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The Economics of State Aid Control in the European Union during the Financial Crisis: the Challenge for a Post-Crisis Rhetoric

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Abstract. *The present paper explores the rationale behind the legal framework regulating the use of state aid by the member-countries of the European Union during the financial crisis. Starting with 2008, the massive interventions in the banking industry of the governments of the member-countries attempting to eliminate the effects of the crisis fundamentally challenged the core logic of the entire policy regarding the control of state aid in the European Union. We attempt to underline the extraordinary dimension of the impact of the financial crisis on state aid control and scrutinize whether the underlying principles of the state aid regime have been changed. We conclude that the special place that the financial industry in general, and the banking industry in particular, enjoys from the point of view of competition policy, is unfounded. European Union is, after the crisis, in the uncomfortable position of re-legitimizing state aid control.*

Keywords: state aid; competition; European Union; financial crisis; banking industry.

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The enforcement of competition law to the banking industry is apparently an old issue of interest for economists. As Adolphe Berle pointed more than a half century ago, "Application of the anti-trust laws to banking [...] becomes a subject of major practical importance" (Berle, 1949, p. 549). It is debatable whether such an observation was actively pursued afterwards. But, as opposed to the experience of American anti-trust policy, the most important aspect of such an issue for the European competition policy is related to the impact of state intervention in the banking sectors. The anticompetitive business practices of the banking institutions have had a less important place in the attention of the competition authorities.

The current financial crisis which started in 2007 and exploded in Europe in 2008 has lead however to massive intervention of public authorities in the economy. Moreover, the financial sector has been the central focus on such an intervention, "the scale of the financial and economic crisis that broke out in the autumn of 2008, and the systemic risks associated with it, were such that Member States used unprecedented amounts of State aid to the financial sector" (Larosiere, 2009, page 6).

All the Member States of the European Union have taken significant steps in the direction of intervention. The amount of aid is unprecedented, even according to the figures supplied by the European Commission. It reaches – at least the state aid pledged ex ante – to 30% of European GDP. In fact, those states that didn't take any action (Bulgaria, Czech Republic, Estonia, Malta and Romania) have a negligible proportion in the financial assets at the level of the European Union (under 1%) (European Commission, 2011, p. 36) and they are countries whose banking sector is dominated by foreign subsidiaries of large European financial groups.

What is a crisis?

The commonly used definition of an economic crisis, formulated by the American statistician Julius Shiskin in 1975, is formal: two trimesters of negative growth of the Gross Domestic Product. In the European Union, growth has dropped from an average of 2% in 2006 and 2007 to 0% in 2008 and -5% in 2009. Such a formal definition does not make however any reference to the performance of the financial sector so, at least in theory, we could witness a crisis in the real economy without a slowdown of the performance in the financial sector. But, in reality, that could rarely happen as the financial sector allocates a large part of the capital in the economy and performs the function of payments. There could be different indicators according to which observers could argue that there is a crisis in the financial sector. For example, the

European Commission argued that „there has been a general erosion of confidence in the past weeks within the banking sector. The pervasive uncertainty about the credit risk of individual financial institutions has dried up the market of interbank lending and has consequently made access to liquidity progressively more difficult for financial institutions across the board" (European Commission, 2008, p. 1). EURIBOR spread, considered a measurement of the confidence of the banking institutions in their counterparts, increased from less that 10 basis points to more than 170 so (the lack of) liquidity has been considered as the main indicator of the crisis in the banking sector.

In fact, the moment of the start of massive intervention of the member states in the financial sector is after the bankruptcy of Lehman Brothers in USA (September 2008), when the financial markets considered that similar events could also happen in Europe. That led to a halting of the interbank crediting.

The possible causes of the crisis

The quasi-totality of the European institutions dealing with economic governance in the European Union has correctly identified the symptoms of the financial crisis: the fall in confidence on the financial markets, lack of liquidity, mispricing of asset, problems in supervision, and wrong incentives in crediting and so on. Obviously, in order to advance an efficient solution for exiting a crisis, any policy-maker has to offer an interpretation related to the alleged causes of the phenomenon he attempts to deal with. Without disposing of such a causality relation, any attempt to take steps in the direction of solving the problems associated with the crisis may be futile. In order to administer a medicine, the health problem has to be assessed. A public intervention that wants to remedy an issue has to act on the core cause that generated the issue.

Maybe the most "theoretically-friendly" document endorsed by European institutions which offered an explanation to the causes of the phenomenon is the "Report of the High-Level Group on Financial Supervision in the EU", chaired by Jacques de Larosiere and published in February 2009. As opposed to other papers, official positions and documents of the European Union, that usually are dealing with the "immediate causes", this report took into consideration the broad economic framework that lead to such symptoms. It explicitly stated that „Ample liquidity and low interest rates have been the major underlying factor behind the present crisis, but financial innovation amplified and accelerated the consequences of excess liquidity and rapid credit expansion. Strong macro-economic growth since the mid-nineties gave an illusion that permanent and sustainable high levels of growth were not only possible, but likely" or that

„In turn, very low US interest rates helped create a widespread housing bubble" (Larosiere, 2009, p. 7).

The Larosiere Report fundamentally argued that the original cause of the crisis was the loose monetary policy adopted by the central banks both in USA and European Union. The most logical recommendation as a way of exiting the crisis should have been the return to a tight monetary policy (the control of the money supply) as well as the return of the interest rate to more conservative levels.

It cannot be but puzzling that among the 32 recommendations formally advanced by the Larosiere Group, none of them dealt in fact with monetary policy. The main explanation may be that the Larosiere Group was mainly focusing on financial regulation in the European Union and its ability to make recommendations of monetary policy was, as a consequence, extremely limited. But as the Report correctly assessed that the other factors derived in fact from the fundamental monetary factor, its solutions cannot be but partial and inconsistent when stopping short of this core factor. All such recommendations – such as review of Basel Rules, Credit Rating Agencies, accounting rules, securitized products and derivative markets, etc. – are just addressing some „immediate" or „derivative" factors. It could be argued that a state of the art financial regulation could not have prevented the emergence of the crisis as long as the monetary factors were the same.

The public policy reactions in the European Union dealing with the financial sector and related to the crisis can be broadly included in three broad categories:

- the first one is the monetary policies of the European Central Bank and the national central banks of the member states (like the Bank of England);
- the second one lies in changes in the regulation dealing with the financial sector;
- the third one lies in the state aid granted by the governments of the member states to the financial institutions.

Without analyzing too close the reaction in the monetary policy, it has to be pointed out that the reaction of the European Central Bank was to treat the crisis mainly as a liquidity crisis. În a systematic way, the European policy papers have highlighted this perspective, focusing on the fact that the large number of financial institutions were solvable (assets more valuable than liabilities) but that they were confronted with a liquidity problem. But this reality is a permanent fact of the fractional-reserve banking system. However, banks cannot avoid "bank run" situations of the deponents.

Starting with October 2008, the European Central Bank applied a "non-standard" monetary policy of "enhanced credit support" which translated into "unlimited central bank liquidity to eligible Euro Area financial institutions at the main refinancing rate and against adequate collateral" (European Commission, 2011, p. 20). Meanwhile, the main refinancing interest rate dramatically decreased with 350 basis points between October 2008 and May 2009 (ECB, 2010, p. 55). That is, after the start of the crisis, the core policy response was exactly the mechanism that the Larosiere Report argued that generated the crisis.

State aid control in the European Union

European Union is the only public authority in the world that enforces a regime of control of state aid associated with competition policy. Due to its particular nature of a political construction – both intergovernmental and supranational – European Union attempts to prevent a competitive subsidy race among its member states.

The legal framework for what is called state aid control is embodied in the Treaty of the European Union (TEU) which explicitly forbids what is called state aid: "any aid granted by a Member State or through State resources in any form whatsoever which distorts or threatens to distort competition by favoring certain undertakings or the production of certain goods shall, in so far as it affects trade between Member States, be incompatible with the common market" (TEU, art. 107). From this perspective, state aid to banks has drawn an important attention from the part of the European Commission, the guardian and the enforcer of TEU, which has frequently enforced the state intervention in the financial sector which was considered to significantly alter the competitive conditions.

Derived from the definition of the state aid presented above, any form of state aid is considered to have four core attributes:

- economic benefit/advantage = besides plain subsidies, competition policy in the European Union also qualifies as state aid an investment by the state in a private entity (including what is termed as "capitalization" or "recapitalization") that does not observe the market investor principle (be done at market prices and be compensated with a market rate of return);
- transfer of state resources = which means that, besides resources from the state budget (any state subsidy qualifies for it), it includes also guarantees from the part of the state regarding the issue of new securities by a private actor and so on. While a guarantee does not

necessarily translated into a transfer of cash between the state and the private company, it may mean so in case of the default. So, all the schemes of guarantees qualify as state aid;

- selectivity of the aid = is interpreted in the sense that any state intervention that is dealing with all the private entities in the economy (such as a reduction of the income tax) cannot be qualified as distorting competition. While even such a position could be criticized from a theoretical perspective, it must be pointed out that industry – wide schemes qualify as state aid. While the financial sector has not been a particular attention from the part of competition authorities, a scheme that supply resources/guarantees to the entire financial sector qualifies as state aid;
- impact on intra-community trade = the aid must have a distortion effect on the natural flows of goods and factors of production on the Internal Market. For example, if a member state awards state aid to the entire banking industry, the banks which compete with the local banks will be negatively affected both on that particular market but also on other national markets in the European Union.

In other words, the subsidies that a member state may award to a particular company determine that such a producer benefit from an artificial advantage as compared to its competitors. In consequence, state aid supports artificial market structures that ultimately result in loss of consumer welfare. Moreover, the basic text of the state aid control in the European Union, which is the Treaty of the European Union, forbids not only state aid awarded to a particular company (that disadvantages the other producers in the same industry) but also subsidizing an entire industry. The reason for such a prohibition comes not from the wisdom that industry-level subsidies affect not only the welfare of that particular country (and other industries) but that such a public policy will favor domestic producers in their competition with other European producers from the same industry. In other words, industry-level subsidies in a member state of the European Union are a form of national protectionism that is incompatible with the Internal Market.

State aid in the financial sector during crisis

All the analysts, including the staff of the European Commission, qualify the degree and volume of state intervention during the crisis in the economy in general and in the banking industry in particular as formidable and novel as compared to the experience of the entire European integration. “The scale of the financial and economic crisis that broke out in the autumn of 2008, and the systemic risks associated with it, were such that Member States used unprecedented amounts of State aid to the financial sector ... in order to restore financial stability and a normal functioning of financial markets, including EU companies' continued access to credit".

In fact, the state aid pledged by the member states to the financial sector reached almost 30% of the Gross Domestic Product for 2008 (European Commission, 2010, p. 2). This is a huge amount which, taking into consideration the already existing proportion of the public sector into the GDP (more than 50%), would lead to an unprecedented presence of the state in the economies of the member countries of the European Union. However, the aid actually awarded between 2008 and 2011 didn't overpass 10% of GDP so the worst case scenario wasn't actually pursued.

The public policy reaction in the financial sector of the European Union confronted with the crisis has been embodied under several Communications issued by the European Commission. It is the case of:

- the Banking Communication = sets the broad principles that the state aid in the financial sector should observe;
- the Recapitalization Communication = attempts to reintroduce the market investor principle in the granting of the state aid by specifying the return that the state should obtain from the aid granted to financial institutions;
- the Impaired Assets Communication = described the mechanisms through which the state authorities should handle the core challenge of the "toxic assets" existing in the banking industry, the main threat to the balance sheet of these institutions;
- the Restructuring Communication = attempted, maybe too late, to tie the state aid to restructuring measures undertaken by banks.

In these policy papers, the European Commission attempts to aggregate the policy reactions of the member states in a European-level scheme that attempted to deal with the crisis. It was a huge effort to keep the logic of the state aid control in Europe and "legitimize" such massive interventions in the economy.

Why is the banking industry so special?

The qualification of the banking industry as a "special" sector in the economy is nowadays a common wisdom. Banks have the function of a maturity mismatch between short term liabilities (demand deposits towards the population) and longer term assets (loans awarded to businesses). Such a maturity transformation leads to a higher liquidity risks for banks which is fundamentally attempted to be dealt with by central banking.

We won't explore in this paper the core debate in law and economics about the difference and relative merits between fractional-reserve banking and 100% reserve banking. It suffices to say that all the alleged characteristics of contemporary banking – its special character – come from the fractional-reserve banking system: "The social cost of a bank's bankruptcy is larger than its private cost, for three reasons. First, it affects uninformed depositors who do not have the incentives or the means to assess the risk they face. Second, the bank's knowledge of its customers, and especially of small corporations, is an asset that would be lost in a bankruptcy. Finally, the bankruptcy of one bank may generate a negative externality for all other banks through a contagion effect" (CEPR, 2010, p. 10).

The European Commission considered that "Banks firstly differ from ordinary firms in terms of the leverage of their business model, i.e. the share of debt in their funding compared to equity" (Larosiere, 2009, p. 25). Moreover, "markets in which banks operate are subject to systemic risk due to the massive negative externalities that a bank failure, or its anticipation, generates on competitors and the economy at large". Such a systemic risk of contagion among the banking operators comes from the fractional-reserve banking and the core challenge for any bank operating in such a system to cover its illiquidity risk.

The impact of aid: the challenge of post-crisis rhetoric

Several economists have argued that the attempts of the European member states to intervene in order to exit the crisis have put the entire logic of the regime of state aid control under question. In consequence, the only reaction that the European Commission could have had, except giving up entirely to this regime, was to ease the limits put in the path of the action of these governments.

But such a conclusion is in fact in contradiction with the claim of the European Commission that the entire scheme was successful and that the anti-competitive impact was negligible. In other words, according to the Commission, there was only business as usual in the state aid regime during the crisis.

As some analysts argue, "the recently adopted State aid rules set a new balance between competition and financial stability" (Gebski, 2009, p. 89). But the term "stability" cannot be understood under the present conditions but as the conservation of most of pre-crisis market structures. In fact, the entire scheme avoided a punishment of the banks that undertook too much risk and built a balance sheet full of "impaired assets". It has to be highlighted that these "toxic assets" have not become so only after the eruption of the crisis. They weren't toxic before only as long as extra-ordinary liquidity generated by the loose monetary policies and by ignorance of the basic measures of risk-management.

The qualification from the part of the European Commission of its stance during the financial crisis has been entirely optimistic: "state aid, with other policy responses, has been effective in reducing financial instability and avoiding a financial meltdown affecting the whole economy" or „state aid has contributed to restore confidence and stability in the financial system" (European Commission, 2011, p. 7).

The theoretical challenge of such conclusions leads to a bigger dilemma related to the nature of the economic systems: if state aid has been so successfull during extra-ordinary period, why shouldn't it be also successfull during an ordinary period? Why reduce state aid after the calming of the financial markets? If there is no "positive aspect" that state aid didn't accomplish during the crisis that it should not perform during normal period of time.

From such a perpsective, a too optimistic evaluation of state aid effects in the European economy during the crisis leads in fact to a plea for the permanentization of state aid in the financial sector. And this cannot be translated but as a quasi-socialization of the banking sector.

Conclusions

The frustration of competition authorities that emerged during the crisis consisted in the awareness that they have to solve problems which have emerged in other areas of public policy such as monetary policy by the central banks or banking supervision by the financial regulators. This is a challenge for the competition approach as we may witness a banking sector which seems to be competitive (if someone looks at the market shares of the banks) but is oversized (because of monetary policy) and with poor protection of property rights (because of poor bank supervision). This is exactly the feeling of Ms. Neelie Kroes, the European competition commissioner, who declared in October 2009 that competition authorities were "doing the work that banking regulators should be doing". Moreover, the idea that the banking sector is somehow insulated from the area of reach of competition policy is also under heavy fire as the same European Commissioner further commented that „this must be the last time that banks are allowed to create such kind of mess". In a certain sense, central banks and banking supervisors have to pay attention to competition principles otherwise European Commission will intervene in cases that it feels that the rights of the consumers are broken.

The entire rhetoric of the state aid control during "normal" times has been under siege by the unprecedented amounts of state aid and its apparently "ad hoc" granting during the financial crisis. The attempt of the European Commission to save the state aid control regime is, after the crisis, under the fire of the opposite perspective: if state aid was so successful, why not universalize it in the banking sector. In other words, this could be also a plea for the socialization of the banking industry in the European Union.

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