International Thematic Proceedings

NATIONAL AND EUROPEAN IDENTITY IN THE PROCESS OF EUROPEAN INTEGRATION

Edited by
Pero Petrović
Milovan Radaković

Belgrade, 2013

Institute of International Politics and Economics

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Publisher
Institute of International Politics and Economics,
Makedonska 25, Belgrade

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Layout Cover Design: Snežana Vojković

Printing by “Mala knjiga”, Novi Sad

ISBN 978-86-7067-180-5

The publication a part of research results within the Scientific Project of IIPE, Belgrade, No. 179029 (2011–2014), and was financialy supported by the Ministry of Education Science and Tehnological Development on the Republic of Serbia.

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Thematic Proceedings
from International Conference

National and European Identity in the Process of European Integration

28–29 june 2012
Belgrade

The work on the Proceedings forms part of research on the project “Serbia in contemporary international relations: Strategic developments and strengthening of its position in international integration processes – foreign policy, international economic, legal and security aspects”. The project is being financed by the Ministry of Education and Science within the programme of fundamental research for the 2011-2014 period.

The publication of the Proceedings has been financially supported by the Ministry of Education and Science of the Republic of Serbia.

The views and opinions expressed in the Proceedings are those of the authors and do not necessarily reflect the official policy or position of the Institute or the Ministry of Education and Science.

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UDC 339.747(4-672EU)

FINANCIAL CRISIS SPREAD IN THE EU AND THE WAYS OF ITS MITIGATION ON THE NATIONAL LEVEL

Abstract: The global crisis and the interventionist efforts of state authorities aimed at economic stabilization have caused a lot of controversy about the advantages of free market system and, therefore, revealed a lack of correspondence with the basic premises of neo-liberal doctrine of 'minimal' governance and 'maximal' market freedom. It is assumed that in order to recover their economies from recession the most developed countries have decided to place low-cost loan funds that were used by their central banks to provide banking and real sector. In contrast to them, the underdeveloped countries were forced to seek appropriate international financial and organizational help, since they do not have adequate development strategy. In order to determine the effectiveness of state policies we considered data on total state aid (as % of GDP) used by the EU member states. Besides that, given paper deals with investigation of mutual dependence between total government expenditures (as % of GDP) and public debt levels in these countries.

Key words: state, crisis, public debt, government spending, aid.

Introduction

Along with the extremely rapid technological development leading to strong economic growth and widespread globalization of relations, there are more frequent crises that have devastating effects on the entire economy. In the fall of 2008, it has become clear that the world is affected by the greatest economic crisis since the Great Depression of the thirties of 20th century. As a result of macroeconomic

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This paper is part of a research project „Social Transformations in the European Integration Process: A Multidisciplinary Approach", financed by: Republic of Serbia. Ministry of Science and Technological Development.

problems and imbalance, incautious behavior of the financial sector and loose regulatory environment, the recession that has assumed systematic and global character has appeared. The global recession resulted in economic stagnation and decreased financial resources that are necessary not only for preventive actions, but in particular, for dealing with crisis and restoration of caused damage. Countries around the world are faced with its negative impacts and many dynamic changes. Leading economists estimate that the current global financial crisis will have far greater scale negative impact than the crisis during 30's in the last century when the United States experienced significant damage and unemployment reached a peak, leaving the state a long time under the influence of the crisis.

The question that is increasingly attracting the attention of researchers in circumstances of more expressive economic turbulence is the scope and role of the modern state. The debate on the necessity for greater engagement of the state was opened, with the aim of finding some new ways to address more effectively many challenges posed by globalization. The Great Depression of the 20th century that occurred in the 1930s strongly supported the interventionist macroeconomic policy in capitalist states, for its devastating effects, aiming at the preservation of public revenues, employment opportunities and preventing the emergence of deep stagnation in the economy. Given the reactions of the state in terms of financial and economic crisis, it is required to obtain answers to many questions that inevitably arise: Which analysis is necessary to perform in order to identify the cause of the problem?; Which institutional mechanisms should be implemented in order to avoid new financial turmoil and ineffective interventions? Furthermore, which disciplinary measures should be implemented to ensure the wise use of taxpayers' money?; Which disciplinary measures should be formulated and implemented to ensure the implementation of defined objectives?; Which regulatory framework is needed to modernize financial monitoring and ensure effective regulatory management?

The wave of state interventionism in the developed states aims to mitigate the effects of global recession and ensure the recovery of world economy, while in developing states behind state interference in economic life, lies opposite intent that "visible" hand of the government signals a strategic rejection of free-market doctrine. In order to increase market liquidity and prevent further deterioration of financial markets, states worldwide implemented programs to inject large sums of money to rescue their financial systems. In terms of the escalation of the crisis, almost all developed states increased the guarantee on deposits of private persons, provided guarantees for interbank lending, cut benchmark interest rates, banned or restricted the sale for a short period and injected capital into troubled banks by buying their shares. In order to prevent mass and panic withdrawal of deposits from banks due to general insecurity, most of them decided to increase the amount of insured deposits. In countries such as Australia, Canada, Germany, Norway, Spain, Switzerland and the United Kingdom comprehensive measures including the purchase of

troubled assets were implemented, while the United States first pushed this program in favor of direct capital injections.

The primary objective of this paper is to indicate the main measures that have been implemented in EU in order to overcome the negative effects of financial and economic crisis. The special emphasis is put on the actions of EC which were coordinated with rescue packages adopted by EU member states.

State aid measures in the frame of EU

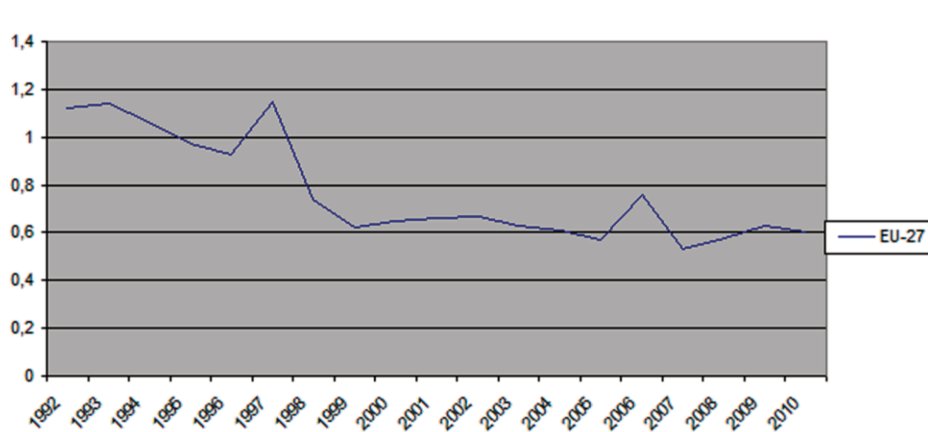
Bankruptcy of Lehman Brothers in September 2008 led to increased fears that the other major financial institutions could collapse and create serious problems to the entire financial system of the EU. Negative spillover effects of the crisis from the U.S. mortgage market showed that public support was necessary to maintain the common European market, since it represented the ultimate guarantee for the economic security and future growth of the EU. Policymakers in the EU, both at Member State level and at the central level, were very surprised by the severity of the financial crisis in early September 2008. Until its escalation, their actions mainly relied on the operation of monetary policy in order to stimulate the liquidity of financial institutions in response to the freezing of the interbank market in the summer of 2007. The trend of reducing the level of state aid as a percentage of GDP in the EU, followed by constant innovation of regulations in this area was present until the beginning of 2008. At the same time, the Action Plan on state aid called: *the Less and better targeted state aid: a roadmap for state aid reform 2005-2009* (small but adequate used state aid: instructions for performing reforms of state aid in the period from 2005 to 2009) was adopted. This plan was designed for the purpose of better use of state subsidies, improving the economic approach, achieving more efficient procedures, simple rules, higher predictability and improved transparency of data and adequate division of responsibilities between the Commission and Member States.[2] Before the first signs of economic crisis, the EU, already faced with increased demands for government assistance, was also faced with the challenge of harmonizing the need for reducing and better directing of state aid to more or less justified reasons for the increase of support in times of crisis.

After September 2008, aggressive measures of easing were taken such as easing monetary policy - in combination with the quantitative incentives, recapitalization of banks, increasing the deposit insurance, providing guarantees, warranties or buying bad assets etc., in order to avoid the insolvency of financial institutions and the collapse of the financial system as a whole.[3] The Member States established a

[2] "State aid action plan: Less and better targeted state aid: a roadmap for state aid reform", Commission of the European Communities *Consultation document*, 2005.

[3] "Economic crisis in Europe: Causes, Consequences and Responses", European Commission, European Economy 7/2009.

Graphic 1: Trend in the overall level of non-crisis aid as a percentage of GDP, EU-27, 1992-2010



Note: In the EU total, data for Austria, Sweden and Finland are included from 1995 onwards, the EU-10 Member States as from 2000 and Bulgaria and Romania from 2002.
Total aid excludes railways
Source: European Commission. 2011. Scoreboard – Data on State aid expenditure – State aid in the context of the financial and economic crisis, *http://ec.europa.eu/*

coordinated response to support the financial system with the intention of restoring stability and preventing systemic crises providing long-term recession or even depression in the EU. However, due to the adoption of discretionary fiscal measures and reduce of tax revenues and spending, in the short term the EU member states more than doubled their budget deficits.

According to specific data given by each country, in the period from 2007 to 2010 EU member states investing most funds in the state aid for the rehabilitation of the effects of the crisis were Ireland (268.50% of GDP), Denmark (67.20% of GDP), Belgium (20.50% of GDP), UK (17.80 % of GDP) and Greece (16.90% of GDP). The financial crisis affected the manifold increase in the amount of total aid from 66.5 billion euros (0.52% of GDP in EU-27) in 2007 to 279.6 billion euros (2.2% of GDP) in 2008. Total granted state aid without the support that is characterized as anti-crisis measures, participated in the GDP in the Union with 0.54% in 2008 years, or with 0.6% in 2009.

Table 1: Total fincial crisis state aid 2007-2010
(as % of 2010 GDP) for selected EU Member States

Member state	Total financial crisis aid 2007-2010	
	in € billion	as % of 2010 GDP
Belgium	72,36	20,50%
Denmark	157,41	67,20%
Germany	252,55	10,10%
Ireland	413,28	268,50%
Greece	38,85	16,90%
Spain	88,80	8,40%
France	116,39	6,00%
Italy	4,05	0,30%
Cyprus	2,82	16,10%
Latvia	2,33	13,00%
Luxembourg	4,94	11,90%
Hungary	2,24	2,30%
Netherland	95,16	16,10%
Austria	27,11	9,50%
Portugal	5,24	3,00%
Slovenia	2,15	6,00%
Finland	0,12	0,10%
Sweden	20,70	6,00%
United Kingdom	301,50	17,80%
EU-27	1607,98	13,11%

Source: European Commission. 2011. Scoreboard - Data on State aid expenditure - State aid in the context of the financial and economic crisis, *http://ec.europa.eu/*

Total aid, regular or as a result of response to the financial crisis, was up 2.5% and 3.6% of GDP respectively. EU as a whole (mainly Monetary Union and the United Kingdom) invested into the financial institutions 236 billion euros (231 cases), equal to the amount invested by the United States. However, the value of the issuance of bonds and lending in the EU is 957.7 billion euros (in 152 cases), and more than triple than in the USA.[4] In the EU, the total of all interventions was 28% of GDP yearly. Governments of EU members placed some funds to some banks in the form of capital injections and encouraged mergers (too big to fall) to revive the credit markets and interbank lending.[5]

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[4] Oskar Kovač, 2010. "*Alternativni putevi saniranja posledica finansijske krize u svetu*", Ekonomska politika, septembar 2010, Internet *http://www.nspm.rs/ekonomska-politika/alternativni-putevi-saniranja-posledica-finansijske-krize-u-svetu.html*, 15/03/2012

[5] Adrian Blundell-Wignall & Paul Atkinson, "Origins of the financial crisis and requirements for reform", *Journal of Asian Economics* 20, 2009, pp. 536–548.

Member states were forced to seek the help of the Commission in order to make quick and effective decisions for taking emergency measures to rescue financial institutions. In order to improve decision-making process, the Commission simplified certain procedural mechanisms used when granting state subsidies, but still trying to ensure strict respect of basic rules and principles.[6] Within just a few weeks after the crisis, it became clear that the existing EU rules were not effective in solving the problems of financial markets, and those simple measures could lead to unfair competition and disturbance of flow of funds between member states.[7] Instead of complete neglect of the existing, special rules of state aid were adopted with more effective impact on the current financial crisis and initiated questions not only on the integrity of the common market, but also the degree of control, legal certainty, protection of competition and the strategies emerging from the crisis.

Aware of the fact that bank failures could cause serious disturbances in the economies of member states, the Commission made several statements with the intention to provide a framework that would allow more flexibility, i.e. provided the backbone of the financial sector after the financial crisis. Many decisions on granting aid measures were made in favor of financial institutions, but then, with the first signs of recovery, the Committee focused its attention on the sustainable restructuring of financial sector and boost growth in the real sector.[8] For this purpose the European economic recovery plan was adopted with the worth of 200 billion euros representing 1.5% of the total GDP of the EU for solving the economic crisis, which should ensure economic growth and social stability, improve production by investing a large part of funds for technological innovation, research and development, new employees, etc..[9] According to the ECB, emergency corrective measures performed by the central banks and governments of member states in the end of 2008 up to now were successful in restoring confidence in financial systems and strengthening their resilience. Fortunately, the worst scenario was avoided since in the late 2010 there was no occurrence of the collapse of European financial institutions, non-systemic crises in the financial system and long-term financial flows dried up in the real sector.[10]

[6] Paris Anestis & Sarah Jordan, "State Aid after the Financial Crisis: Restructuring Measures to Restore Viability and Minimise Competitive Distortion", *Global Competition Review*, 2011, pp. 67–70.

[7] Nicolaides Phedon & Eleonora Rusu Ioana, "The financial crisis and state aid", *Antitrust Bulletin*, Vol. 55 Issue 4, 2010, p. 759.

[8] Paris Anestis & Sarah Jordan , "State Aid after the Financial Crisis: Restructuring Measures to Restore Viability and Minimise Competitive Distortion", op. cit., pp. 67.

[9] "Euro Area Fiscal Policies and the Crisis", *Occasional Paper Series*, European Central Bank, No 109, April 2010., http://www.ecb.int/pub/pdf/scpops/ecbocp109.pdf.

[10] "Measures taken by Euro Area governments in support of the financial sector", *ECB Monthly Bulleting*, April 2010.

Thanks to taking appropriate actions aimed at solving the problems, the total amount of aid granted to financial institutions was sevenfold reduced in the period between the first quarters of crisis until the end of 2010 (approximately 250 billion euros per quarter from October 2008 to June 2009 compared to 38 billion euros in the quarter from July to December 2010). Moreover, the number of Member States which secured the assistance was also decreased - e.g. in the last quarter of 2008. The 14 member states approved the financial aid packages of several billion euros, while in late 2010 only four Member States had that possibility (Germany, Greece, Spain and Ireland).[11] The total support in 2010 amounted 73.8 billion euros, which was 0.60% of GDP.

Reducing the use of aid was in parallel with the gradual leaving the program of support by Member States. Number of applied measures packages through June 2011 was halved in comparation with the peak of the crisis. At the beginning of last year, only seven Member States had a program of recapitalization and eight guarantee schemes, which suggests that the situation in the financial sector was more stable than at the beginning of the crisis. However, regardless of the results obtained, it should be noted that the support was provided by the ECB in the course of 2010 both in the form of support in terms of liquidity and in the form of decreasing interest rates.[12] Thanks to its intervention, there was a solvency of European banks and they gradually returned to their profitability, but at a much lower level than before the crisis. In addition to mitigating the risks to financial stability, help is also aimed at restoring the normal functioning of the financial system, both in terms of long-term viability of banking institutions and in terms of lending opportunities of European companies and households.

The most recent indicators of the European Commission regarding the effect of state aid show that the EU member states increasingly use the opportunities arising from the defined rules. It is important to emphasize that there is no direct or exclusive causal relationship between the level of state aid granted to Member States and market development because it is extremely difficult if not impossible, to separate the effects of state efforts to support and other policy makers, especially the injection of liquidity and the ECB's macroeconomic movements both in the states and the international plan. It should be noted that the global economic crisis presents a unique test for the state aid system in the EU because it is necessary to adjust the goals of competition and the idea of a common market, on one hand, and the needs of each state, with the help of state intervention to prevent further negative effects of the crisis.

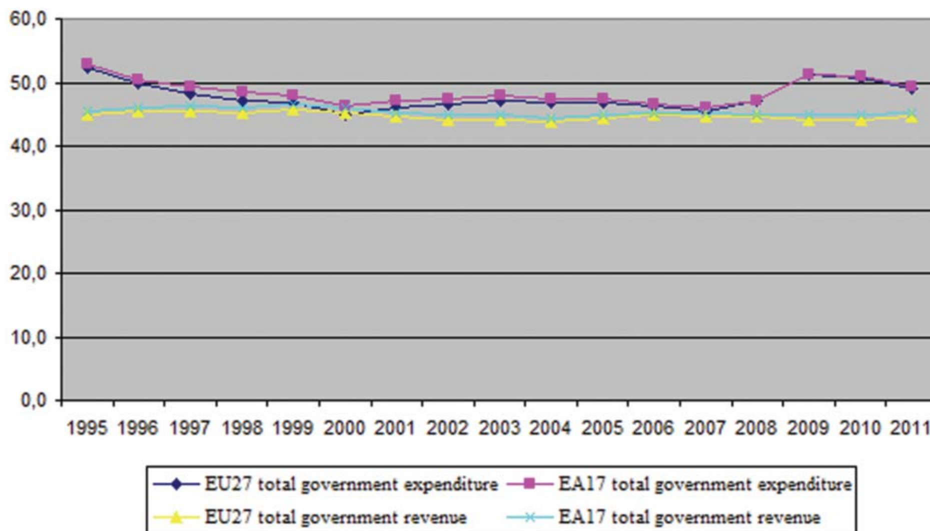
[11] "The effects of temporary State aid rules adopted in the context of the financial and economic crisis", European Commission, *Commission Staff Working Paper*, 2011.

[12] Ibid., pp. 76.

State expenditures and revenues within EU in the circumstances of global crisis

The state has an important role in the economy which is reflected in public services, redistribution of income and prevention of instability in the business cycle with the help of automatic stabilizers, as well as implementing measures in the field of active fiscal policy. As expected, the economic and financial crisis in 2008 and 2009 led to decreased state revenues and increased expenditures (as% of GDP), which resulted in the increase of the deficit.[13] In 2010 total government expenditures in EU-27 amounted 50.3% of GDP while total revenues decreased to 44% of GDP, causing a deficit of 6.4%. By observing and comparing the trend in public expenditures and revenues, it is evident that the instability of public expenditure as % of GDP is much higher than income, even in the periods of relative stability.

Graphic 2: EU-27 and EA17 government revenue and expenditure in % of GDP from 1995 to 2011

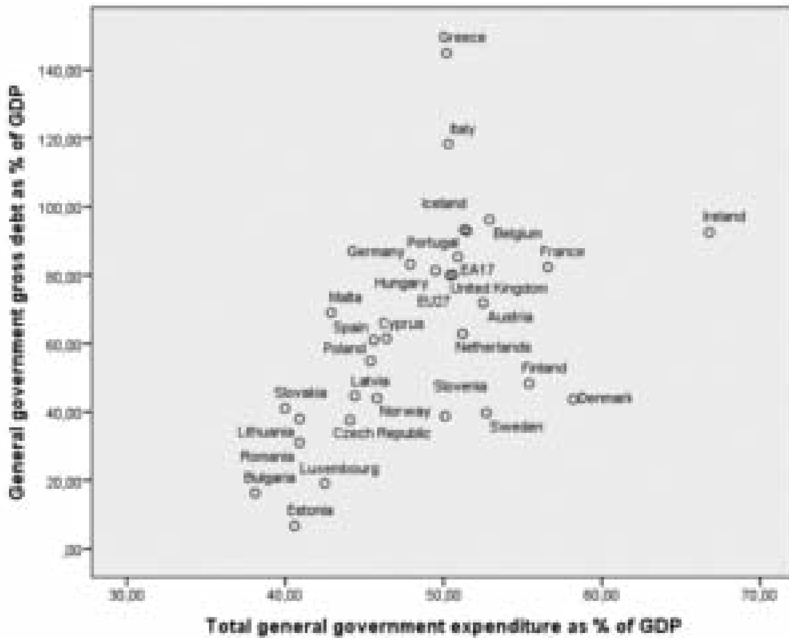


Source: Eurostat

[13] "The effect of the economic and financial crisis on government revenue and expenditure", Economy and finance, Eurostat, European Commision, Statistics in focus 45, 2011.

Due to the escalating economic and financial crisis, the total public revenues are significantly reduced. Increased expenditures as % of GDP in the period between 2008 and 2009 was without precedent as it was the largest growth in expenditures in the period 1995-2010. It should be noted that in times of crisis, public expenditures tend to increase due to the growing number of people who lose their jobs and payments of higher social security benefits in case of unemployment.[14] In general, public spending EA-17 is more or less achieved in a similar way as a movement within the EU27, although at slightly higher level. In 2010 the highest level of budget deficit as% of GDP was recorded in Ireland (-31.3%), Greece (-10.6%), UK (-10.3), Iceland (-10.1%), Portugal (-9.8%) and Spain (-9.3). Only in Norway the budget surplus was recorded in the amount of 10.6% of GDP.

Graphic 3: EU-27 government expenditure and gross debt in % of GDP, 2010



By reducing public revenues due to a decline in economic activity and increasing public expenditures due to stimulus spending aimed at impoverished population and troubled economy the crisis significantly increased the public debt of many member states. Taking into account only the level of macroeconomic indicators, data of

[14] Maureen Lewis & Marijn Verhoeven, "Financial Crisis and Social Spending: The impact of the 2008–2009 crisis", *World Economics*, Vol. 11, No. 4, 2010, pp. 79–110.

Eurostat for 2010 indicate that some states burdened its GDP according to some criteria more than allowed. The highest level of public debt as % of GDP was recorded in Greece (144.9%), Italy (118.4%), Belgium (96.2%), Portugal (93.3%), Iceland (92.9%) and Ireland (92.5%). Positive correlation between the existence of general government expenditures and gross debt (both as % of GDP) of EU Member States can be seen on the graphic 3.

Conclusion

Thanks to the measures applied the tendency of the negative trends in GDP growth stopped. The global economy began to stabilize, thanks mainly to better financial conditions resulting from large government intervention and the intervention of central banks, but it is expected that the process of recovery would be slow and long. Until now the accepted measures and priorities in the fight against the crisis were to strengthen banks' capital and establish better credit flows. However, the recovery of world economy based on the injection of new liquidity into the economy is fragile. What is obvious is that one continent is lagging behind the others – that is Europe.

Finding a new path of development is a priority of EU economic policy as the EU Member States have started to fight budget deficits since the government intervention packages have provoked a huge increase in public spending. Most of them invest huge funds to prevent the collapse of their economy and halt the further increase in unemployment. Given that the majority of states still need to support spending, public debt will continue to increase. Although the implementation of strong state interventions largely achieved the desired effects of restoring stability, they, by their nature, have a distorting effect and should be subject to continuous monitoring and attention of policy makers in the short term. Therefore, there is a dilemma when to stop applying the stimulus packages, for their application would result in inflationary trends if applied in long term. In addition, there is a concern that the applied measures will contribute to achieving sustainable development of the state and that the positive signs recorded in 2010 have only the short lasting effect caused by the measures applied and they are not an indication of complete recovery and going out of the recession.

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