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THE WAY FORWARD AFTER THE CRISIS – ACHIEVING DEVELOPMENT THROUGH STRUCTURAL REFORMS IN THE EU FINANCIAL MARKETS

Abstract

The hard times EU economy is experiencing in the moment soon will inevitable come to its end. Looking ahead, under the assumption of a gradual modest recovery and the absence of the materialisation of major risks, financial market conditions are expected to improve further. In particular, liquidity and funding constraints for banks should continue to ease and risk premia in financial markets should decline further. Lending volumes should eventually turnaround and start to rise, though remaining at modest levels. This will stimulate the economy as a whole and will introduce conditions for stabilizing the financial market and encourage households and corporate to drive successfully the EU towards a well-functioning post-crisis environment.

Key words:

Control, regulatory reform, financial crisis, financial sector, structural reforms.

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Financial Sector Polices in the European Union

Financial markets in the EU have become substantially more integrated since 1999, with the introduction of the euro and an intensification of efforts to complete the single market in financial services. The elimination of exchange-rate risk on the bulk of intra-EU capital flows has stimulated investor demand for the provision of financial services on a cross-border basis. Meanwhile, the financial integration process has been further stimulated by the creation of a common EU regulatory framework covering all main segments of the market, i.e. banking, insurance/pension funds and securities. This common regulatory framework derives from EU-level legislation, proposed by the Commission and adopted by the Council and Parliament, which is binding and either directly applicable in all of the Member States (like regulations) or required to be transposed into national law or rules by the Member States (Directives). In this way, the common regulatory framework reflects an overarching strategy for financial integration and development that is applied at the EU level. The formulation and implementation of EU-level financial regulation was facilitated by the introduction of the Lamfalussy framework in 2001/2, which facilitated the legislative process and involved the creation of EU-level committees of supervisors for the banking, insurance/pension and securities sectors. Accordingly, the EU-level dimension in financial sector policies has become increasingly important.

Managing the financial crisis

Since the onset of the global crisis, exceptional interventions by public authorities have been fundamental to avert a meltdown of the financial system[1]. The measures have been formulated and implemented at national level, but the general approach has been co-ordinated at EU level. The scale of interventions by public authorities has been very substantial, equivalent to about 30 per cent of EU GDP. Intervention has had two objectives: (i) to preserve financial stability while endeavouring to minimise distortions of competition and market functioning within the internal market and preserving a level playing field across banks; and (ii) to prepare for the return to normal market conditions and proper lending to the real economy. So far, the first objective has been prioritised. All interventions have taken place in compliance with EU state aid rules, so as to minimise the risk of distortion in competition and market functioning and to ensure the earliest

[1] detailed information: Financial stability review, Dec. 2009, ECB publication; www.ecb.int/press/key/date/2009/html/sp091211_1.en.html.

possible return to viability among financial institutions and normal functioning of markets.

In line with the G20 conclusions and taking into account that the economic and financial recovery remains fragile, the EU Council has decided that an early withdrawal of financial support is unwarranted. However, the Council in December 2009 agreed principles for a coordinated, but differentiated exit from financial support schemes. These principles include:

(i) facilitating adequate incentives to return to competitive markets;

(ii) ex-ante exchange of information on the intentions to phase out (this information will be centralized by the European Commission);

(iii) transparency towards the public and financial sector,

(iv) an ongoing assessment of the stability of the financial system.

Moreover, the Council agreed that the timing for exit will be carefully assessed on the basis of several elements, including:

(i) macroeconomic stabilisation;

(ii) a return to «normal market conditions» and banks' observed behaviour;

(iii) a strengthening of the banks' balance sheets and their capacity to deal with impaired assets;

(iv) the normal functioning of credit channels; and

(iv) the impact of anticipated strengthened regulation.

Regulatory reform in the EU financial sector

Also since the onset of the crisis, the EU has taken a range of regulatory initiatives to safeguard financial stability within an integrated financial market. These initiatives have been in the areas of transparency, valuation, prudential risk management and market functioning. The proposed reforms are highly consistent with the corresponding G20 proposals. Further revision of EU rules on capital requirements for banks have been proposed for adoption at the EU level in order to: (i) improve the way in which banks[2] assess the risks connected with their trading book; (ii) impose higher capital requirements for re-securitisations; (iii) increase market confidence through stronger disclosure requirements for securitisation exposures; and (iv) introduce dynamic provisioning. Further work is

[2] detailed information: EU banking sector stability, Aug. 2009, ECB publication; EU banks' funding structures and policies, May 2009, ECB publication.

foreseen inter alia on systemically relevant financial institutions and crisis prevention, management and resolution.

As a means to increase further integration and financial stability, enhanced competition and interoperability amongst Central Clearing Counterparties on the derivatives market should be improved by the impact of the «Markets in Financial Instruments Directive» and the «Code of Conduct on clearing and settlement». Regarding over-the-counter (OTC) derivatives markets, the European Commission – along lines agreed by the G20 – intends proposing in 2010 new legislation[3] that will address main shortcomings of the current derivatives market organisation. The proposed measures will shift large parts of derivative markets from predominantly bilateral over-the-counter to more centralised trading, clearing and settlement.

Another line of regulatory reform aims at addressing areas with little oversight in the past. The EU has adopted a regulation on credit rating agencies in 2009 in order to ensure that they meet the international code of good practice. In 2009 the Council also adopted rules on the remuneration in the financial sector and the coverage of alternative investment funds. Both of these are now to be discussed by the European Parliament and most of the changes should be adopted by 2010.

The new supervisory framework of the EU

Reflecting the progress achieved in financial integration and the lessons learned from the recent crisis, the EU supervisory architecture is also being reformed. The reform, which must be agreed by the Council and the European Parliament, based on a Commission proposal, implies that European financial supervision will be based on two pillars. The first pillar will consist of a new European Systemic Risk Board (ESRB). Its main purpose will be to monitor and assess risks to the stability of the financial system as a whole («macro-prudential supervision»). The ESRB will provide early warning of systemic risks that may be building up and, where necessary, recommendations for action to deal with these risks.

The second pillar will be the new European System of Financial Supervisors (ESFS). The ESFS will be responsible for supervision of individual financial institutions («micro-prudential supervision»). The system will consist of three European supervisory authorities for banks, insurance and securities markets. There will be a European Banking Authority, a European Insurance and Occupational Pensions Authority, and a European Securities and Markets Authority. The

[3] detailed information: Legal framework of the Euro system and the European System of Central Banks, ECB legal acts and instruments, Aug. 2009.

aim is to unify supervisory practices across Member States and be able to act efficiently in case of financial emergency.

Following the adoption of the reform package by the European Council in December 2009, the European Parliament will start debating it in early 2010 with a view to establishing the new system in the course of 2010.

The EU's response to the crisis in the area of structural reforms

Within the European Economic Recovery Plan (EERP)[4], Member States have initiated far-reaching policy responses to the crisis. Temporary state aid frameworks were agreed at EU level to provide a legal framework for Member States' support to businesses. Guidelines were drawn up on labour market policies during the crisis, providing a reference point for national authorities. Surveillance on the EERP implementation has shown that it constitutes a robust response to the crisis. Temporary measures on the labour market (mostly on shorter working hours and unemployment benefits) appear in particular to have helped mitigate rises in unemployment. Other measures so far include, inter alia, investment in physical infrastructure, especially in energy-efficiency projects, R & D support, easing financing constraints to small and medium enterprises and reducing administrative burdens for businesses. Overall, structural crisis measures taken under the EERP are considered to be well-targeted, timely and of temporary nature.

With economic activity nowadays stabilising, the focus is now moving to the design of exit strategies, which will also contain a strong structural reform element. While the crisis has a significant negative effect on GDP growth in the short-term, its long-run impact on potential growth depends largely on the policy measures taken ahead. Inter alia, exit strategies require the phasing out of temporary support measures so as to facilitate the essential reallocation of resources to new activities. At the same time, the phasing-in of a longer-term structural reform agenda becomes indispensable. The challenge now is to develop and implement a comprehensive growth agenda, which includes actions to help complete the single market, develop green growth strategies, bolster labour supply by tackling segmentation in the labour market, and elaborate a strategy for the knowledge triangle (education, R&D and innovation).

[4] detailed information: http://ec.europa.eu/research/index.cfm?lg=bg&pg=newsalert&cat=x&year=2009&na=ppp-310309; http://www.ceep.eu/index.php?option=com_content&view=article&id=1:welcome-to-joomla&catid=1:latest-news.

The euro area structural reform dimension

The euro area is facing significant challenges to mitigate the impact of the crisis on potential output, to increase its adjustment capacity and to minimise the costs of the necessary reallocation of resources. Tackling these challenges requires important structural reforms of labour and product markets.

The euro area is taking decisive measures to prevent unemployment from becoming permanent and to improve competitiveness. The Lisbon Strategy for Growth and Jobs has helped raise employment rates up to the onset of the crisis and contributed to the creation of 16 million jobs in the euro area in the last decade. Several dimensions of labour market policies will be especially important in the post-crisis period: (i) active labour market policies (e.g. through the improvement of public training schemes and public employment services) are especially important given the surge in unemployment; (ii) reforms of employment protection legislation (EPL)[5] to facilitate the reallocation of labour, especially in countries where there is a large gap between the protection provided to workers on permanent contracts and those on temporary contracts; (iii) putting in place tax and benefit systems that reduce the benefit dependency by making work pay will become increasingly important to encourage workers to move to new activities; (iv) raising labour supply, including through measures which extend working lives, will be needed to counter the effects of population ageing and also to help bolster the sustainability of public finances (these will need to cover all sources of labour supply such as working hours, female participation rates and labour supply of older workers, including measures which increase effective retirement ages); (v) to avoid losses in price competitiveness, wage developments should be closely aligned to the evolution of productivity.

The forward-looking growth strategy requires a significant restructuring of economic activities which is of crucial importance in boosting productivity. There are several dimensions of product market policies which will be particularly important in the post-crisis period in order to smooth this process and make it effective. In the European context, the efficient functioning of the internal market will be essential in ensuring that industries can restructure on a European scale, thereby benefiting from economies of scale and scope. The emphasis needs to be placed on improving market functioning (especially in services). Also, policies aimed at ensuring a modernisation of the framework conditions underpinning the knowledge economy are essential in boosting (total factor) productivity. There is scope to improve various dimensions of innovation policies and education systems in most euro-area countries.

[5] detailed information:
www.ilo.int/public/english/region/eurpro/geneva/.../emp_prot_leg.pdf.

The way to potential growth

The implementation of the structural reforms discussed previously will determine the future path of potential growth both in the EU and in the euro area. In addition to bolstering growth and jobs, structural reforms will contribute to the long-term sustainability of the EU's public finances. Whilst country specificities require that labour and product market reforms will have to be tailored to national circumstances, given the medium term risks to growth, the key challenge for all countries will be to accelerate the pace of structural reforms. Over the long-run, productivity is the key to raising potential output and this will require action in terms of opening up markets, especially in services, supporting the business environment through a lower administrative burden and especially supporting R&D/innovation. Recent simulations with the QUEST economic model run by the European Commission services confirm the beneficial effects on output and employment of a wide range of reform initiatives, including smart tax reforms; measures that improve the skill composition of the labour force; R&D subsidies; raising competition in the final goods market; increased financial market integration; and measures that remove entry barriers in certain markets. Overall, if a comprehensive structural reform agenda is implemented, potential growth in the EU and the euro area could be boosted by between 0.5 % and 1 % annually over a five to ten year horizon. The envisaged «EU2020» Strategy provides the mid-term oriented framework for growth oriented reforms and the successful implementation of this Strategy will be instrumental for achieving higher potential growth.

Are there grounds for optimistic forecast?

According to the European Commission's Autumn 2009 Forecast, GDP is set to fall by about 4 % in the EU and the euro area in 2009. The cumulative output loss amounts to some 5 % of GDP since the recession started in the second quarter of 2008.

Swift and large-scale policy actions undertaken by governments and central banks have led to a marked improvement in financial market conditions in the EU since summer 2009, with some stress-indicators now back to pre-crisis levels. Risk perceptions have fallen and risk premium have eased spreads in interbank markets and for corporate bonds.

The high leverage of many economic sectors will weigh on financial market developments. The outlook for the quality of loans to households and firms may deteriorate further in 2010, and the historical evidence suggests that banking sector repair takes time. The financial sector may therefore experience difficulties in carrying out its intermediation function and supporting the recovery.

However, the results of the EU-wide forward-looking stress test of the banking system presented by the Committee of European Banking Supervisors in October 2009, suggest that large EU banks are sufficiently capitalised to head off a severe macroeconomic deterioration.

Signs of improvement in the economic situation have become increasingly apparent in both confidence indicators and hard data since the summer of 2009. Together with the impact of improved confidence across sectors and countries, growth turned positive again as of the third quarter of 2009 in both the EU and euro area. This initial upturn in economic activity in the EU and the euro area is, however, largely driven by temporary factors. In particular, the favourable impact of inventory adjustment (with the destocking process coming to an end) and stimulus measures are expected to fade away in the course of 2010. The recovery thereafter is projected to be different from earlier cyclical upturns as the economy is finding its way to a new post-crisis equilibrium. Several factors are expected to dampen domestic demand over the forecast horizon, including a need for financial deleveraging across sectors, an expected further deterioration of the labour market and supply constraints stemming from the adverse impact of the financial crisis on potential output. The EU's external environment is also affected by the ongoing rebalancing of world demand. As a result, EU export growth is set to firm only gradually over the forecast period.

Notwithstanding the support from an improved external environment, a sustained pick-up in the underlying recovery would require an improved outlook for private domestic demand. Traditionally, an upturn in exports spurs demand for investment which subsequently supports employment and private consumption growth. At present, however, this export – domestic demand nexus is anticipated to be weaker. A historically low capacity utilisation rate, relatively weak demand prospects, subdued profitability gains and still moderating credit growth underpin the projected (unusually moderate) recovery of gross fixed capital formation, which is projected to turn positive only in 2011. This, together with the need to deleverage households' balance sheets further and the expected bleak labour-market situation, is likely to make private consumption sluggish, recovering to about 1 % growth only by 2011.

Overall, after the temporary boost during the second half of 2009, real GDP growth is expected to ease somewhat and to regain ground only by the second half of 2010. As both external and domestic demand gradually strengthen, growth could recover to about 0.5 % quarter-on-quarter (q-o-q) during 2011 in both the EU and the euro area. Taking into account the weak carry-over from this year, annual growth rates will be limited to about ¾ % in 2010 in both regions. In 2011, GDP could grow by some 1½ %, thereby starting to gradually close the output gap that will have opened up by then as a result of the crisis.

Conclusion

The hard times EU economy is experiencing in the moment soon will inevitable come to its end. Looking ahead, under the assumption of a gradual modest recovery and the absence of the materialisation of major risks, financial market conditions are expected to improve further. In particular, liquidity and funding constraints for banks should continue to ease and risk premia in financial markets should decline further. Lending volumes should eventually turnaround and start to rise, though remaining at modest levels. This will stimulate the economy as a whole and will introduce conditions for stabilizing the financial market and encourage households and corporate to drive successfully the EU towards a well-functioning post-crisis environment.

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