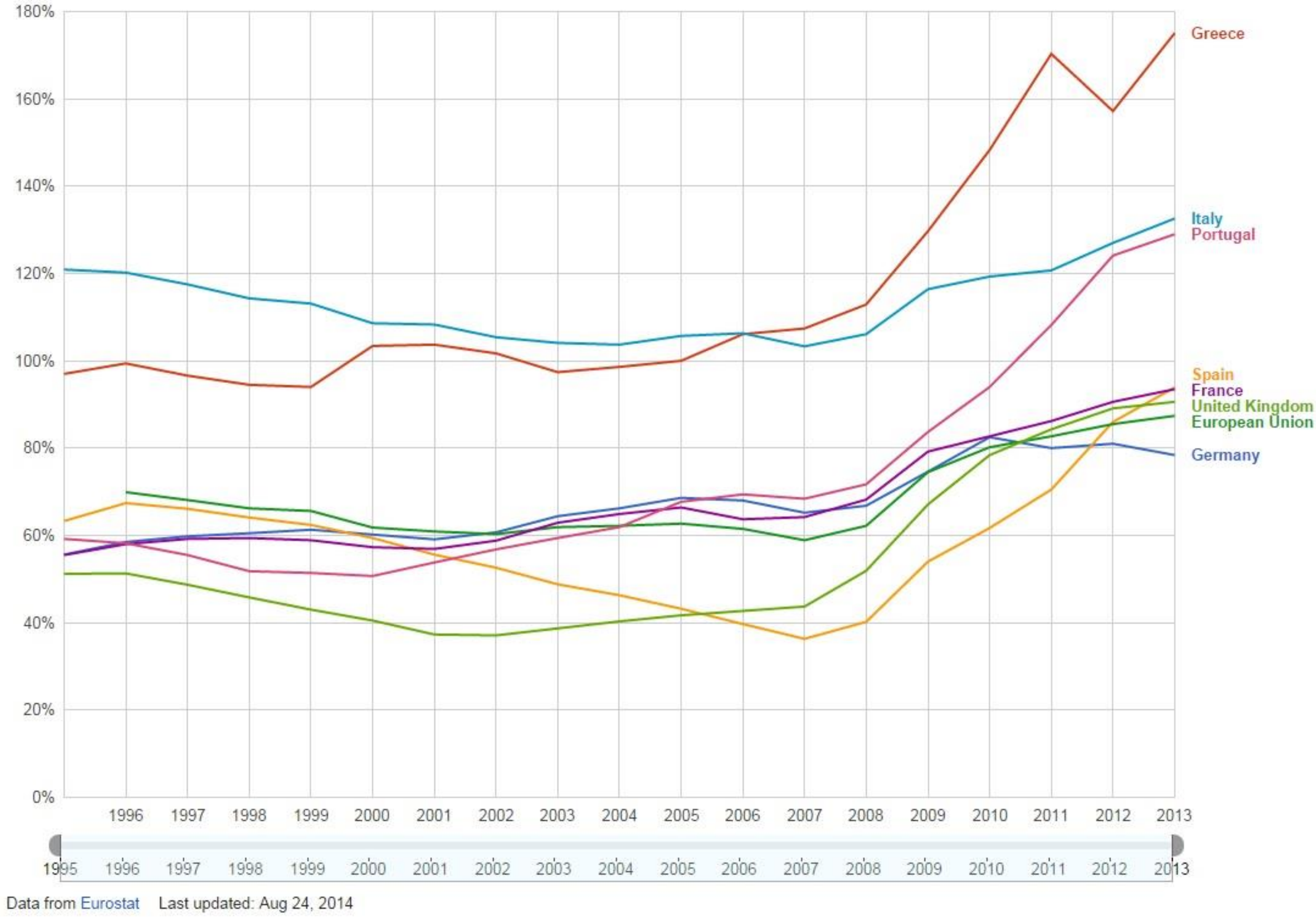
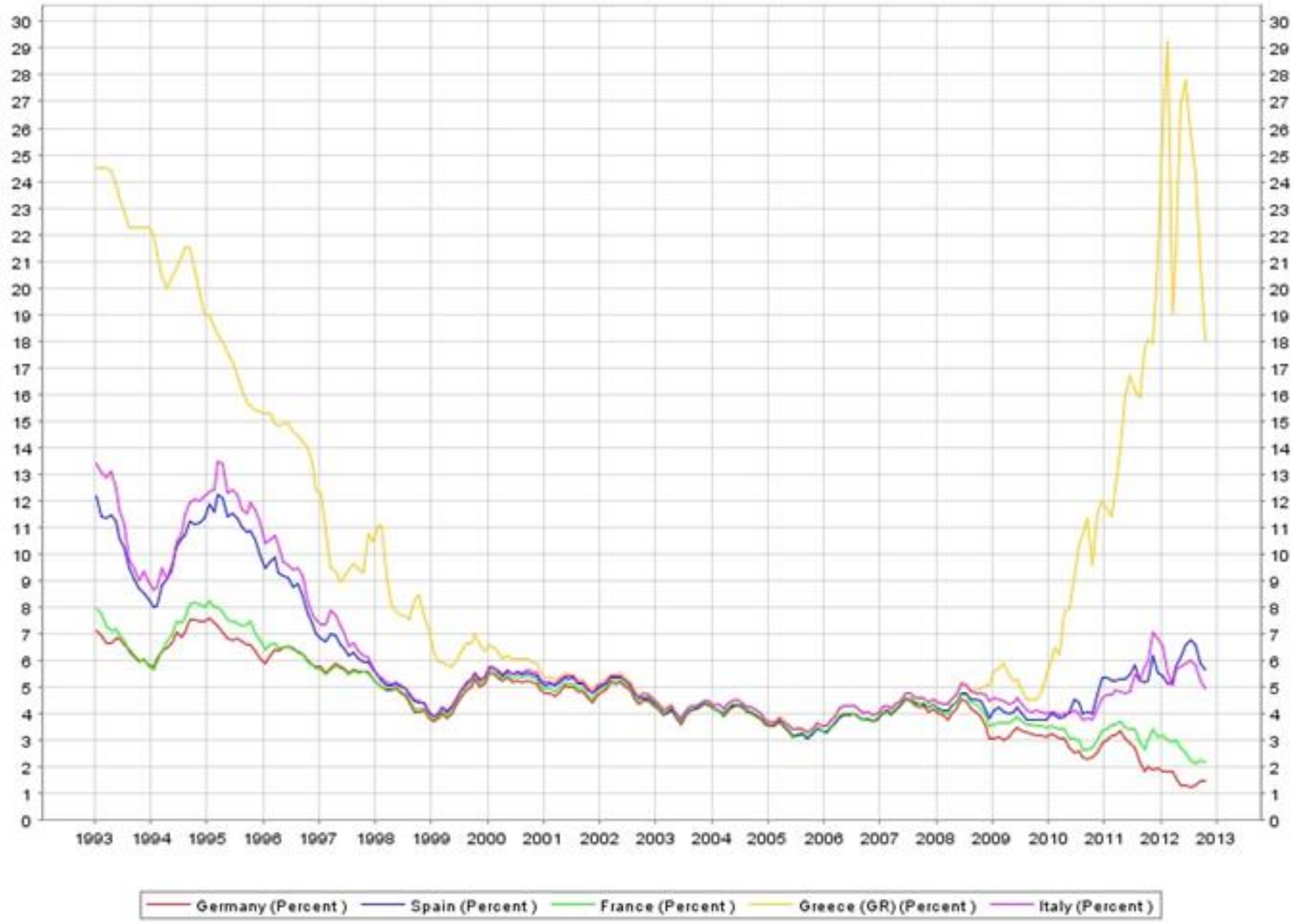
Appendix 1



Government debt as percentage of GDP for Greece, Italy, Portugal, Spain, France, United Kingdom, Germany and the EU

Appendix 2



Yields spread for Germany, Spain, France, Greece and Italy
Source: European Central Bank

Appendix 3

Country	Moody's	Fitch	S&P
Austria	Aaa	AAA	AA+
Belgium	Aa3	AA	AA
Bulgaria	Baa2	BBB-	BBB
Cyprus	B3	BB+	BB
Czech Republic	A1	A+	AA-
Denmark	Aaa	AAA	AAA
Estonia	A1	A+	AA-
Finland	Aaa	AAA	AAA
France	Aaa	AAA	AA+
Germany	Aaa	AAA	AAA
Greece	C	CCC	CCC
Hungary	Ba1	BB+	BB+
Ireland	Ba1	BBB+	BBB+
Italy	Baa2	A-	BBB+
Latvia	Baa3	BBB-	BBB-
Lithuania	Baa1	BBB	BBB
Luxembourg	Aaa	AAA	AAA
Malta	A3	A+	A-
Netherlands	Aaa	AAA	AAA
Poland	A2	A-	A-
Portugal	Ba3	BB+	BB
Romania	Baa3	BBB-	BB+
Slovakia	A2	A+	A
Slovenia	Baa2	A-	A
Spain	Baa3	BBB	BBB-
Sweden	Aaa	AAA	AAA
United Kingdom	Aaa	AAA	AAA

The ratings given to the European countries by the Big Three

Source: The Wall Street Journal, European Sovereign Credit Ratings, 15th October 2012 http://online.wsj.com/article/SB10001424052970203914304576630742911364206.html