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WORKING DOCUMENT N° 3

on financial supervision and regulation - the future model

Special Committee on the Financial, Economic and Social Crisis

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The current crisis has revealed major failures in the financial regulatory and supervisory frameworks, which did not succeed to identify potential risks and prevent the escalation of the crisis. This is now widely recognised at different levels, in particular, it is worth mentioning the thorough analysis on the origins of the financial crisis undertaken by the De Larosière report[1] and the Turner report[2].

The challenge now is how to reshape the financial system to make it more robust, while at the same time ensuring that it maintains its scope for innovation and for fostering economic growth. Put simply: a financial system that does not come at the expense of citizens but at their service.

The current financial market turbulence highlighted the increasing gap between ever more globally active financial institutions and purely national supervision[3]. There is broad consensus that the main culprits responsible for the current crisis are:

- Risk-taking incentives for banks and financial institutions and a supervision model that failed to adapt;
- Mispriced guarantees awarded to the financial sector;
- Increasing opaqueness of the financial sector and resulting counter-party externality;
- Focus of regulation on institution-level risk rather than on aggregate systemic risk[4].

These factors were not contained by regulatory or supervisory policy or practice. The provisions for capital requirements for banks relied too much on the banks managing risk themselves and on the adequacy of ratings. There was too much focus on individual institutions instead of general developments in sectors or markets. The increase in off-balance sheet vehicles and the expansion of derivative markets led to opacity and a lack of transparency. This points to serious limitations in the existing regulatory and supervisory framework, both in a national and cross-border context[5].

Incomplete information and the lack of available data, together with the attitude of national authorities not sharing information with each other, made effective supervision impossible. Regulators and supervisors focused too much on micro-prudential supervision and not sufficiently on macro-systemic risks of contagion.

The crisis worsened as the European Union does not possess an appropriate crisis

1 The High Level Group on Financial Supervision in the EU, Report, 25 February 2009 (De Larosière report).
2. FSA, The Turner Review, A regulatory Response, March 2009, (the Turner report).
3 Following the cross border expansion and consolidation of the European banking and financial industry in recent years, a small number (compared to the total number of more than 8,000 banks in the EU) of multi-jurisdictional banks and financial conglomerates account for a disproportionate share of total assets (note that already in 2003 the top-50 EU banks accounted for more than 60% of total assets of all EU banks) (Marco Lamandini, Briefing paper: "To What Extent Did Financial Regulation and Supervision Fail in Preventing the Crisis?", PE 433.435, p. 7).
4 Acharya/Richardson, Restoring Financial Stability, p. 25.
5 The High Level Group on Financial Supervision in the EU, Report, 25 February 2009 (De Larosière report). p. 10.

management infrastructure. Due to the lack of cooperation between the different national authorities, crisis response, despite the liquidity induction by the ECB, remained national and therefore occasionally had negative spill-over effects on other Member States.

This is, of course, an incomplete account of the problems the financial regulatory and supervisory faced. It demonstrates, however, that there is a vital need for an overhaul of financial market regulation and supervision in the European Union to address these regulatory gaps, guard against future crises, restore confidence and create a viable and sustainable financial system which protects growth and jobs.

Towards a new financial supervisory architecture

The current financial turmoil clearly showed that big financial conglomerates raised significant cross-border externalities that can undermine financial stability[1]. Fragmented national supervision led to regulatory arbitrage and provided incentives to national supervisors to compete via lax supervisory standards and practices to avoid putting national industry in a less competitive position or out of fear that some institutions would shift part of their business to less strict regulatory systems. This behaviour signals a moral hazard, which is bound to cause subsequent difficulties[2].

The legislative proposals currently under consideration lack the ambitious vision necessary to overcome the aforementioned deficiencies. Splitting micro- and macro-prudential supervision hampers the necessary information exchange on critical institutions from the supervisory authorities (micro-prudential level) to the central banks (macro-prudential)[3].

In addition, dividing supervisory authorities into sectors (banking, securities, insurance) creates an extra regulatory burden entailing loss of competitiveness for Europe's financial industry and inadequate protection of investors. Geographical fragmentation between London, Frankfurt and Paris bears the risk of impeding the flow and coordination of information between the different bodies. Since problems with proper information exchange have already manifested themselves as one of the major failures that led to the crisis, it would be inadequate to carry on with a structure that did not succeed in the first place.

Therefore, the European Parliament should call for a bolder approach in presenting plans for a European Financial Services Authority (EFSA), which should merge the supervision of overlapping industries of banking, insurance and securities and build on a network of national supervisory authorities. National supervisory authorities have detailed knowledge and expertise and should be in charge of the day-to-day supervision on a micro-level. On the other hand, EFSA will be of crucial importance in coordinating supervision on a more supranational level, since national supervisors do not possess a full overview and cannot coordinate and communicate responses in an efficient and timely manner.

In setting up EFSA it has to be ensured that it has adequate staffing and resources to perform

1 Marco Lamandini, Towards a new Architecture for European Banking Supervision, paper presented at the ABI Conferences on "The future of the European Banking Supervision Architecture", Rome, October 2008.
2 Guy Verhofstadt, The financial crisis – how Europe can save the world, 2009, p. 58.
3 Bini Smaghi, A Financial Stability Framework for Europe: Managing Financial Soundness in an Integrated Market", paper presented at the CFM-IMF Conference in Frankfurt am Main, 26 September 2008, p. 2.

its supervisory functions. In order to address systemic risk, supervisors should be at the forefront of risk assessment and not lagging behind the institutions they are meant to supervise.

Towards a new financial regulatory framework

The EU needs strong financial regulation in order to ensure confidence in capital markets and to preserve the integrity of the financial system. The ultimate goal is to enable capital markets to fulfil their main purpose of allocating capital in the most efficient way and to provide resources to the real economy.

If it were to be successful, prudential regulation should be based on general principles such as simplicity, clarity, coherence and transparency. Prudential regulation should aim at enhancing the resilience and soundness of the financial system.

One of the problems in the current regulatory framework is the lack of a proper understanding of bank activities, upon which prudential regulation should be based. Therefore, a full assessment of the financial system's behaviour is a key to designing an effective and adequate prudential regulation, able to address the inherent risks of bank activities. For instance, if regulators had a better understanding of the subprime mortgage scheme, they would have been able to design rules able to prevent or mitigate the effects we have experienced during the financial crisis.

Another important element is that different financial institutions face different risks and risk-averseness. Hence, the 'one size fits all' approach is not appropriate: prudential regulation needs to be calibrated to the variety of structures and purposes of financial institutions.

In addition, prudential regulation has to provide incentives for prudent behaviour so that the necessary self-correcting process in the market can take place. Financial institutions need to be motivated to improve the quality of their risk management schemes and to adopt strategies and business models, which internalise the contribution of their activities to systemic risk. This will promote greater financial stability. Furthermore, regulation needs to impose constraints to reduce excessive risk taking and to encourage “real entrepreneurship”, by shifting the model from aiming at the short term-gains to long-term benefits[1].

The current crisis showed that the failure of a cross-border institution can have substantial implications on financial stability across national borders. Therefore, a well-designed rules-based European deposit guarantee scheme could be the first step in protecting the banking system from future financial crises.

The following areas of financial regulation deserve particular attention:

- **Leverage, liquidity and capital requirements**

It is now a shared concern that bank capital regulation may amplify business cycles. While the Basel II framework represents an improvement over previous approaches, it is still pro-cyclical. Policy making should focus on the "boom-bust" cycle. Mistakes in risk assessment are made during the boom period (period of strong growth in bank balance sheets and credit, a

[1] Guy Verhofstadt, The financial crisis – how Europe can save the world, 2009, p. 91.

rise in leverage, etc.)[1]. Hence, better regulation during boom periods could limit the amplitude of the bust. Therefore, the Basel framework should be revised to become counter cyclical. The revised framework needs to ensure that banks are putting aside an increasing amount of capital in more prosperous economic times, which can be released in situations of economic distress. Furthermore, the proper global implementation of those rules (including US) is of crucial importance.

In addition, different institutions (asset holders) have different capacities for different risks. The way to reduce systemic risk is to encourage the flow of risk to financial institutions with a structural capacity of holding that risk and not a statistical capacity[2]. The capacity for risk is related to the maturity of funding and not to the type of the institution. Diversifying assets and risk holders would make the system more resilient and it would prevent a situation of "liquidity dry-up", where traders sell or buy when everyone does the same[3].

- **"Too-big-to fail"**

Since the hit of the financial crisis governments across the globe have injected hundreds of billions of taxpayers' money into failing financial institutions, deemed "too-big-to-fail". Ever since, the public debate revolved around the question on how to deal with such institutions in order to prevent the systemic breakdown threats they pose. Currently, plans in the US (by introduction of the Volcker-rule) suggest that such institutions should be limited in their size. We do not believe that this is a viable option. "Too-big-to-fail" institutions can be regulated in a way that at least partially offsets the risks they pose to the rest of the financial system.

First, regulators need to keep firms from becoming too risky as a proactive measure. Second, the regulation has to make it easier to resolve a financial institution when things do fail. Third, proper macro-surveillance should combine monitoring of financial systemic risks and mitigating the spill over effect that these may have on the business cycle.

- **Reform of the accounting and financial reporting rules**

During the financial crisis, financial reporting standards — particularly those relating to "mark-to-market" accounting — came under tremendous pressure, with respect to both the transparency of financial statements under existing accounting standards and the clarity of related disclosures.

In revising accounting standards, policy makers should focus on designing rules capable of providing verifiable information that market participants can use both as inputs in their own valuation and as calibration for their own and others' unverifiable information.

In addition, specific accounting rules are necessary to address the miss-match in the maturity of assets and liabilities. The tendency of financial institutions to rely on less expensive, short-term funding increases systemic fragility.

[1] Avinash Persaud, CRIS hearing on "Financial regulation and supervision", 25 February 2010.
[2] Avinash Persaud, CRIS hearing on "Financial regulation and supervision", 25 February 2010.
[3] Avinash Persaud, Too much capital, note enough safety?, at www.voxEU.org , 13 June 2009,.

- **Consumer/investor protection**

The MiFID regime was barely in place when the financial turmoil came to its height. It is based on the assumption that financial intermediaries could advise on or sell any type of product as long as they apply suitability or appropriateness tests depending on the type of client they deal with. To put it simply, this would mean that more risky products would be deemed unsuitable or inappropriate for less experienced clients. However, these rules do not apply to transactions between financial institutions, based on the assumption that more sophisticated counterparties do not need the MiFID safeguards since they can assess and manage risks properly. Yet, history has shown that those institutions were not able to do so.

It becomes clear that the MiFID rules alone would not have been sufficient to prevent the spread of highly innovative and risky financial instruments, which were at the core of the crisis. Therefore, the MiFID model has to be complemented by additional rules to ensure that financial innovation does not lead to highly complex and opaque instruments, which even highly sophisticated investors cannot manage properly. One possible solution would be to guarantee the quality of the financial products on offer by introducing quality and risk label.

Concluding remarks

The EU needs stronger European supervisory architecture and prudential regulation that could foster financial stability.

The crisis has clearly shown that distress situations could not remain contained within a single country, but have spill over effects at European and global level. Many discussions and statements at the global level (G20 and BIS) have taken place, but not many concrete results in the form of actual revised regulation have materialised. Therefore, EU needs to play active role at the global stage in pursuing a major reform of the global financial system. Where, however, progress at international level is not sufficiently far reaching, EU should lead by example.

It is important to stress that all countries should be obliged to follow the rules agreed upon in Basel to eliminate regulatory arbitrage and foster financial stability on an global level.

The current crisis has provided a unique opportunity to reform the financial regulatory and supervisory system by creating a momentum that EU policy makers need to use in order to bring forward the current model of financial regulation and supervision.

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WORKING DOCUMENT N° 4

on the contribution of cohesion policy to the economic recovery: linking crisis exit policy with long term growth and structural change

Special Committee on the Financial, Economic and Social Crisis

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The impact of the crisis has been territorially asymmetric. There are countries as well as regions and cities that have suffered more than others. Across Europe, the crisis aggravated structural weaknesses of the economy, adding to what had been generated or petrified by stagnating economic growth of the last decade. It has also made it clear that relying simply on relatively favourable macroeconomic conditions to ensure growth, jobs and competitiveness is not enough. It is legitimate to ask from where the growth that Europe needs can come. It is also legitimate to say that the European economy is facing a decade of deep structural adjustment aimed at both removing barriers to growth and exploiting new business opportunities.

1. Cohesion policy: linking exit strategy and long term growth

Cohesion policy is an important public policy instrument which can be turned against the crisis and address short term demand stimulation while at the same time investing in the long term growth and competitiveness. In this context four issues are relevant.

First, cohesion policy long term programs for 2007-2013 have been fixed with a strong focus on what is today seen as priorities in the context of opportunities created by the crisis and of the EU2020 Strategy. This includes: investment in development of new skills, energy efficiency and renewable energy, investment in public works such as transport infrastructure but also smart infrastructure – broadband, sustainable urban transport, investment in sustainable economy at all levels of European governance, investment in measures supporting SMEs and eco-innovations , investment in water efficiency and in new forms of funding for SMEs, including risk capital schemes and new forms of guarantee schemes.

Second, companies with good growth potential that are innovative and future-oriented do not appear attractive to a banking sector contaminated by risk aversion. Banks rather favour politically protected sectors and companies. Victims of this approach are exactly those companies which Europe needs most to generate long term sustainability of growth, jobs and competitiveness. In a time when banks constrain their credit provision in such ways, cohesion policy provides innovative business a secured source of funding.

Third, in many respects this crisis provides countries with the opportunity to reconsider their development trajectories and devise new policies and instruments to accompany the change. Then the question is how we can devise interventions striking the right balance between sheltering existing jobs while creating new ones. How can we help firms to face the crisis and prepare to go the distance? Many of these issues can be best addressed through place based policy approach. It is legitimate to ask whether central governments know enough, whether we can target investment from policies decided and designed in the capitals. It is essential to understand local preferences and use local knowledge in order to channel public resources towards the most productive investment. That is why the regional dimension of the cohesion policy can allow to better target public resources on growth enhancing investments.

Fourth, to facilitate the contribution of cohesion policy to crisis exit strategy, the European Commission has proposed to address specific concerns related to the implementation of programs. These are important resources. While during the financial perspective 2007-2013 negotiations cohesion policy funding available to individual member states has been capped, at local and regional level, structural funds are often the major source of public investment funding. This is very much in line with observed trend of growing public investment at sub-national level accompanying declining public investment at national level.

2. The contribution of cohesion policy to the European economic recovery package

At the end of 2008, in the context of the financial and economic crisis, cohesion policy was facing three major challenges. First, overcoming the liquidity constraints in a number of Member States and regions. These hampered the pre-financing of projects in the regional (multi-regional, national) development programmes under cohesion policy. Second, facilitating and accelerating investments in Member States and regions. Third, improving productive capacity and competitiveness.

The crisis related amendments to cohesion policy management system as reflected in the European Economic Recovery Package[1]. were set up to offer greater flexibility in the use of the European Regional Development Fund and the European Structural Fund, give regions a head start and target expenditures on smart investment with a view to lead and facilitate the structural transformation through new investment patterns.

Giving regions a head start has been addressed by increasing cash flow through increased advance payments to 2007-2013 programs. As a result, in 2009 an additional EUR 6.25 billion[2] for investment was provided. The entire advances paid in 2009 rose to EUR 11.25 billion and those paid since 2007 to nearly EUR 30 billion. Resources to Jaspers (Joint Assistance in Supporting Projects in European Regions) were increased by 25% to help Member States prepare major projects. The management and acceleration of intermediate payments for major projects was facilitated. Simplified state aid rules allowed to make advances to state aid schemes eligible up to 100% and it clarified admissible guarantees in case of advanced payments to state aid schemes. It put in place a temporary framework under the state aid rules, providing for 2009-2010 a lump sum of aid up to EUR 500,000, state guarantees for loans at a reduced premium, subsidized loans for green products, and risk capital aid up to EUR 2.5 million per SME per year (instead of current EUR 1.5 million) in cases where at least 30% (instead of 50% now) of investment cost comes from private investors.

In the scope of the European Economic Recovery Plan, the European Commission also proposed some changes to such existing instruments as the European Globalisation Adjustment Fund (EGF) and the framework for state aid measures.

3. The response of regions and cities to the crisis

Policy response to the crisis at local and regional level has gone beyond the instruments of European cohesion policy, even though, as we can see in available surveys[3], in most regions and cities recourse to EU policy instruments was significant. Most of the regions have

[1] "A European Economic Recovery Plan" COM(2008)800. Available at http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=CELEX:52008DC0800:EN:NOT

[2] Data as referred to in this section received from the European Commission, Directorate-General for Regional Policy.

[3] Committee of the Regions survey "European Economic Recovery Plan in Regions and Cities: One Year On", January 2010

introduced anti-crisis measures, adopting comprehensive anti-crisis (regional or local) strategies or action plans, while others have made extensive use of existing policy instruments.

Concern for rising unemployment has translated into emergency measures to maintain existing jobs and/or provide financial support for SMEs. A lesson that is emerging from the crisis exit policies is that there is a need of a better coordination between different levels of government. Local and regional authorities also express expectations about better information on available anti-crisis policy tools. Surveys[1] indicate that the actions undertaken by the second layer of governance in Member States have been of great importance in overcoming the economic crisis. Actions to promote growth and employment carried out across all regions include, among others:

- public investment: investment in regional infrastructure not only gives regions the opportunity to boost the economy but also to emerge from the crisis stronger than they were before. In this context many regions are engaged in investment in renewable energy and the construction of energy efficient buildings. This type of investment not only facilitates job creation but also the improvement of regional competitiveness.

- SMEs' access to finance: SMEs are particularly concerned with this problem due to their heavy dependence on bank credits and limited recourse to financial markets. Their situation is particularly difficult in case of small companies as their capacity to scale down employment to reduce costs is very limited or does not exist at all.

- investment in skills: many regions support and further develop the skills of employees and currently invest in the employment of young people.

- facilitating access of consumers and employers to information on job opportunities. Often specific communication strategies are set up related to the crisis and growth opportunities.

With their tailored strategies, regions answer to specific needs within their territories that are otherwise not sufficiently addressed at the European or national levels. While national recovery plans mainly target large companies and the financial system, regions focus on the real economy and take into account their territorial specificity. In fact, by supporting entrepreneurship and SMEs and by boosting their innovation capacity, regional actions can contribute to turning this crisis into an opportunity to strengthen regional economies and safeguard jobs.

4. The impact of cohesion policy "on the ground"

As regards the implementation of new projects on the ground, EUR 93 billion was allocated by the end of 2009 to specific projects, representing 27% of the total financial volume for the period 2007-2013. Many of them were pre-financed through the advances paid to Member States and regions. In addition, reimbursement claims by Member States to the Commission increased significantly in 2009.

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[1] Ibid.

The major injections of funds and highest rates of absorption are observed in the countries which were particularly hit by the economic downturn. Investment declined by more than 35% in all of them and consumption by more than 10%, also among the highest in the EU. The payments of the policy accounted for more than 4% of the national GDP in Lithuania, close to 4% in Estonia and 2.5% in Latvia, and to more than 2% of GDP in Hungary and Poland.

Some sectoral Operational Programmes of 2007-2013 in Latvia, Lithuania and Ireland, focused on innovation, business support and human capital witnessed particularly fast implementation in 2009: around 30% of the total allocations of these programmes for the whole period were already paid to the final beneficiaries thus contributing to counter the effects of the crisis during its worse moment. Similarly, at regional level, most of the ERDF Operational Programmes in Germany, which underwent one of the deepest declines of GDP in 2009, played an important role in avoiding a collapse of demand and employment with absorption rates above 25% in all cases.

Most of the countries mentioned above had a limited fiscal capacity to play a major counter-cyclical role. The size of their respective national recovery packages belonged to the smallest in the EU in terms of GDP. Cohesion policy accelerated payments and investments where a significant counter-cyclical stimulus was needed.

In some of the countries most affected by the crisis, cohesion policy accounted for a more than one half of the total public investment. Its role in supporting public investment is likely to be even more important in the coming years.

In 2009, the policy was representing already 90% of total public gross fixed capital formation in Lithuania and over 50% in other four Member States (Hungary, Portugal, Estonia and the Slovak Republic). It is estimated to have also contributed to more than 20% of the public investment undertaken in some Convergence regions of Spain, Germany and Italy and likely to increase in relative terms in the coming years.

In summary, despite the fact that cohesion policy is a development policy with a medium to long term orientation, and not a short term anti-cyclical policy, the advance payments and the acceleration of implementation on the ground in 2009 represented a significant injection of purchasing power into the economy and contributed to address the collapse of private consumption (-3%) and investment (- 15%) compared to 2008, and this in particular in those countries and regions which had suffered most from the crisis. This investment has followed the pattern envisaged by Lisbon Strategy-based earmarking.

5. Recommendations for the future cohesion policy and its role in EU2020

Need of enhanced coordination and better use of synergies between different levels of public governance and different policies.

Multilevel governance offers broader policy space allowing us to more effectively promote economic recovery in the EU. Cooperation between the local and regional authorities as well as partnership between these authorities and the private sector have proved successful in many instances in shaping urgent anti-crisis policy plans. However, there is still much to be

improved in terms of cooperation between the local and regional, the national and the EU level.
Need of taking into account territorial specificities and asymmetric impacts of crisis when designing crisis exit policies.

The effects of the crisis might result in weakened territorial cohesion if it is not countered by policies targeting specific problems in a differentiated manner. The uneven impact of the crisis across regions reflects different competitive starting points and means different long-term outlooks as well as varying degrees of recourse to anti-crisis measures offered by the EU.

Need of aligning crisis exit investment patterns with long term growth priorities.

In order to reduce or avoid the risk of structural after-shocks, focusing the exit strategy on long-term sustainable growth should be the leading criterion for policy choices. From this perspective, the content of fiscal packages is essential. Policy choices should be made in accordance with medium to long term strategies which implies that public investment must be properly targeted, aiming at medium to long term impacts. Public investment in innovation, research, education, energy efficiency, new technologies is the way to go.

Need of strengthening local lending.

Regions will continue to gain in importance in driving the economic agenda of the EU. Regulation of the financial services industry should take into account the need of stimulating entrepreneurship and financing for SMEs. Cohesion policy can mitigate the impact globalisation on financial services. Local lending needs to be maintained or even strengthened. This can be stimulated through strong regional banks. Bank credit committees will be much more comfortable with providing working capital finance if they feel the strong backing of the EIF. The EIF should take on the role of mentor to selected groups of SMEs and have an active role overseeing the life of the credit file.

The financial support for SMEs in cohesion policy should move towards venture capital finance. This would allow greater involvement of the banking sector and a better use of structural funds.

Cohesion policy as the main delivery mechanism of the EU2020 Strategy.

We should try to realise each of the following issues: we should quickly implement those projects that have already been selected; we should speed up the selection of projects that can provide a contribution to the agreed objectives, including the facilitation of the exit from the crisis; and we should ensure that, despite growing budget pressures, the national co-financing needs are met in order to ensure the full utilisation of the EU budget.

Cohesion policy's strengths come from its three basic characteristics: it sets strategic guidelines that are conditions for the resources to be transferred and they are binding both for Member States and regions (unlike Open Method of Coordination); it leaves space for Member States and regions to tailor interventions to the specificity of places; and it has a machinery to monitor and support in achieving goals.

So if we reform the policy in the way we have discussed over the last 2-3 years, we will have an excellent delivery machinery for EU2020. This reform should embrace: concentration on the 2020 priorities, strengthening conditionality (earmarking), better results evaluation system, strengthening the role of the Commission, and giving the EP together with a dedicated Council, the competence to check the process.

29.3.2010

WORKING DOCUMENT N° 5

on European economic governance and EU tools for economic and social recovery

Special Committee on the Financial, Economic and Social Crisis

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European economic governance and EU tools for economic and social recovery

Context

The economic situation remains complex and uncertain. What started as a financial crisis, and subsequently developed into an even deeper economic and social crisis, has now become a sovereign debt crisis. This poses a whole new set of challenges for the European authorities.

Despite analysts' concerns having focused in recent months on the sustainability of public finances, we should not forget that the crisis was not caused by fiscal slippages in national economies. This is clearly proven by the fact that those countries with a surplus and a relatively low level of debt have been seriously affected by the crisis.

The origin of the crisis was indisputably financial. Monetary policy, understood in a broad sense, has been unable to ensure the smooth running of the financial system and sustain economic activity. That is why a tough anti-cyclical fiscal policy was needed, which has funded intensive rescue plans, stabilised economic activity, overcome the short-term effects of the crisis and temporarily compensated for the limitations in European monetary policy.

However, because of the level of debt in public sectors, this fiscal policy should not be continued long term, and it cannot compensate for the lack of credit that will remain an issue in the medium term. The medium- and long-term sustainability of the economic recovery will depend on future macroeconomic policies being appropriately structured.

The crisis has prompted an examination of both the European structure and European governance. It has revealed the main shortcomings in the European decision-making mechanisms and systems of governance in the euro area.

In this context, Europe is faced with the dilemma of more Europe or less Europe. Despite the differing situations in the various European economies, the most important issues must be decided together, as the inherent advantages of a comprehensive European response form the key to emerging strengthened from the crisis.

As a result, we need more and better Europe.

With the entry into force of the Lisbon Treaty in December 2009, the EU now has a more appropriate **framework** for adopting the necessary reforms. In this respect, decisions need to be taken promptly and effectively so that we can move towards better governance.

The fundamental **aim** must be to achieve levels of growth that allow stable and high-quality jobs to be created.

The **strategy** of effectively combining economic policy measures, to ensure that changes are made in substance as well as in form, and the benefits of this strategy must be felt as soon as possible throughout the EU.

It is this aim and this strategy that guide the following financial and fiscal proposals:

1. Better governance of the European financial system

The current crisis has shown how in recent decades the financial system has been moving away from its main function – namely, serving the real economy – and how purely speculative transactions, which are clearly harmful to the stability of the system, have increased exponentially. As a result, the priority must be for the financial system to work for the benefit of productive and high-quality investment, thereby ensuring stable economic growth.

The measures proposed are as follows:

A. At national level

Coordination of Member States' decisions on their respective financial systems: mechanisms must be defined and created to ensure that measures to strengthen and recapitalise national financial systems comply with common guidelines laid down by the EU, so that there is a joint response to the challenges facing the global financial market. This would also prevent distortions in capital flows within the EU and possible unfair competition between Member States.

B. At EU level

We must improve the transparency, credibility and stability of the financial system. To this end, the following proposals could be studied:

Acceleration and expansion of the reforms initiated in the European financial system
The various institutions responsible at EU level must positively encourage a move towards better regulated and supervised financial markets. The crisis has shown that the financial system and the real economy are closely linked, which is why we must not only improve control of the various markets, but also carefully assess the links between them.

With this aim in mind, the reforms included in the de Larosière report, and debated in this Parliament, must be quickly adopted and sufficiently funded to ensure that their effect is wide-ranging.

In addition, the recommendations made by the new supervisory authorities and the future European Systemic Risk Board should be binding, both on those entities that may run cross-border risks and on those transactions that may be regarded as not transparent. The possibility of banning such transactions could even be considered.

Stability Fund
To increase financial stability and prevent speculative attacks on Member States, it is proposed to set up a Europe-wide financial stability fund, which will operate in a similar manner to the IMF. Countries would be able to access this fund after submitting a reform and macroeconomic adjustment plan accepted by the fund's managing authority. Assistance would be conditional on this plan being duly implemented, which would therefore limit the possible moral hazard that may arise.

Its funding would be managed by the Eurogroup, through the issue of European bonds, which would pave the way for a sovereign debt market to be created in the euro area. The euro-denominated bonds would also serve to attract foreign capital and would increase the liquidity, depth and solvency of the European debt market. The fund would also help to consolidate the euro as a global reserve currency, by discouraging possible speculative movements.

A European deposit guarantee fund
Setting up a Europe-wide deposit guarantee fund would allow struggling cross-border banks to be supported and would therefore reduce the EU's systemic risk. This fund should be established through contributions from those entities with cross-border activities in the sector. In setting up this fund, we should use the best practices that have been proven in existing funds, both within the Member States and internationally.

European rating agency
It is also proposed to set up a European rating agency in order to improve the credibility of information on the credit quality of security issuers and their financial liabilities. Experience has shown us that outsourcing these functions has not always offered the best results, but instead has led to unjustified instability in the economy. The possibility of setting up an ECB department with this responsibility, which would use the information available to the ECB, could be studied.

List of financial instruments according to their associated risk
The creation and publication of a list of financial instruments on the market, ranked by their risk level, and the establishment of conditions for their acquisition would undoubtedly help to increase transparency and reduce distorting effects in the financial market.

The ranking could be as follows: firstly, the safest instruments, which would be available to the general public; secondly, those instruments for which a licence would be required in order to acquire them; thirdly, those instruments that could only be acquired by highly qualified institutions; and finally, above a given risk level, the acquisition of certain products could be restricted.

Creation of clearing houses in unregulated or unofficial markets
The aim of this proposal is for these clearing houses to function as intermediaries, thereby guaranteeing the bilateral transactions carried out. This would also help to increase the transparency of these unregulated markets, as all transactions would have to be registered and could therefore be checked by supervisors.

Anti-cyclical ratios

In order to make the prices of financial assets less volatile and prevent the formation of speculative bubbles on the markets, we should look at the benefits of introducing anti-cyclical ratios to improve the ranking of liquidity in the system, ensure that entities have the appropriate level of leverage, and more precisely determine the acceptance of risk in the market, with a greater or lesser requirement for collateral. In this way, by using specific ratios, we would ensure a much more appropriate and more effective outcome, compared to the monetary policy mechanisms employed to date.

2. Coordinated, sustainable and anti-cyclical European fiscal policy

Fiscal policy has become the key tool for reinvigorating economic activity and compensating for the apathy of private investment. As a result of this apathy, the public finances of European governments have taken a severe hit.

On the understanding that sustainable public finances are vital, in a context of weak economic growth and high unemployment, the immediate consolidation of public finances could be counterproductive. Stimulus measures must be maintained until the economic recovery is well-established, thus avoiding the risk of reversing the signs of incipient growth.

We must increase the coordination of European fiscal policy, which must have a solid anti-cyclical function and which must be sustainable in the medium and long term.

As a result, we need to combine measures to increase income with appropriate control of spending.

A. Income measures

From the **perspective of the Member States**
The emphasis must be placed on **combating tax fraud**. This strategy must be a priority, as tax fraud represents a real drain on national budgets, seriously distorts competition and threatens the principle of fairness in the application of tax.
Reducing the effects of this tax fraud would significantly increase income, which in turn would relieve the growing pressure on public finances and *would lead* to a fairer tax system, which is too heavily dependent on wage earners.

The Council, together with Parliament, must therefore **speed up the adoption of the directives on savings and administrative cooperation in the field of taxation**. The European Union could also promote a **pilot plan against tax fraud**, enshrining the principles of transparency, automatic exchange of information and institutional loyalty.

From the **EU perspective**
It is vital that we ensure the EU's **financial independence** by introducing a series of **pan-European taxes**, which will increase the EU's ability to develop its own initiatives and/or correct certain conduct.

Firstly, there could be a **tax on financial transactions**, with the triple objective of fundraising, information-gathering and reduction of speculative transactions. If this tax is properly designed, it will firstly form an important and permanent source of income from the financial sector to the real economy and, at the same time, will provide information on financial instruments and capital movements. It will also reduce speculative transactions by making them more expensive, with the effect that unproductive activities will be limited.

The worldwide imposition of this tax would be the best scenario, which is why it must be negotiated between the G-20 leaders. In this way, its effectiveness will be maximised and competition distortions will be avoided.

The EU should in any case aim to impose this tax at European level, by analysing its effects and the various alternatives.

Secondly, there could be a **special tax on those transactions originating in or destined for jurisdictions that do not cooperate in tax matters.** In this case, the aim is to deter the opacity and impunity with which transactions are carried out in 'tax havens', and therefore reduce tax evasion.

Thirdly, there could be a **tax on the bonuses** received by executives. The pay of executives must be based on the medium- and long-term results of companies, and not on the short-term earnings, as has been the case to date. In this respect, a tax on bonuses would discourage too much focus being placed on short-term objectives and therefore excessive risks being taken in the economy.

This would effectively involve applying the 'polluter pays' principle in the financial markets.

Lastly, there could be **'green taxation'**, in particular the **tax on carbon use**. This would help to promote the use of clean energies and therefore the development of a whole sector with a huge capacity for job creation and wealth throughout Europe.

B. Spending measures

In a context in which spending must be constrained, both the Member States and the European Union must selectively reduce their spending and redirect it towards productive investment, in those areas with a structural impact such as education, infrastructure or RD&I. This will have a dual effect: in the short term, it will reinvigorate economic activity and, in the long term, it will allow for the reforms needed to achieve a new model of intelligent, sustainable and integrated growth, in line with the EU 2020 Strategy.

At national level

The Member States must make **profound changes to their spending policies**, in order to bring them into line with the aims of a new model of European growth. They must therefore: promote active employment policies; give strong support to SMEs; help to restructure the industrial sector within the framework of the EU Single Market; clearly commit to investment in the 'knowledge triangle' (education, research and innovation); and prioritise green technologies.

These national policies must be coordinated within the Stability and Growth Pact (SGP), which is the only tool for budgetary harmonisation and the main tool for economic governance in EMU. We must highlight the SGP's function as an instrument of growth and apply it in a manner more consistent with its anti-cyclical role.

More and better information is vital, which is why **the planned reforms of Eurostat** in relation to the control of public finances must be speeded up, to ensure greater transparency and trust and provide new **structural ratios** allowing us to properly understand the sustainability of long-term public finances, regardless of the effects of the present situation.

We must also avoid equalising current spending and investment. The application of the **golden rule** will allow us to correctly determine strategic investments within the annual deficit, in line with EU objectives and the plans approved by EU leaders.

At EU level

It is proposed to **reinforce the investment role of the EIB** so that it becomes the driving force for future EU investment.

The economic crisis has highlighted the importance of the EIB as an investment instrument to help struggling companies and sectors and to undertake major European structural reforms.

It is the only practical, quick and effective EU-wide tool for promoting investment in those strategic sectors that can stabilise the economic recovery.

Its mandate must therefore be reinforced on a long-term basis so that it can become one of the future pillars of the new European governance.

3. Towards a new model of growth

The economic crisis has shown us that we need proper economic government of the European Union in order to steer the recovery and lead the EU towards a new model of growth.

As set out in this document, the measures to be implemented within the framework of this new governance must firstly focus on restructuring the financial sector, to make it more stable and transparent and to ensure that it once again serves the real economy. Secondly, there must be a more effective, coordinated and sustainable fiscal policy, which will help to bring about the structural changes needed. The aim behind all of this is to achieve stable growth that will create high-quality jobs.

In addition to ensuring a prompt economic recovery, these measures will also establish the foundations of a new model of medium- and long-term growth, in line with the latest proposals for the EU 2020 Strategy.

Better coordination of economic decisions will generate the political determination needed to carry through the reforms, and an increase in investment in strategic sectors will ensure that these reforms are adequately funded.

In this way, we can achieve the aims of intelligent growth, based on innovation and knowledge, sustainable growth, which is respectful of the environment as well as being competitive, and integrated growth, which is focused on a high level of employment and which promotes social and territorial cohesion.

EUROPEAN PARLIAMENT 2009 - 2014

Special Committee on the Financial, Economic and Social Crisis

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WORKING DOCUMENT N° 6

on the European economy and industry facing the climate change challenge

Special Committee on the Financial, Economic and Social Crisis

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"*Today's financial crisis can be a gateway to tomorrow's environmentally responsible economy*"
Al Gore,
Former Vice-President of the United States

1. Introduction

The current economic crisis has had severe consequences. In particular it brought loss of jobs for millions of peoples and loss of confidence in the financial sector, which resulted in a plunge in loans to businesses and high number of bankruptcies.

According to the EU 2020 strategy[1], "strong dependence on fossil fuels... and inefficient use of raw materials expose our consumers and businesses to harmful and costly price shocks, threatening our economic security and contributing to climate change". In this context, the current crisis also presents an opportunity to make a crucial transition to a resource-efficient, low-carbon economy that is sustainable in the long run. This is supported by the expectation that the green technologies market will triple by 2030 and that up to 25 million new 'green' jobs could by created globally by 2050[2], provided the appropriate policy measures are taken.

2. The move to a sustainable economy

According to Deutsche Bank Climate Change Advisors[3], the shift in fuel supply will result in a broad success for the companies that are investing in clean energy technologies. Already, climate change sectors have outperformed the other market sectors since the markets hit rock bottom in March 2009. This holds especially for energy efficiency companies, whose returns have increased over 125%.

While investors would like to take advantage of this shift, they will also look for transparency, longevity and certainty in order to deploy capital. Consequently, stable climate and resource-use policies need to be in place to reduce the risks that accompany an uncertain and indecisive Europe.

European Emission Trading System (EU ETS)

Work has started on introducing these needed policies but it is incomplete. For example, under the EU ETS, CO_2 emissions from certain sectors like the power, steel and cement industry have been given a price. But EU ETS has so far not proven to provide a stable, transparent or certain framework to reduce fossil energy use.

As recently pointed out by the Environmental Audit Committee of the UK[4], emission caps under EU ETS were set too high and the carbon price has, therefore, been too low to encourage the necessary investment in low-carbon processes. A carbon price of €20-€40 per ton of CO_2 is expected in 2020, while the price needs to be around €100 to decarbonise the economy.

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[1] Commission Communication of 3 March 2010, "Europe 2020: a strategy for smart, sustainable and inclusive growth", (COM (2010) 2020).
[2] Statement of UK Prime Minister Gordon Brown.
[3] "Investing in Climate Change 2010: A Strategic Asset Allocation Perspective", January 2010.
[4] "The role of carbon markets in preventing dangerous climate change", January 2010.

A core problem of the current EU ETS is the "hangover" of surplus emissions permits from Phase II, which can be banked for use in Phase III. This would not only undermine the effectiveness of the system, but would also lead to companies starting Phase III in very different positions. Therefore, the EU ETS cap should be tightened, e.g. by limiting the access to Clean Development Mechanism (CDM) permits, adopting a higher ambition target and cancelling the "new entrant reserve"[1] allowances.

All allowances need to be auctioned, since free allocation reduces the incentives for companies to cut down emissions. Ideally, a legally binding climate agreement is reached in which all countries take effective action to reduce emissions. If all countries put a price on carbon, there will be no risk of carbon leakage. As this is currently not the case, under Phase III of EU ETS, many industrial sectors will be exempted from auctioning because they are "at risk of carbon leakage". Around 75% of the industrial sectors are eligible for free allocation, while a recent study[2] shows that complete auctioning of allowances would drive only less than 2% of emissions abroad.

Therefore, any measure to tackle carbon leakage should be limited and differentiated to the type of leakage (investment or operational[3]) and exposed sector. Free allocation as a main approach to tackle carbon leakage carries serious drawbacks. It places the burden on other sectors, since the carbon price faced by the rest of industry increases by up to 30%[4]. And at the same time, the sectors at stake can increase their profits by passing on the full carbon costs for credits they have received for free.

We propose to consider moving away from free allocation towards a combination of auctioning and some form of border levelling since it is more effective. The aim of EU border levelling is to ensure that producers from outside the EU face similar carbon costs, e.g. by requiring them to purchase CDM credits. With the CDM credits mitigation projects in developing countries are funded.

The introduction of a floor price on carbon in the form of an auction reserve price would help to reduce volatility of carbon prices and thus the risks of investing in low carbon projects. This idea is also supported by Joseph Stiglitz, who recently announced that the financial crisis has shown that it is dangerous to rely on carbon trading without such a floor price.

Energy efficiency

Energy efficiency is one of the most promising growth areas: it will not only reduce energy consumption and costs, but also improve our energy security, enhance the competitiveness of our companies and create other social benefits like lower greenhouse gas (GHG) emissions.

A study by McKinsey[5] shows that energy efficiency could reduce global GHG emissions by 30% per year relative to business-as-usual emissions in 2030, of which 50% with negative costs[6]. Unfortunately, several market imperfections reduce the uptake of these opportunities

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1 Member States are allowed to set aside a national pool of spare allowances for new or expanding industrial installations. Unused allocations from installations that are closed down are added to this pool.

2 Carbon Trust & Climate Strategies, "Tackling carbon leakage: Sector-specific solutions for a world of unequal carbon prices", March 2010.

3 Investment leakage involves relocation outside the EU, while operational leakage refers to reducing output in favour of imports.

4 Carbon Trust & Climate Strategies, *idem*. p. 2.

5 McKinsey & Company, "Pathways to a Low-Carbon Economy", 2009.

6 Energy savings outweigh the upfront investment costs.

with net economic benefit such as the malfunctioning of financial markets. In the current capital-constrained economy, investors might choose the low-capital opportunities instead of the most cost-effective ones that have high initial costs. An EU energy savings fund combined with a binding energy savings target could spur the adoption of energy efficiency measures.

A different tax regime

Billions have been spent and lost in this global financial crisis. In this difficult time it is imperative to increase employment and make labour more attractive. It is therefore necessary to shift away from taxing labour towards taxing environmental pollution and capital. A harmonised tax regime for vehicles based on CO_2 emissions was insisted on by the Commission and backed by Parliament. Carbon taxes for the non-ETS sectors (e.g. buildings, transport) will increase overall welfare and cost-efficiency according to the Commissions impact assessment[1].

In addition, a tax on financial transactions could reduce volatility and speculative trading in capital markets, limit socially undesirable transactions and help stabilizing financial markets. Together with an appropriate supervision framework, it could contribute to a more long term oriented financial system.

3. Vision of a future economy

The future and sustainable economy will need to move beyond economic growth, since GDP is no measure for well-being or sustainability. The focus on GDP has led to short-term profits, the depletion of natural resources and almost only benefited the richest 10% of our societies.

Shifting away from an economy driven by fossil fuels to a low-carbon one, presents vast possibilities for businesses and industry. Clear, certain and predictable climate change policies are needed to ensure that EU retains a place at the frontier of this shift. Provided the appropriate economic policies are put in place, a positive impact on employment is to be expected[2]. In the EU, up to seven times more green jobs could be created in the next ten years than would be lost in the coal and nuclear sectors[3]. This is because green sectors, such as buildings insulation or renewable energies, are more labour intensive than their substitute industries such as oil, gas and the nuclear industry.

The effects of the crisis on the car industry, for example, were the most profound; car production in Europe fell by more than 25% in the first half of 2009 compared to the same period the year before. Demand for passenger cars - especially large, fuel-consuming ones - have dropped to historically low levels. This industry, which is currently reliant on heavy industrial processes, will be affected by the rising shifts in oil prices and shifting demand for hybrid cars. It needs to fundamentally change as it will not be able to fall back on the pre-crisis business-as-usual scenario. Although the transition period is going to be difficult for workers in this sector, even with the necessary training programs, the alternative is to hold on to a sector of the past, running on finite and expensive fossil fuels from third-countries.

The importance of change also rings true for the steel sector - another industry, which cannot have a future without innovation. It needs iron ore and fossil fuels, which are finite resources.

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1 SEC(2008)0085, part. II, p. 51.

2 European Trade Union Confederation, "Climate Change and employment", February 2007.

3 European Renewable Energy Council and Greenpeace "Working for the climate: renewable energy & green job [r]evolution", August 2009.

Ensuring the competitiveness of that industry will depend on its ability to rely less on the highly unstable market for finite natural resources. High recycling rates and the use of renewable energy are indispensible, if EU were to retain its competitiveness in the steel sector.

Overall, the companies, which will come out of this crisis as winners are the ones that can reap the benefits from the shift in demand to green and durable products and services. Spikes in oil prices or shortages of certain raw materials will not hurt such companies, as they have found ways to reduce their dependencies on foreign imports for their inputs through efficiency and recycling.

At the same time, there will also be a large-scale redistribution of jobs, mostly within sectors. Jobs will be created in companies that can take advantage of the opportunities created by climate policies, while jobs will be lost in companies that cannot adapt. The occupational transitions should be anticipated and dealt with properly in order to reassure workers and enable them to adapt their skills to the structural changes.

To secure a successful and socially just transition on the labour market, the key focus of employment policies must be on life-long learning, access to education and training for all, and high levels of social and transition security between education and employment or between jobs. Neither in economic or social terms is it acceptable to leave people behind; therefore it must be ensured, that every employee is equipped to participate in the new green economy.

4. Efficient use of natural resources

The crisis has exposed fundamental weaknesses of our economy. Therefore, future economic growth can only be secured, if we transform our economy into a resource efficient one. Reducing dependence on non-renewable resources is more than just recovering from the "fossil fuel addiction"; it also entails lower use of raw materials like land, water, metals and other natural resources.

The share of raw material costs in total inputs for final demand is limited compared to labour costs, for example[1], and therefore, so are the incentives of companies to reduce the use of natural resources. Nevertheless, the growing world population and rising industrialization lead to intensified competition for raw materials. In the EU the supplies of natural resources like rare metals are sparse. Faced with resource shortages in the hands of politically unstable regions, the EU can only keep its competitive advantage by using natural resources more efficiently, for example through recycling and innovative, cradle-to-cradle product designs.

It is also necessary to ensure that the burden of future resource shortages and the associated higher prices for food and energy on the most vulnerable people is not disproportionally high. Energy poverty can to a certain extent be addressed by better insulation of homes and other energy efficiency measures. This, however, may not be enough. The future economy needs to be sustainable in the long run, not only for the environment, but on a social level as well.

A revised EU strategy is needed to guarantee accessibility to key natural resources for the EU industry. Such a strategy needs to tackle, in particular, resource efficiency and recycling, through higher, more inclusive and better defined recycling targets.

[1] CE Delft, "Resource productivity, competitiveness and environmental policies", December 2009.

5. Specific recommendations

a) Internalizing environmental effects by:

1) **Tightening the EU ETS cap, full auctioning, border levelling and an auction reserve price.**
The EU needs to increase its emissions reduction target from 20% to at least 30%. Recent analysis has shown that continuation of the 20% target would imply an EU reduction of only 4% compared to business-as-usual[1]. Also, there is the risk that the EU ETS price would fall to near zero, due to the banking of surplus allowances from Phase II to Phase III and the possibility to have 50% of the reductions covered by the Clean Development Mechanism. Tightening the EU ETS cap by increasing the emission reduction target to 30%, full auctioning, border levelling and an auction reserve price could reduce this risk.
2) **Introducing a carbon tax for the non-ETS sectors, e.g. buildings and transport.**
3) **Introducing a tax on financial transactions.**
4) **Introducing a market-based instrument for biodiversity** (e.g. through a Green Development Mechanism[2]). Under such schemes, biodiversity would get a value by rewarding conservation measures and discouraging biodiversity destructing economic activities.
5) **Phasing out environmentally harmful subsidies to fossil fuel consumption/production, agriculture and transport.**

b) (Improved) Legislation on energy savings, soil, recycling and renewables by:

1) **Adopting a binding energy savings target of 20% in 2020.**
2) **Speeding up the adoption of a soil directive.**
3) **Improving recycling targets and definitions.**
4) **Introducing an emission performance standard for power plants.**
5) **Developing an interconnection plan for a European smart grid.**

c) Financing

1) **Introducing subsidies for the development of innovative and sustainable technologies and enabling businesses and individuals to access financing for energy saving measures.**
In its resolution of 11 March 2010 on investing in the development of low carbon technologies (SET-Plan)[3], the Parliament has asked for at least €2 billion per year of the EU budget to be spent on developing low-carbon technologies.
2) **Prioritising climate change in the forthcoming budget reform**
The budget should be restructured from unsustainable subsidies towards more future-oriented investments in education, R&D, renewable energy, sustainable agricultural

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1 CE Delft, "Why the EU could and should adopt higher greenhouse gas reduction targets", March 2010.
2 Netherlands, Environmental Assessment Agency, "A Green Development Mechanism, Biodiversity compensation on a global, regional and biome scale", 2009.
3 P7_TA-PROV(2010)0064.

practices, etc.

3) **Linking the EU Structural Funds with social and environmental conditions.**

   A climate assessment should be introduced for all structural funds interventions, which should apply immediately to major projects. Higher levels of coherence between policies, investments and use of the specific funds should be secured. For example, the Globalisation Fund could be used much more efficiently in order to help workers upgrade their skills to enable them to find employment in the new, green sectors.

4) **Offering preferential rates to finance projects with a high social and environmental value through the European Investment Bank.**
   The EIB could borrow funds on financial markets at preferential rates thanks to Member States guarantees and funding from the EU Budget. An EU agency could prioritise projects (for example energy efficiency investments, development of public transport, smart grids) that could benefit from such low interest rates, which would strengthen their profitability.

5) **The Commission should issue green bonds with Member States guarantees in order to finance green investments.**

<u>d) Mainstream climate in other EU policies</u>

Climate Commissioner Hedegård has made it her objective that every proposal by the Commission should meet the economic and environmental goals of the EU. It is essential that climate change is mainstreamed in other EU policies, in particular industrial, trade and employment policies. Therefore, climate impact assessment should be introduced for any directive proposed by the Commission.

14.4.2010

WORKING DOCUMENT N° 7

on Global governance, international monetary policy and tackling global imbalances (incl. the issue on tax havens)

Special Committee on the Financial, Economic and Social Crisis

Contribution by Kay Swinburne
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Rapporteur: Pervenche Berès

It is understood that three of the main contributing factors to the current financial crisis are global imbalances, regulatory governance and monetary policy. The purpose of this report is to examine the effects of these factors and propose measures to bolster the financial system against a future shock of this magnitude.

The credit crisis of 2007/9 can be considered to be the first crisis of globalisation. It is worthwhile briefly considering the historical perspective from which this problem evolved.

1995 was the year that China joined the WTO, marking a major step forward in globalisation. Indeed from 1996 onwards China's current account surplus increased every year up to the crisis, with the exception of the 2001/2002 recession, reflecting rapid export growth and relocation of manufacturing via foreign direct investment.

Most major economies had also converged on the policy of using the overnight target rate as the sole control mechanism to combat inflation, typically measured on a basket of goods and services in each economy which continued until the current crisis, when emergency measures such as quantitative easing were employed. Monetary policy was therefore a strong contributory factor to the development of the crisis.

Late 1997 saw the ASEAN financial crisis which resulted in capital flight and currencies being forced to float; the effect was disastrous with GDP falling by over 30% in USD terms in 1998. The area witnessed collapsing currencies, widespread bankruptcies, plunging asset prices (particularly in real estate) and social unrest. By comparison China, which also pegged its currency to the USD, was largely insulated from the problems of its neighbours due to the Renminbi not being convertible and FDI into China being in manufacturing facilities rather than easily monetizable securities.

The launch of the Euro in Jan 1999 saw many member countries benefit from lower interest rates including Greece, Italy, Portugal, Spain and Ireland - precisely the countries in the EU who were most exposed by the financial crisis because of imbalances in their economies.

Other events which frame the crisis include: the LTCM crisis, the stock market collapse in 2000 (dot com bubble burst) and the effect of the events of 9/11. The Federal Reserve slashed interest rates making home affordability attractive, with the stock market out of vogue, much speculative money entered the housing market encouraged by skewed and existing fiscal policies.

Global Imbalances

Imbalances on a small scale are manifested by imperfections that exist in all markets and are arbitraged away by market participants. Their effects are therefore transitory and the arbitrage assumption is core to most mathematical pricing and risk models. Similarly, interest rate setting authorities' models assume that by fixing the overnight rate the entire term structure of interest rates will be efficiently priced by the market. There is no scope for a structural imbalance in these situations. However the combination of scale and statistical 'tail events' did lead to imbalances that had direct impact on the crisis.

On a larger scale we can consider imbalances within an economy including: the over-reliance on the financial sector (UK); over-reliance on the export sector at the expense on domestic consumption (Germany, China); consumer debt levels (UK, US); and large budget deficits/surpluses. Whilst these imbalances are not independent of the crisis, it is considered that they impact more strongly on the ability of member states and constituent countries to react to the crisis, unlike the China surplus/ US deficit and the accumulating surplus of oil exporting countries.

Key to the crisis was the combination of the China current account surplus and the US current account deficit. On a global level, the amount of savings and the amount of lending is by definition a zero sum situation. It is rational and desirable that savings flow to the best investment opportunities in terms of productivity and risk adjusted return. This would broadly characterise the nature of the US deficit in the 1990's. During the technology boom led by the US, productivity increased and corporate profits swelled. In a benign inflation environment and with open, liquid securities markets, the US witnessed large foreign capital inflows via portfolio investments and direct investment. This environment came to a halt with the dot-com bubble burst of early 2000.

During the last decade significant budget surpluses have continued to amalgamate in China and increasingly in the oil exporting countries. In China, fiscal policy is geared towards promoting export growth at the expense of domestic consumption. This involves domestic tax policy and a managed exchange rate regime. The provision of a social security system, rebalancing the tax burden between corporate and individuals and the enforcement of property and human rights would all contribute to greater domestic consumption while at the same time reducing the incentive to keep saving.

Similarly, it is argued that the Renmimbi is being kept artificially low and has a distorting effect on world trade. However a weaker Renmimbi would not balance world trade unless Chinese domestic consumption was to increase. Hence the effect of a weakening would be to make other manufacturers more competitive but the extent to which other countries could compete with the established manufacturing base and a workforce without collective representation is not clear.

Surplus has also developed in the oil exporting countries, attributable to the huge increase in the price of oil. In broad terms, these countries share the attributes of low domestic consumption, and underdeveloped societies welfare systems thus increasing the saving imperative. As the US dollar is the major reserve currency and the base price for oil, there is an incentive to hold savings in USD.

By 2000, the US deficit had changed from a benign to a problematic situation. Rather than portfolio and investment inflows, foreign savings inflows were used to fund government, corporate and personal borrowings. The US went from a balanced or short lived budget surplus to record deficits. The issuance of treasury debt to fund this deficit across the maturity spectrum did not result in an increase in interest rates as might be expected, but rather a *decrease*. This was largely attributable to Chinese and foreign purchases of treasuries. This mechanism had secondary effects on corporate and consumer debt with its effects spreading globally.

The US government debt market is the deepest and most liquid market in the world, denominated in the world's reserve currency, it becomes the 'natural' home for a risk adverse investor. The problem that arises is one of scale. An efficient market theory would assume that an investor would direct investments to the best risk adjusted return. Alternatively, in the situation where an asset class becomes expensive relative either to fundamentals or other securities, other market participants would be expected to arbitrage the difference.

The Chinese purchase of US debt was ongoing and on such a scale that the effect of these purchases was to push down interest rates across all maturities. In relative value, the interest rates of other issuers, both sovereign and corporate was pushed down. Effectively risk premium disappeared and funding became cheap.

In the US tax incentives, government policies aimed at increasing home ownership amongst the low paid and the loosening of the credit quality of mortgages exacerbated the boom. The lack of an appropriate risk premium in the government bond markets led investors to participate in riskier markets in the search for yield. This took the form of lending to borrowers of lower credit quality and at very high loan to value ratios and their global distribution via credit derivative structures maintained a steady source of funds to the mortgage origination market.

In normal market situations, one would expect the risk of a transaction to lie with the lender but China has largely been protected from the effects of the crisis and it is in both the US and China's interests to maintain orderly and stable treasury markets. Given the continuation of the flow of funds, discipline is required either through regulation or policy.

Monetary Policy

The monetary response of interest rate setting bodies to all of these developments has been central to events globally. It has been suggested that interest rates in many countries were kept too low but the main problem lies in the strict mandate of price stability. In the UK an inflation rate of 2% was targeted and measured with respect to the consumer price index (CPI). It is necessary to define the basket in terms of 'sticky' prices which have inertia in their response to the monetary climate so that policy does not erratically respond to short term movements in volatile prices such as energy.

However, up to 25% of the CPI basket is comprised of imported goods on which monetary policy would have little effect. Globalisation through lower prices of imported goods effectively imparted price deflation on the goods component of the basket. The policy response of low interest rates to maintain a 2% inflation target meant that services inflation was running too high and that the economy was therefore running faster than it should have been. This in turn contributed to the asset price, primarily real estate, inflation witnessed in the UK, which was not measured in the CPI.

The ECB by contrast has a two pillar strategy where it also assesses the risks to price stability. The ECB was consistently criticised during the last ten years for too hawkish a stance on monetary policy with higher than necessary interest rates. Although a tighter monetary policy was not in itself sufficient to prevent asset price booms in some member states, the conclusion would be that monetary policy is necessary but not sufficient to ensure price stability, suggesting that new policies may be needed.

The econometric models used to establish the appropriate overnight interest rate do not explicitly use inputs such as asset prices in their calculations or indeed other indicators of imbalances specific to this crisis. Other important inputs such as the output gap (the difference between the actual and optimal economic output) are not observable. However, it is considered better to work with a well understood and simpler model, where the deficiencies are known and qualitatively accounted for, than a complex model with more and uncertain inputs.

A recent IMF paper suggests that a higher target inflation rate, provided it is well communicated and kept stable, would not affect the output gap but would mean higher average nominal interest rates. This would provide more room for manoeuvre in a crisis using only interest rates as a tool. It has been suggested for example that in the absence of a zero rate floor to interest rates, the correct policy rate in the US currently would be 3 to 5 percentage points lower.

The policy proposals that are being discussed in the EU institutions at the moment do not sufficiently scrutinise the reliance of the financial institutions and regulators on mathematical modelling. While it no doubt has a place and has contributed to the availability of new financing channels, it has proven deficient in crisis times.
(See annex 1)

Global Governance

The absence of global institutions is likely to have facilitated the prolongation of unsustainable events which led to the depth and breadth of the crisis. However, the coordination of corrective measures via the G20 forum has been beneficial and should enable the implementation of future financial sector reforms globally. The upgrading of the global Financial Stability Board and current focus on international bodies such as the IMF and World Bank should encourage the strengthening of current weaknesses.
(See annex 2)

The current Maastricht cap of 60% debt to GDP ratio of member states has been systematically flouted. It is not the absolute size of the deficit in the context of the European economy that is problematic but rather the size compared to the domestic economy. It is critical that member states create credible and sustainable deficit reduction plans and publish financial statements that are both accurate and transparent. Off balance sheet transactions, unfunded public liabilities, labelling government spending as ‘tax credits’ to manipulate the balance sheet are examples of so called financial engineering by governments. By contrast, New Zealand has a much more transparent policy towards public finance reporting and it is recommended that an approach such as this be adopted.

It should be acknowledged that whatever steps are taken as a result of this crisis, there will be future economic shocks. The state is the insurer of last resort and as such consideration should be given to the fiscal room for manoeuvre. Monetary policy within the EU is too blunt a tool, particularly in the wake of globalisation, to address problems such as asset bubbles and financial sector imbalances. However in light of the destabilising effect of these factors in the ensuing crisis we need to identify the most effective areas to implement a policy to contain emerging financial imbalances. These would almost exclusively be contingent capital triggers on the balance sheet of lenders and would necessarily involve the consolidation of all subsidiaries, branches, SPEs and SPVs in the calculation.

Tax incentives may have contributed to increased consumer and corporate debt, with debt accounting and tax issues further encouraging corporate borrowings which, although strong in any case as a result of the low term structure of interest rates were more attractive as the servicing costs of the debt are allowable expenses against a tax liability. There is no 'balancing effect' in the issuance of equity funding.

The financial sector saw lower capital requirements based on inadequate risk models, buying back equity in the market and cancelling it as a means to improve earnings per share, and low tax efficient debt issuance to fund balance sheet leverage. A large proportion of earnings were used to purchase back shares in preference to using retained earnings for capital or distributing cash dividends to shareholders.

The cheap availability of debt also contributed to the explosive rise in the private equity industry with transaction levels in individual deals and funds in the industry reaching record levels each year. Any future policy must address not only a higher capital cushion but the asymmetry in the funding solutions available to the corporate sector.

It has been suggested that tax havens have had a part in the crisis although it is not obvious that there is any connection. Often SPEs, SPVs or funds will be domiciled in such locations as the entity itself is not taxed. However, any distributions to shareholders or owners in the structures are taxable in the investor's home tax jurisdiction. The benefit of a tax free domicile for the fund or vehicle maximises the potential investor base and while tax liabilities may be deferred they are not avoided.

It is not likely that the tax free domiciles of these vehicles was the driving force behind their creation and were not instrumental in the ensuing problem. Tax avoidance or tax fraud issues are not specific to the crisis and are better dealt with by enforcement.

It has been suggested that a financial transaction tax applied within the EU or more beneficially on a global basis would be a suitable response to the current crisis. However, evidence suggests that this would not deter behaviour in the financial markets. To modify trading activity would require a punitive rate of taxation which would be impractical and inoperable globally across asset classes.

Policy needs to consider (see annex 3 for further details):

- *The implementation of a pro-cyclical monetary policy with respect to interest rates;*
- *Whether a higher target inflation rate globally would be warranted;*
- *The role of subjective judgement by regulators and Directors at times of market stress and less reliance on mathematical modelling;*
- *The state of the oil market, imbalances in oil producing countries and OPEC;*

- *Closer co-ordination of taxation policies globally through G20 to minimise tax arbitrage opportunities;*
- *A ban on buying back and cancelling previously issued equity to limit organic growth in financial firms;*
- *Minimising tax incentives which favour debt financing over equity financing;*
- *An ex-post analysis of this crisis in the terms of the debt assumed by each member state, their ability to service and reduce it including determining an appropriate future debt to GDP ratio;*
- *A requirement by Member States to publish financial statements that are accurate and transparent;*

Annex 1 : Global Governance: Mathematical Modelling

The policy proposals that are being discussed in the EU institutions at the moment do not sufficiently scrutinise the reliance of the financial institutions and regulators on mathematical modelling. While it no doubt has a place and has contributed to the availability of new financing channels, it has proven deficient in crisis times. This should not be surprising for three reasons.

First, in a crisis we observe a herd mentality in financial market participants which results from a (usually relatively short lived in terms of an economic cycle) collapse in risk appetite. Efficient market principles such as arbitraging market dislocations fall by the wayside in the drive for principle safety. This would be challenging to model.

Secondly, a crisis is by definition a 'tail' event in the distribution of possible market reactions. Such tail events occur more frequently than expected by models, but are nevertheless infrequent enough that any meaningful statistical modelling information is insufficient to capture them. Indeed it is everyone's desire to avoid tail events thus making it *de facto* a rare event which cannot be modelled.

Finally, all financial institutions will use substantially the same models and where the risks on their balance sheet are aligned, these models will trigger the same hedging events at the same time which tests the liquidity of the underlying market and can lead to a self reinforcing downward spiral as happened with LTCM.

This is where the size of positions has a deleterious effect and needs to be constrained. It is not easy to imagine how a risk model can incorporate the market activities of your competitors in the analysis. The principal policy recommendations flowing from this would be

(i) increased capital held on holdings whose values are not directly observable in a liquid market and rely heavily on mathematical modelling;
(ii) calculate capital on *gross* exposures. This would entail a haircut for net positions but would recognise the effect of large exposures in unstable market conditions;
(iii) scenario analysis based on qualitative and industry/regulator agreed metrics as opposed model based VAR or Monte Carlo analysis;
(iv) a capital premium on mathematically valued products who have not been in existence for 2 economic cycles. One of the problems with credit derivatives is that they have not been in existence for long enough to assess their behaviour and the robustness of their valuation and risk management over a long period;

Annex 2 - Global Institutions and their future role

What has become apparent during the global financial crisis is that the interconnectedness of the world's financial markets must be reflected in the work of global institutions. Organisations need to communicate effectively in crisis times and normal times in order to ensure coordinated approaches towards regulation, monetary policy (where applicable) and financial accounting to ensure proactive measures can be taken when markets are overheating.

G20 The expansion of the forum from the G8 to the G20 is to be welcomed as the breadth of coverage reflects the global nature of the crisis and the required actions by governments. However, discussions need to take place to ensure that agreements reached at these summits are translated into actions agreed by all constituent members, otherwise it will become a meaningless entity very quickly. The G20 Pittsburgh summit adopted a framework for multilateral surveillance of macroeconomic policies, with the aim of making national policies consistent with balanced growth and including regular consultations on commonly agreed policies and objectives.

IMF During the crisis the IMF's resources were tripled, however, countries still view the available funds as a last resort and have an implied stigma attached. Proposed reforms of the body should be implemented including: improved governance; the method of accessing funds available and ways of building on the new crisis prevention instruments; such as the flexible credit line and other sources of contingent financing. Beyond assisting distressed member countries with funding and expertise during crisis situations and monitoring multilateral policy dialogue, it has been tasked with acting as secretariat to the G20 forum in achieving the framework detailed above by building on its existing surveillance analysis and reporting back to the G20.

WTO The nature of the global imbalances, particularly between the US and China would suggest that protectionist measures witnessed so far may escalate - for example the Chinese tyre ban by the US and the Chinese action on US poultry. The role of WTO needs to be strengthened as an ultimate arbitrator between competing members in arising trade disputes

IASB The convergence of global economies, with respect to accounting standards over the past decade, is welcomed; however, the US now needs to move permanently to adopt IAS and the EU needs to ensure that it does not waiver from IAS in the post-crisis era.

BIS The work of the BIS is respected and therefore supported by all major financial centres. The recommendations from the Basel Committee on Banking Supervision, particularly Basel II were implemented by most European Banks, although they were not fully implemented by their US counterparts ahead of the crisis. A commitment from regulators of all major financial centres needs to be made with respect to Basel III and its full implementation across all jurisdictions.

Annex 3: Resulting Policy Recommendations

One common thread permeating all of the recommendations outlined below is the issue of *size*. Size is a relative concept whether we are talking about budget deficits, balance sheet leverage, the impact of derivatives or any other aspect of a crisis. In general, the issue of size should be a primary consideration when assessing the risk to stability in any financial framework and will no doubt impact on other developments outside the scope of this report such as so called 'dark pools' and the impact of large hedge funds on market stability. In the recommendations that follow, the role of 'size' should be considered.

- Too often the regulatory framework has been viewed as a set of boundary conditions in which products and business are financially engineered to operate within. In such a rapidly changing industry, adherence to principles rather than rules is necessary but with penalties for non-compliance.
- A major deficiency in the oversight system has become evident as a result of this crisis and opportunities for regulatory arbitrage need to be minimised globally through firm agreement at the G20 level, and within the European member states they should where possible be abolished through the application of a common rule book for financial services.
- Loopholes which allow subsidiaries of foreign financial services to operate significant business in the EU unregulated need to be closed, whilst College of Supervisors for all global firms need to ensure close supervision across all markets.
- Risks from aligned financial sector exposures need to be identified early. The people best placed to identify an emergent risk are the financial institutions themselves. In an analogy of interest rate setting committees, it is proposed that the major European financial institutions produce a bi-annual report on the current state of financial market stability and the outlook for risks to that stability. The report would be signed by the CEOs and CFOs of the institutions for which they would be held accountable and delivered to the FSB and ESRB for consideration
- Tax incentives which favour debt financing over equity financing need to be minimised. The problems associated with over-reliance on debt financing have become evident, particularly for tax payers who have bailed the financial system out, and hence any tax incentive to the extent that it is desirable at all should be focused on equity financing.
- Tax policies, while still exclusively remaining the responsibility of member states, may benefit from a more coordinated approach in order to ensure the operation of an effective single market in financial services.
- The size of financial institutions and their respective balance sheets have introduced the concept of 'too big to fail'. Proposals already made to address this, and supported by this report are that banks are required to produce a "living will" to detail their orderly liquidation in the event of a crisis and are required to hold increased capital.
- Senior management and Board Members at financial institutions have demonstrated lax control and little understanding of the risk that they were dealing in. Although not all non-executive directors should necessarily be expected to understand the minutiae of complex financial mathematical models, they should be expected to understand the business model sufficiently so as to be able to provide a first stage of regulatory oversight, to question new products and their risk management and to assume responsibility for aligning investor

and employee interests with respect to compensation. Regulators should be tasked with monitoring knowledge and suitability of board appointments.

- A ban on buying back and cancelling previously issued equity needs to be investigated as a mechanism for limiting the organic growth in financial firms. The inability to buy back their own shares would ensure that banks have to find genuine growth opportunities to increase earnings per share, or else retain the earnings as an increased capital cushion. They might alternatively choose to distribute dividends which are historically low compared to the capital allocated to bonus payments. This would also ensure that liquidity is left in the market for other participants. Aside from takeover opportunities, which themselves are limited by competition rules, growth in financial firms needs to be self limiting.
- The failure to manage other monetary indicators such as M2/M3 monetary aggregates and exchange rate targeting suggest that targeted pro-cyclical interest rate policies may be needed to work alongside monetary policy. Research needs to be done to identify the most effective areas to implement this and would necessarily involve the consolidation of all subsidiaries, branches, special purpose entities and special purpose vehicles.
- Member states should be required to publish financial statements that are both credible and transparent. Off balance sheet transactions, unfunded public liabilities, labelling government spending as ‘tax credits’ to manipulate the balance sheet should no longer be allowed and investigation into the merits of operating a more transparent policy towards public finance reporting along the New Zealand model is recommended in order to maintain investor confidence, particularly in the euro region, and allow better assessment of a member state’s ability to cope with a large magnitude shock.
- An *ex-post* analysis of this crisis in the terms of the debt assumed by each member state and their ability to service and reduce it needs to be carried out. Each member state should determine an appropriate debt to GDP ratio and avoid reliance on a pre-set “group” criteria.
- Consideration at a global level needs to be given to the state of the oil market which is very exposed to manipulation and large price movements. Research needs to be carried out into the imbalances caused by oil producing countries and the role of global bodies such as OPEC as it is proposed that the oil market may be too small to easily absorb speculative capital and is too important in global economic terms to be manipulated by speculative flows.
- Research should be carried out to determine whether a higher inflation rate target (as proposed by IMF paper 2010) would be warranted, including whether it would be practical and implementable without negative consequences to economic growth or investor confidence in the euro region.
- Recommend less reliance by financial institutions and regulators on mathematical modelling. While it no doubt has a place and has contributed to the availability of new and novel financing channels, it has proven deficient in crisis times. Regulators and Board Members should be required to apply subjective judgement at times of market stress.

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Special Committee on the Financial, Economic and Social Crisis

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WORKING DOCUMENT N° 8

on "Economic Exit Strategies : Financial and Monetary aspects, SMEs, Innovation and New Opportunities for sustainable growth"

Special Committee on the Financial, Economic and Social Crisis

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Introduction

We are experiencing the most severe financial and economic crisis since the establishment of the modern international financial architecture. It has become necessary to view this moment of crisis through the prism of many decades of experience, and to apply the lessons learned from the successes and failures of our manifold socioeconomic endeavours. Our globalised economic order has evolved to contain elements that are under-regulated, unsupervised and unequal; and it has proven to be unstable and unsuited for the demands of the 21st Century.

The following is aimed to help in redefining a sustainable model for society, which is governed by the values of **freedom, solidarity and responsibility** and while upholding the concept of Social Justice and the responsibilities derived there from.

Innovative SMEs as a driving force for EU recovery and future growth and welfare

The **social market economy** of the European Union is perhaps one of the greatest achievements of the Union. Nonetheless the social expenditures of such an economy require that the economy grows to sustain these expenditures. SMEs are the most nimble participants in an economy and sustainable economic growth relies on SMEs ability to recover and start growing, adding jobs and supporting the social expenditures of states through their tax contributions.

A healthy SME sector is the backbone of any healthy **free market economy** and it is this sector that contributes most to the labour market by creating jobs. One of the fundamental premises for a healthy SME sector is the existence of **competition**, of a level playing field. EU Competition policy must not be 'softened', if anything, it has to be strengthened and SMEs have to be put in a position where they can bring forth their concerns related to competition and expect a clear and timely resolution of any conflict that might arise.

One of the great achievements of the European Union is its **Internal Market** which allows for a fertile business environment throughout the Union whilst also benefiting the consumers. Nonetheless, SMEs face numerous challenges in operating in the Internal Market and often operate below their efficient scale. Especially at the micro level, SMEs need to be supported to be able to operate throughout the Internal Market, their access to information pertaining to opportunities needs to be brought up to the level where trans-European platforms can be established. Only then SMEs can explore business opportunities, can find complementarities and ultimately they can find the means to gain access to markets within the Union.

One of the existing measures defined by the EU is the **Small Business Act**, which contributes to the improvement of the SME environment. Implementation of the SBA is largely in the domain of Member States, thus monitoring by the Union has to be strengthened to ensure a timely and satisfactory implementation of the SBA.

Furthermore, this *Small Business Act* should be reviewed and be linked up with a **stronger social dimension** (*New Social Small Business Act*, mentioned by French designate Commissioner Michel Barnier at his hearing before the European Parliament). Creating the right competitive conditions for the economy to generate future jobs should service a greater social cohesion and reinforce society's tissues.

The **services directive** provides for massive opportunities for SMEs and its implementation is also in the domain of MS and it is proving to be one of the most challenging implementations. As the largest part of the SME sector of the European economy has moved towards service-provision, implementation of the Services Directive is crucial for future growth of SME's. Monitoring by the Union of the implementation of the services directive is of key importance.

One-stop shop needed for every administrative issue needed for SMEs.
Former Commissioner Mario Monti advocated a one-stop shop for the establishment of companies, which has been by-and-large implemented by member States. This needs to be taken further by establishing one-stop-shops for all administrative matters concerning SMEs.

The employees that provide the most added values by age group are those at the twilight of their working career and their loss from the labour market through retirement erodes the skills and the experience accumulated by them. Keeping citizens active and productive after retirement is among others in the economic interest of Europe. The loss of their expertise can be mitigated by engaging **senior citizens** to remain active through looser structures and networks based on their civic engagement and by linking them with economic actors and academia. SMEs can profit most from such a network of informal structures that can be consulted, as most SMEs find it hard to afford these services from the consultancies active in the economies. **Knowledge accumulated in senior citizens must be circulated to the benefit of all by the establishment of a network at the level of the European Union.**

Small and Medium-Sized Enterprises are **wealth creators locally**, both through their local contributions as well as through their employees. This sector is responsible for the largest proportion of employees in any market economy and in an economic recovery, they are also the first ones to start hiring again. To strengthen this position of SMEs as the key factors in creation of employment, their business potential has to be furthered, as well as job creation in this sector stimulated. **Providing for tax incentives and even subsidies for SMEs** to keep and to create jobs, although costly at first sight, actually creates value, as the contribution to GDP of individual employees dwarf both the costs of them being alternatively in the care of the state or the funds needed to be invested in supporting existing jobs. Needless to say that the higher skilled the job is, the larger the contribution to GDP. **There are more than 20 million SMEs in the European Union - thus if, in an ideal world, each of those could add a place of employment, it would mean an equivalent reduction in unemployment.** Only if a fraction of this can be achieved through support schemes both at the national and at the European level, it would have a tremendous impact on unemployment and, consequently that of growth. The Eurogroup needs to invest itself in an effort to **coordinate taxation** relative to SMEs of the MS as tax competition among Member States potentially damages SMEs and can destroy highly skilled employment.

Any SME policy of the European Union has to have an **external dimension**. With the fledgling EU External Service, new opportunities can be brought to fruition as regards the issue of market access. Market access would allow SMEs to augment their growth potential and to facilitate this, the Union can have an instrumental role, if the **new EU external service** is geared towards providing support for SMEs. In every external representation of the Union there should be a support structure for SMEs. Beyond market access, SMEs have to be supported in investing in the developing world, as this can create wealth locally and can act as a catalyst for the aid provided to emerging countries.

Innovation is the strongest engine of economic growth and as such it needs to be effectively linked up with the economy, the principal beneficiary of innovation. So far, in administrative structures, the domain of innovation has always been a premise of the educational structures. Bearing in mind the impact of innovation on the economy, reflection is needed on perhaps an administrative adjustment where the domain of innovation pertains to administrative structures devoted to the economy and industry. **An organic link between industry and innovation and, consequently with education is highly desirable**. Innovators need to be at the forefront of investments at the European and national level. Since innovating start-ups, by definition carry a high risk/bankruptcy profile, an entire rethink of their financing and corollary activities is needed. Since these innovating start-ups are in the most difficult position when it comes to getting financing through the banking system, credit guarantee schemes need to be drawn up for specifically this segment.

New **partnerships between industry and academia** have to be established to further streamline innovation activities. In this respect, SMEs can gain significant research resources but the universities engaged in such partnership gain a fertile ground for the transposition of their research into real goods and services, not to mention that their graduates potentially gain employment with the companies concerned. New partnerships of this kind can be establishes via centres of excellence, innovation parks and both through physical and virtual networks among stakeholders. The Union can lend a helping hand in the establishment of the premises for such partnerships by providing the framework for these.

In an increasingly competitive global marketplace, the **EU needs to focus on some key areas where it can develop leading capacities through innovation**. Bearing in mind that the population at large of the Union is an ageing population, it is but sensible to ascribe special attention to the **healthcare sector**. The Crisis wreaked havoc in the automotive industry, yet the EU based manufacturers have weathered the downturn significantly better that their US counterparts. This presents a comparative advantage, as EU manufacturers are in a better position to **keep investing in R&D and stay in the lead by innovating and implementing the general trend of the greening of the industry**. The Union can contribute by both regulation and by funding assistance aimed at the development of eco-friendly vehicles, including those used in public transport networks. In parallel with the focus on the automotive industry, the EU should also focus on innovation in the so-called 'greening' of the European economy--renewable energy, second generation bio fuels, low-carbon production processes--e.g. the replacement of fossil raw materials in the production of plastics, industrial chemicals, building materials. With the price of oil off from the peaks experienced in the run-up to the financial crisis, focus on greening the economy should not be lost. **Synergies are significant between the automotive sector and the sectors mentioned beforehand.**

In this context**, new skills are required for the new jobs**. The most important skill would seem to be the ability to formulate complex solutions to new and unforeseen problems and the capacity to learn new and different skills throughout a lifetime. Somehow, we must find a way not just to supply more educational opportunities, but to create demand for those skills as well.
A long-term agenda should contain a **higher level educational attainment** within the EU. A persistent pattern of under-investment in education sector is not sustainable over time and will

deprive future generations of opportunities and EU of qualified workforce.

Looking at the Future: Trends and Opportunities

Global community is at present challenged by having reached a stage, which offers an opportunity to either foster a process of sustainable development or lay the groundwork for the eventual destruction of the society itself, as we know it today. This stage applies to five areas: (a) climate change, (b) demographic change, (c) increasing urbanisation of society, (d) changing relationship of governments and international civil society organisations, and (e) endeavours to develop a global information society. All of them encompass change, not without embedded conflicts.

(a) Climate Change

Recent reports from the United Nations on global warming bear out the need to take vital measures to effect a major adjustment to the negative effects of the present development. The environmental activist and former Vice-President of the U.S.A., Al Gore (2009), supports "that many scientists are now warning that we are moving closer to several 'tipping points' that could make it impossible for us to avoid irretrievable damage to the planet's habitability for human civilization." Urgent action is needed in spite of resource constraints.

(b) Demographic Change

Demographically there are almost 500 million people worldwide over 65 years old and for the first time in history this age group outnumbers children under 5. While aging is the result of advances in the medical and economic fields, it is **important to promote labour force participation and boost incentives designed to encourage people to stay in the work**. Low birth rates, rising life expectancy and a continuing inflow of migrants force us to create the right conditions for sustainable societies.

(c) The Urbanisation of Society

The United Nations estimates that in 2008 for the first time in the history of mankind, more that 50 percent is living in an urban environment. This evolution has impact on the quality of life and the use of resources (food, access to water and electricity).

Imbalances are created as the trend to lower fertility rates is more prone than in an agricultural one and urban populations are further projected to grow quickest in the poorest countries. Of the three billion world-wide living in cities, it is estimated that one billion live in a slum environment.

We cannot afford to wait and therefore architects and city planners must engage together in efforts to improve living conditions.

Furthermore, **local and rural communities have to be fostered as they provide for opportunities in relation to the economy at large, employment and community building**. To this end, regional markets have to be stimulated and there need to be local structures meant to assist with the implementation of decisions from the European and even the Global level. Through these structures, another dimension can be added to the dialogue between policymakers and those concerned by policies. **Providing support for these communities also provides an avenue to tackle exclusion through the reinforcement of the community tissue and thus augmenting its absorption capability.** Exclusion is at the base of the problem of poverty and although we must not turn away from poverty, it needs to be realized that increased inclusion exponentially reduces poverty.

(d) Relationship of Governments & International Organisations to Civil Society Organisations

A change has taken place, and is still in progress, in the attitude and approach of Governments and International Organisations such as the European Union towards CSOs, which is signalling a partnership approach in the search for sustainable development. The impact of CSOs within EU sponsored, up to the present day, has strengthened this trend. Accredited representatives of CSOs are also invited to make oral presentations and submit written statements, which become official documents.

(e) The Information Society

The Information Society is also challenged to contribute to a sustainable development. Beyond existing participation inequalities in different parts of the globe, **information technologies have the potential to mobilise large parts of the society and help emerging new type social movements**. Well- informed citizens get networked in the "global village" and are thus enabled to seek out local solutions in global challenges. This is due to the notion of knowledge as the capacity to act and the ability to make the right decisions for a sustainable world.

Recommendations

- Strengthening the social market economy avoiding competition restrictions
- Full use of Internal Market capacities and new business opportunities throughout EU for SMEs
- New Social Small Business Act
- One- shop- stop for every administrative issue for SMEs
- Establishing a European seniors consultancy network
- Tax incentives and subsidies for SMEs
- Boosting employability by "One SME- One Job" Project
- External dimension enabling SMEs to compete internationally, the role of the EU external service
- Innovation stronger linked up with industry
- New partnerships between business, science and university research
- Backing knowledge- based innovations on which EU's future depends on
- Demand led education system
- Promoting labour force participation and encouraging people to work and stay in the work longer

- SMEs as a tool for restoring the community economic and social tissue
- Devolving power to the communities: local implementation of global decisions
- Seeking out a proactive approach towards exclusion, which often responds to poverty
- Using the full potential of the emerging information society in order to engage locals in sustainable society planning

Conclusion

Growth and prosperity are indivisible. Today, all states are far more closely interconnected than ever before as active participants in the modern globalised financial and economic system. This critical moment calls for prompt, decisive and coordinated action to address the causes of the crisis; mitigate its global impact; and establish mechanisms to prevent similar crises in the future. Today, we have to prioritize the required lines of action; and define a clear role for the European Union in the implementation of our coordinated approach **towards a sustainable social environment**.

EU's pursuit of profit and economic growth must be leavened by our collective responsibilities in the satisfaction of jobs creation, the realization of sustainability and the achievement of welfare. All these expressed in the form of a new *Small Business Act embracing a strong social dimension* and at the same time by remaining fully committed to development aid to the most vulnerable nations of the world.