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## **WORKING DOCUMENT No 1**

on the spread of the crisis to the real economy and on the EU's public finances

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*United in diversity*

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## **I. The effects of the crisis:**

### **A. On the real economy:**

The crisis began in the financial sector that was quickly paralysed by a severe lack of liquidity; following the bankruptcy of Lehman Brothers, confidence in the solvency of financial institutions was shaken to its core.

Thereafter, owing to the integrated nature of world financial markets this sectoral crisis spread to the real economy in 'record time'<sup>1</sup> and was compounded by the fall in demand and the collapse of world trade in the final quarter (Q4) of 2008.

The credit crisis and the resultant crisis of confidence caused households to eschew consumption in favour of savings. This fall in demand naturally led to a drop in production. However, manufacturing industry order books are now filling up again<sup>2</sup> and it is beginning to look as though the worst is behind us.

Corporate investment suffered firstly from the 'credit crunch' and falling demand and then from the stock-market crash, which limited companies' scope for borrowing and investment, undermining their ability to innovate and, ultimately, their competitiveness.

In total, the EU GDP fell by 4.9% between Q2 of 2008 and Q2 of 2009, the severest downturn since the beginning of the European integration process.

The crisis has of course had an impact on employment in the entire EU, with the exception of Luxembourg, although the jobless rate rose by an average of only 1.9% across the EU-27<sup>3</sup>. Unfortunately, the negative impact on employment will continue as a result of the customary delay with which economic trends are mirrored in the job market: Commission forecasts point to an EU-wide rate of unemployment of almost 11% in 2010, which, it continues, will have serious implications for the EU's labour force.

On the positive side, the EU's balance of trade has stabilised as a result of both a significant fall in its imports and an upturn in its exports thanks to its speed in reacting to the recovery in global trade<sup>4</sup>.

What is more, credit is becoming available once again, although the effects of this on growth have been muted; although the banks once more have the funds to lend to companies they remain loath to do so. It is no longer therefore a problem of resources, but one of confidence and risk aversion.

### **B. On public finances:**

Europe's public finances were already in a poor state before the crisis: since the 1970s the

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<sup>1</sup> European Economy 7, 2009.

<sup>2</sup> STAT/10/9, Eurostat.

<sup>3</sup> 'The impact of the crisis on employment', Eurostat, 79/2009.

<sup>4</sup> STAT/10/9, Eurostat.

level of Member States' public debt has gradually crept upwards under the impact of the various economic downturns the EU has experienced.

The cost of recovery plans, falling tax revenues and high welfare expenditure have caused both public debt and the ratio of public debt to GDP to rise in all Member States, although not to a uniform degree across the Union. The EU's average budget deficit will thus increase from 2.3% of GDP in 2008 to 7% in 2009 and 7.5% in 2010, while its public debt will rise by 20% between 2007 and 2010<sup>1</sup>.

As a result, the overwhelming majority of countries no longer meet the criteria laid down in the Stability and Growth Pact and have had proceedings brought against them under the excessive deficit procedure. Moreover, the OECD claims that if the EU-27's public debt is not consolidated, or if unsuitable strategies are pursued to counter the crisis, it could treble by 2050<sup>2</sup>. It should also be borne in mind that the current, historically low, interest rates are not sustainable.

## **II. Economic recovery policies:**

### **A. The Member States:**

National governments gave priority to saving financial institutions by injecting capital and liquidities and making use of the deposit guarantee scheme to restore confidence in the system<sup>3</sup>.

A number of recovery and stimulus measures were then pursued, worth a total of 2.7% of EU GDP in 2009 and 2010. The 'mechanical' effect of Europe's particularly powerful automatic stabilisers also came into play.

These resources were allocated as follows: 39% to measures directly supporting households, 16% to measures supporting the labour markets (reducing labour costs and working hours and facilitating part-time work), 20% to investment (in promising sectors of industry and infrastructure projects) and 25% to support for businesses (credit facilities and guarantees, setting-up of credit mediators and reducing administrative costs)<sup>4</sup>. Most Member States also maintained a stable level of research and development expenditure in 2009 and 10 even increased it.

Particular support was provided to the sectors the most affected by the crisis, with specific support measures for the automotive sector in 13 Member States. Although indispensable to prevent bankruptcies or factory closures not attributable to mismanagement, such measures can clearly not be continued indefinitely without jeopardising the principle of free and fair competition within the single market.

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<sup>1</sup> European Economy 7, 2009.

<sup>2</sup> Spread of the crisis - impact on public finances, C.W. Eijffinger, EP 429.990, 2010.

<sup>3</sup> See 'Spread of the crisis - impact on public finance', C.W. Eijffinger, EP 429.990, 2010, pp. 5-9 for a rundown of the various measures taken in each Member State.

<sup>4</sup> See 'Spread of the crisis - impact on public finance', C.W. Eijffinger, EP 429.990, 2010, pp.10-12 for a in-depth presentation of measures taken in seven of the EU' principal economies.

Of course, the Member States' public finances have also been seriously disrupted. Several Member States have already presented plans to consolidate and stabilise their budgets by 2013. Their partner countries, particularly those which, by virtue of their size, have the greatest impact on the economy as a whole, must urgently do the same.

## **B. At European level:**

1. Contrary to what has been too often said, the ECB and the EU's other central banks were remarkably quick to react, right from the earliest stages of the crisis: on 9 August 2007 the ECB made EUR 95 billion in 24-hour loans available to the banking system, the first in a remarkable series of unconventional support measures. At the same time, short-term interest rates were slashed to a level barely above zero.

2. When the financial crisis became acute, the EU's political authorities also reacted quickly and decisively: the recovery plan agreed at the Eurogroup summit of October 2008 which averted the collapse of the financial markets following the failure of the Paulson plan.

Not only did the euro successfully weather the worst financial storm since the Second World War, the eurozone has also demonstrated that it could provide extremely effective protection for its members.

At this point in early 2010 credit is once again circulating normally between financial institutions and most banks that received financial bail-outs have begun to pay them back. Although the system is not yet free of all toxic assets, the financial crisis can be said to have passed.

3. The EU implemented a recovery plan as early as in December 2008, without waiting for the inevitable economic consequences of the crisis. The plan was criticised as being merely the sum of Member States' national plans and pessimistic voices mentioned that the sums involved were substantially lower than in the US recovery plan. This criticism failed to take account of the fact that the national plans were coordinated, that situations varied greatly between Member States, and thus called for differing solutions, and that the overall additional expenditure of EUR 200 billion (1.5% of EU GDP) came on top of the impact of the automatic stabilisers.

The plan includes EUR 5 billion earmarked from the EU budget to fund energy infrastructure and the provision of extremely high-speed internet in rural areas.

It also makes provision for increased loans from the EIB and EBRD to be granted principally to SMEs.

In parallel, the Commission has launched three public public-private partnerships entitled: 'Energy-efficient Buildings', 'Green Cars' and 'Factories of the Future'.

A European microfinance instrument has also been set up to enable workers made redundant to launch their own start-ups; it should become fully operational in 2010.

EUR 6.25 billion has also been granted from the Structural Funds ahead of schedule so as to

speed up the launch of projects that could contribute to the economic recovery.

According to a Commission progress report, *'implementation of the EERP (European Economic Recovery Plan) ... has not only prevented economic meltdown, but helped stabilise the economy and allowed for a marked improvement in financial market conditions'*<sup>1</sup> and the Commission considers that, taken as a whole, the aforementioned recovery measures boosted Europe's GDP by 0.75% in 2009 and will cause it to rise by a third of a point in 2010.

What is more, the European Globalisation Adjustment Fund provided help for almost 25 000 workers made redundant in 2009.

4. A further example of European solidarity was offered by the Balance-of-payments (BoP) financial assistance instrument, which was used to help Hungary, Latvia and Romania. To that end, the overall ceiling for the BoP scheme was increased to EUR 50 billion.

### **III. Recommendations:**

#### **1. The time has come to focus all our policies towards achieving the overriding goal of doubling our growth potential.**

Economists forecast that the EU's growth potential will not exceed 1.5% per year over the course of this decade. However, 1.5% growth will solve none of our current problems: not unemployment, not budget deficit control, not debt reduction and not, above all, the task of restoring the European economy to global competitiveness vis-à-vis the emerging countries.

The Europe 2020 strategy represents an opportunity to remedy this situation that we must grasp with both hands.

The steps that need to be taken are well known and already enshrined in the Lisbon Strategy: increasing labour market participation, fostering knowledge, training, research and innovation, exploiting the remaining untapped potential in the internal market and applying the principles of 'flexicurity'. The Lisbon Strategy did not fail as a result of its diagnosis or its prescribed remedy, but because no one forced the patient to take the medicine. This is why a review is needed, in conjunction with the national parliaments, to take stock of the progress made and areas where we have fallen behind schedule. An annual meeting to publish and compare results, which would not shy away from 'naming and shaming', would be taken more seriously than the open method of coordination currently in place.

Greater coordination is required between our economic policies: firstly, to ensure that measures taken in one Member State do not harm the economies of the other Member States or negate measures taken by them and, secondly, because, setting aside the amounts involved, the nature of national expenditure needs to be compared in order to assess contributions from national budgets to the funding of EU policies and the realisation of EU objectives.

In the same vein, the structure of the EU budget must be brought into line with the new priorities of the post-crisis period. This would require, of course, revising the financial perspective and finally initiating a political debate, which can no longer be postponed, on the financing of the EU budget through own resources.

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<sup>1</sup> Progress report on the implementation of the European Economic Recovery Plan, European Commission, 2009.

## **2. Each Member State must consider how best to adapt its model for economic development.**

It is only natural that not all the Member States share the same development model: issues of size, demographics and geography, as well as natural advantages, handicaps and individual histories have created a diversity that makes Europe's economy unique and constitutes one of its main assets. The crisis has highlighted the strengths and weaknesses of each of these models and lessons must be drawn. It should also prompt us to lay down more systematic arrangements for exchanges of good practices.

Nonetheless, some questions need to be asked in every Member State.

By way of an example, a reorganisation and consolidation of the banking sector now appears inevitable.

Similarly, much thought must be given to Europe's role as an industrial power in the 21<sup>st</sup> century, as its share of world manufacturing output has fallen sharply. Such considerations should of course take into account our undertakings with regard to climate change and the potential of 'green' business activities. Better use of the EU budget must also be made to promote and pool national research, development and innovation efforts.

## **3. The challenge of an ageing population.**

Even before the crisis, the Commission had forecast that this phenomenon would reduce Europe's growth potential by 1% per year as of 2020. It would be unthinkable for this fundamental fact of demography, carefully calculated and readily predictable, not to be at the heart of our economic policy. A key part of any strategy to address this issue must be employment and worker training. It should be added that no progress has been made in setting up a single European labour market; there is twice as much worker mobility between the EU and third countries as there is between Member States.

## **4. Each Member State must bring its public finances back under control.**

First of all, it is clear that if measures supporting the economy are phased out too soon or too late this could result in another economic downturn, which would only weaken Europe's public finances even further. At the same time however, the example of certain Member States illustrates that countries that cannot come up with a credible plan for restoring balance to their finances risk being punished by excessive interest rates, which would be another obstacle to growth.

Thereafter, a reallocation of resources will be needed to strengthen investment in sectors with strong growth potential and to reduce the deficits brought about by the crisis.

**5. The question of financial and budgetary solidarity within the EU can no longer be avoided.**

Each Member State is of course responsible for putting its own house in order and, as such, Ireland has decided to take extremely stringent and credible measures. Greece should now follow its example.

That being said, it is unacceptable for a Member State in financial difficulties, whether as result of its own mistakes or not, to be forced to go cap in hand to the IMF for help: European solidarity must take precedence over international solidarity, otherwise the EU no longer has a purpose. The Union must endow itself with appropriate mechanisms, instruments and political agreements, in accordance with the Lisbon Treaty.

**6. What external economic policy should the EU pursue in the post-crisis world?**

The difficulties encountered in the Doha round of world trade talks and the failure of the Copenhagen conference have demonstrated that there are as yet no mechanisms of governance for our multipolar world: how can we expect the USA, China, India and Brazil to give up demands for unanimous decision-making when our own Member States accepted it only after half a century of tentative cooperation? Would it not be wise, as a first step, to consider more pragmatic, geographically modest solutions, whilst maintaining the EU's determination to continue to be a driving force within the G20 group and contribute to reducing imbalances in the world economy? In this regard, the role played by each institution in representing the EU on the world stage must be clarified with a view to demarcating responsibilities and having a single delegation for each function.