Margit Agneta Steen

# Government responses to the 2008 financial crisis

The nature of the solution

Case the Netherlands, Germany and the United Kingdom

Final version

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**Abstract**

The 2008 financial crisis is the most severe economic crisis in Europe of the post-war era. At the national level, Schmidt's ideal-typical models of capitalism illustrate government responses to previous economic crises. At the European level, the constructivist's structure-agency model is used to explain policy changes. In this master thesis, the crisis induced responses of European governments are examined and tested at the national level to Schmidt's ideal-typical models of capitalism and at the European level to the constructivist's structure-agency approach. This study will show that at the national level the responses are dominated by *ad hoc* responses while at the same time member states turn to the European level for a permanent solution. The member states relied on traditional public policy patterns to weather the crisis and resulted in a convergence of expectations at the national level.

**Preface**

When I started this thesis (October 2008), the financial crisis had just begun in the Netherlands. This subject was a risky and, above all, challenging topic. Doing research on this topic while the crisis was still going on was from time to time difficult to manage because events rapidly followed one another. However, this topic allowed me to research one of the most important political economic events of the past decades. It was an exciting journey from which I have learnt so much.

Without the help of my supervisors, this thesis would not have been possible. I am especially grateful for the support and trust of my first supervisor, Dr. Shawn Donnelly (*University of Twente*). Our many meetings and conversations really helped me grasping the complex theories used in this thesis. Also, I would like to thank Professor Dr. Doris Fuchs (*Westfälische Wilhelms-Universität Münster*) for her helpful comments with respect to the literature I used in my thesis.

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Margit Steen

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**Introduction**

As the current financial crisis is spilling-over to the real economy causing massive lay-offs and bankruptcies, European governments implemented a policy mix of nationalisations in the banking sector and setting-up emergency funds to provide financial assistance to banks and insurance companies to restore systemic stability in the financial markets of their country. For instance, the Netherlands has set-up an emergency fund of €20 billion to bail-out banks and insurance companies facing liquidity problems (*De Volkskrant*, 11-10-2008) So far, ING (Internationale Nederlanden Groep), Aegon (the 'Algemene Friesche', the 'Eerste Nederlandsche', the 'Groot-Noordhollandsche', the 'Olveh' and the 'Nillmij') and SNS Reaal (Samenwerkende Nederlandse Spaarbanken) applied for almost €15 billion to recover from their liquidity problems. And also the British government, the European role model for its monetarist macroeconomic policy-making, (part) nationalised eight banks in one day (FT.com, in depth UK banks, last accessed at 9 January 2009). At the European level, some European governments are also pressing the EU Commission for new and better European regulation, the European Central Bank (ECB) adjusted the interest rate in the eurozone while the EU Commission works overtime on approvals of member states' state-aid requests, and investigating strategic action plans while keeping an eye on international meetings of heads of states.

The state interventions and increased regulatory demands on the one hand and monetary responses on the other are to be seen separately, but they reinforce each other in the battle to overcome the financial crisis. The state interventions in terms of nationalisations and bail-outs at the national level were at that time absolutely vital to prevent the banks from falling over. A bankruptcy of a bank would have major consequences for the economy, as will be shown later. The monetary responses in the form of lowering the interest rates mainly aimed at a different aspect of the problem: the frozen inter-bank lending market which caused serious problems on the balance sheets of the banks. While the state interventions wiped out the symptoms of a much bigger problem, the monetary responses were believed necessary to tackle the actual crisis and revive the inter-bank lending market. Obviously, there is a certain tension between these two responses as politicians do not have any power over monetary policies. This proved to be a frustrating issue especially in the eurozone since the economies suffered from an asymmetric shock at the beginning of the crisis which made the ‘one size fits all’ policy-making strategy impossible for the ECB at that time.

After decades of reforms caused by globalisation and Europeanisation, pushing the EU member states towards monetarism, these actions of state-aid and nationalisations are remarkable shifts in policy-making, especially for the UK. At the member state level, this raises questions with regard to the nature of these shifts: are member states following the same rescue strategy or are they moving in different directions? Are the member states’ responses of a temporary character –have they simply captured new ideas– or will this generate a shift in policy-style and generate new regulation and therefore have a more permanent character? And more importantly: is this a turning point in European economic policy-making? Is there a shift away from monetarism back to Keynesianism? Has there been a change in thinking? Have member states captured new ideas and will this lead to a new relation between politics and the economy?

In addition, one should consider the effects on the relations between the member states on the one hand, and between the national and European level on the other since these shifts in policy also raise questions concerning the EU’s responses. Obviously, the current EU’s competition policies and the member states’ recent actions of state-aid do not reinforce each other and are likely to produce severe tensions between the member states and the EU Commission. The member states reformed their public policies drastically in the 1990s as a result of globalising and European pressures which resulted in deregulation of, for instance the financial sector (Schmidt 2002). In terms of Schmidt’s ideal-typical varieties of capitalism, which will be discussed below, we are now witnessing a resurgence of the traditional national policy-styles. In particular that of the ideal-typical model of managed capitalism considering the recent nationalisations and other state interventions.

Although at the European level some incremental changes can already be observed to accommodate the needs of the member states to overcome the crisis, as is illustrated by the decreasing interest rate in the eurozone, this is not, however, a guarantee that the EU will reconsider its policies and produce new regulation. Questions remain about the EU's political willingness and institutional capacity to change its policies: will the EU continue to accommodate the member states' policy shifts in the future and produce new and/or reform existing regulation, or will the EU Commission stand firm and maintain current policies?

In this chapter I will start by examining the problem of the financial crisis after which the objective and the impact of this study will be discussed. In section 1.2 I will review the place of my study in the literature.

### *1.1 Problem statement, objective and relevancy*

A liquidity crisis in the banking sector poses serious threats to the stability of the entire financial system. Like all other businesses, banks need cash for their daily operations. Banks usually repay their debts by borrowing money from the capital market or other banks (Gillis et. al. 2001, 566). A liquidity crisis occurs if the capital market or banks, for whatever reason, are not willing to provide new loans to the banks. Obviously, this situation can be quite disastrous as, in this scenario, banks cannot repay their outstanding debts. In extreme situations, this can result in a bank-run and eventually a bankruptcy. A bankruptcy of a bank will initiate a domino effect through the financial sector as outstanding loans to other banks will not be repaid as well. This will eventually result in systemic instability followed by deep economic recession. It is therefore of utmost importance for governments to restore systemic stability as soon as possible to avoid further damage to the economy and complete exhaustion of (foreign) reserves.

In my opinion, the liquidity crisis opened a window of opportunity; a demand for structural reforms in national and European policy-making concerning the European financial market(s) may be arising. Therefore, the **research question** of this study is:

> What are the effects of the crisis induced responses on the policy-styles of European national governments and of the European level as a consequence of the financial crisis?

The objective of this study is to examine the nature of the policy shifts of European governments which are confronted with failures in the banking sector: whether these policy shifts are structural changes which alter the policy-style of a government, or more ad hoc responses of a temporary character with no significant effects on the policy-style. Are governments capturing new ideas and can these ideas be transformed into a shift in their policy cultures?

Many actors suffered the consequences of the liquidity crisis: not only individual banks which faced bankruptcy, but also central banks which function as a lender of last resort, investors who lost a great amount of their capital, governments which tried to secure systemic stability and favourable economic conditions, and, of course, consumers who found themselves in a situation with insecure prospects concerning their savings and pensions. This study will compare the nature of the policy shifts of four actors: the Dutch government, the German government, the UK's government and the EU and its financial market policy-making at large. These cases are interesting because, first of all, the UK, the Netherlands and Germany fit into two of Schmidt's ideal-typical models of capitalism. This makes it interesting to compare their responses between and within these two varieties. Second, the European level should be included in this study as the member states' responses are influenced and restricted by EU legislation. A permanent shift in policy-styles will also be reflected in EU regulations and policy-making since the member states and the EU constantly influence each other (this will be discussed in greater detail in section 1.2.2.). By analysing the actors' crisis induced responses and comparing these outcomes over time, patterns may appear concerning the governments' policy choices.

On the one hand, the world is currently in a unique situation which offers exceptional opportunities for policy learning, changes in policy-styles and a transformation of the financial markets. On the other hand, however, this is obviously not the first financial crisis in history –certainly not in Europe. Therefore, governments might decide to radically change national and European financial policies in an attempt to avoid similar scenarios in the future. Then again, governments may also decide to implement only ad hoc responses to weather the crisis as many difficulties will have to be over won to accomplish a policy shift. To the best of my knowledge, no studies have been made yet at the time of writing to the nature of the responses of governments in this crisis and their effects on the policy-styles of governments. By setting a precedent, this study can function as a starting-point for further research; as a basis for critical analyses of the actual responses of the governments and help to make generalisations about other member states or regions.

Chapter 2 will go into the set-up of this study. Methods and data collection will be discussed to define the strategy and structure of this study. Chapter 3 will present and analyse the collected data after which chapter 4 will discuss the results.

### *1.2 Place in literature*

In order to answer the above raised questions, I relate on several types of literature. First, I relate to literature concerning rules, norms, and policy change since this plays a significant role in this study. Second, I place my study in literature related to financial crises more generally. In the Western world, a battle for ideas of economic policy-making has taken place after 1945 and the following decades (Yergin and Stanislaw 2002, xiv). Up to the 1970s, it seemed to favour Keynesianism which argues that governments should run deficits in economic downturn to stimulate aggregate demand. This was followed by an era of monetarism from the 1980s onward which emphasised only minimal or no governmental interference in the economy, apart from ensuring stable macroeconomic conditions. Economists of the Chicago school of economics and Milton Friedman were prominent promoters of this school of thought. It is beyond the scope of this study to argue which theory is best to solve the current crisis. However, they both offer ideas of how governments should act to overcome the crisis. This can provide some structure to determine if and how the governments are going to change their policy-styles in relation to financial markets; although it seems unlikely that a laissez-faire strategy is deemed appropriate by any government considering the enormous amount of energy and resources governments have already invested so far.

Third, I relate to literature of the constructivist approach and policy learning at the European level. These studies provide an explanation and analysis of the processes of policy learning. Behaviour of governments and other stakeholders in these kinds of situations is crucial to understand the processes of policy learning. European collective action will only be possible if the EU Commission can find the institutional capacity to reform and even then, only if all governments intent to comply with the potential new financial structure. This study will show that reforming EU regulation is a slow and complicated process. The political system of the EU is fragmented and with many vetoes which makes even the smallest changes a hard nut to crack.

I will also discuss Schmidt's three ideal-typical models of capitalism. In her book *Futures of European capitalism*, Schmidt outlines three models of capitalism in Europe with which different responses of European states to pressures of globalisation and Europeanisation are explained and illustrated (2002). In this study, this model is applied to the current crisis in an attempt to explain and predict member states' responses to the financial turmoil. This study shows that member states in times of crisis are inclined to rely on traditional and national patterns of public policy-making rather than on European ones, even though they are heavily restricted in their public policy options by EU legislation. This will be illustrated by Schmidt's model of ideal-typical varieties of capitalism (discussed below).

Two different theoretical approaches are used for the analysis of the two levels of governance. It should be kept in mind, though, that theoretical approaches also have certain limitations. Although these theoretical approaches can explain the processes and how they took place, they cannot predict them in advance. Schmidt's model explains and illustrates government responses of European *national* governments. With this model it is possible to explain and contrast the different responses of countries in each category. However, Schmidt's model is not able to explain policy responses at the European level. EU public policy-making cannot be compared to policy-making at the national level; it lacks many of the traditional national public policy characteristics (see for instance figure 1.1). In addition, this study also investigates the effects of the policy shifts on the relationship between the national level and the European level. The constructivist approach is able to explain the processes of influence between the two levels of governance. These two approaches can help formulate expectations and hypotheses which we expect to see played out in the case studies.

*1.2.1 Rules, norms, institutional structures, and policy change*

The relationship between (structural) norms in financial and economic policy and agency plays an important role in this research. Norms are the basic and underlying fundamental beliefs about what is ‘appropriate, legitimate or just’, and are deeply embedded in institutions and society to dictate ‘appropriate behaviour’ (Meyer 2006, 20, 25). Norms find their expression not only in laws and policies, but also in institutional structures and rules. This is where to look for an explanation of why norms tend to be incredibly stable over time even if this is less efficient in the long-term. Many politicians will be hesitant to challenge these collective norms since this produces high potential political and financial costs. Consequently, certain policies and institutional structures become locked-in or path-dependent.

So, how can norms determine the outcomes of policies or determine the appropriate response to a situation? Héritier defines institutions as ‘rules of behaviour or *institutional rules*’ (emphasis in original) (Héritier 2007, 6). These institutional rules are created by the collective and continue to influence options and beliefs of the public at large. To be clear, these institutional rules are created by human actors. Because norms are represented in institutional rules which dictate the appropriate behaviour, the institutional rules also have a constraining effect. The constraining effects of these institutional rules limit the number of possible policy-options *and* determine which policy-option is the most appropriate which, therefore, shapes the outcome.

One of the issues raised above concerns the responses of the governments and whether this will change policy-styles or not. But what, then, will cause change? The current debate on changing existing norms and structures has moved away from the ‘punctuated equilibrium’ discussion, which argues that pressures or crises external to the system initiate in a very short time rare turning points causing a reconsideration of existing norms (Djelic and Quack 2007). This can be a war or a serious economic crisis. Whatever the cause for a crisis, this situation can be seen by politicians or other stakeholders as an opportunity to challenge the prior existing norms and structures to implement new norms (Meyer 2006, 26). Schmidt, whose model will be discussed in more detail below, argues that external pressures such as globalisation and Europeanisation (the impact of EU integration on the policies and policy-styles of member states) combined with external crises (for instance the oil crises) caused the changes in policies of European states in the post-war era (2002, 61), which is then filtered through national and European institutional structures to adapt prior-existing norms. According to Schmidt, the success of stakeholders to change norms and therefore policies depends to a great extent on the mediating factors such as economic vulnerability, policy legacies and preferences, institutional capacity to change, and discourse, play important roles in adjusting norms (idem, 63). Especially situations of economic crises open the window to new structures and policies. The discourse element enables the stakeholders to negotiate and convince other actors of the new policy preferences. In other words, the discourse element can be used to increase or support the institutional capacity for change. Checkel elaborated on this discourse argument and will be discussed in section 1.2.2. This study will function as a model to show whether Schmidt's theory about changing norms can be applied to the current events.

In more radical versions of normative change and the consequent policy changes, the coalitional forces come into play. After the new ideas have been identified and decisions have been made, it is up to the policy-makers to implement these ideas. According to Gourevitch, the individual policy-maker cannot bring about a policy change by himself; to explain the process of the actual policy change the 'broader political context' must be examined (1989, 88). On the one hand, policy-makers have to win elections to gain political power to make and implement the actual policy. On the other hand, economic actors hold the power over investments, labour and other economic activities. Each of these groups has certain policy preferences which can only be achieved with the help of each other. Politicians need the economic actors to win elections; the economic actors need a winning coalition to get their policy ideas implemented. In this study, we are interested in what member states and the EU are doing. Therefore, it is important to understand that the process of capturing new ideas is not sufficient to initiate a policy change. This is only possible if there is a winning coalition not only at the member state level, but also at the EU level. This overlaps with what has just been discussed about Schmidt's ideas on normative change. To be successful in that, one needs, for instance, the discourse element, the right policy preferences, and economic vulnerability.

Nowadays, the contemporary debate on policy change focuses on ‘gradual but transformative change’ over time (Djelic and Quack 2007). The idea is that changes come about through small incremental steps of which the cumulative effect will be significant enough to be called normative change. These incremental changes can be fed through international, supranational or transnational policy-making (Meyer 2006, 25-7). Again, discursive practices play an important role as they take place in epistemic communities. This will also be discussed in paragraph 1.2.2. Kathleen Thelen, introduces a list of five processes which generate incremental normative changes: displacement, layering, drift, conversion and exhaustion. For this study, the idea of ‘layering’ in which new ‘arrangements’ are built upon already existing institutional structures seems to be most functional (cited in Djelic and Quack 2007). At the European level, building those new arrangements will only be possible if they do not conflict with already existing norms at the member state level. This should be demonstrated later in this study by the expectations of the member states in relation to the demand for improved European banking regulation.

Considering the relatively short time-span of this study, it will not be possible to observe the cumulative and gradual processes over time. To do this, a much longer time-span would be needed. Instead, it will be interesting to see whether this financial crisis is one of those breaking points in history even though the debate has moved on to the gradual changes and their cumulative transformative changing effects. The economic policy choices made by the governments are responses to the crisis: actions they would otherwise not have taken. Their choices –and therefore the outcomes of their choices– are influenced by already existing norms and institutional rules. To prove that this crisis is a **breaking point** which will cause normative change, permanent new legislation or new institutions have to be set-up in one or all of the countries investigated in this study and after the financial crisis has hit that particular country. Any normative change will work its way through the political system and change existing regulatory policies. However, there are many problems related to the measurement of norm change. It is important to discuss these as norms play an important role in my study. Several approaches have been developed to ‘measure’ norm change and they will be discussed below.

Agents play an important role in processes of policy change because, as Schmidt explained, institutional capacity is one of the elements needed to facilitate change. However, achieving radical change in fragmented political systems, such as in Germany, is far more difficult than in a political system with majority governance. The former can only achieve radical change through a sequence of incremental steps over time whereas the latter can achieve radical change when necessary –for example, at the punctuated equilibrium moments. Discourse and the agency-structure debate also play an important role in this debate; these are discussed in greater detail below.

Change of norms play a significant role in this study. Therefore, problems related to the measurement of norm change should be addressed. This has been a controversial subject for several decades and resulted in a rich discussion in literature. Many models have been developed to measure norm change. The behavioralists use either statistical methods or quasi-controlled experiments to demonstrate a causal relation between ideas/beliefs and policies (Yee 1996). The main problems with these models are, however, that they have become extremely complicated over time and that this will make a critical judgment virtually impossible. In addition, 'mental events' cannot be measured, let alone be repeated in experiments. Even if a 'true model' can be designed, it would only prove that causes exist (or not) but it would not be able to explain *how* these causes influence outcomes: 'Their [behavioralists] commitment to empirical analyses of observable behaviour that can be tested or falsified renders them reluctant and ill-equipped to analyze the intersubjective meanings and symbolic discourses that give ideas their causal effects'. Second, the institutionalists use, for example, the epistemic communities approach (see below) to establish a causal linkage between beliefs and policy outcomes. However, Yee argues that these approaches lack 'an analysis of the ideational causal mechanisms or capacities that render the meanings of ideas and beliefs compelling to actors'. Finally, discursive approaches have great interpretive capacities with which 'the symbolic languages and intersubjective meanings of ideas themselves' can be revealed. Unfortunately, this approach fails to explain the causal effects between ideas and policies.

As has become clear, this study has a rather limited time frame and will therefore focus on the more 'observable' policy changes resulting either from temporary actions or permanent changes. If any permanent changes (discussed in 2.2) are found, it will be investigated if this can be connected to change of norms following the ‘punctuated equilibrium’ approach described above.

*1.2.2 Policy learning and epistemic communities*

At the European level, this study follows a constructivist approach of mutually constitutive structure-agent processes. Other approaches, such as liberal intergovernmentalism or neo-functionalism, follow a ‘rationalist ontology’ and explain European integration from an agency-centred viewpoint (Risse 2004, 161). These approaches argue that actors preferences are ‘exogenously given’ whereas constructivists claim that interests and preferences of actors are determined and shaped by political culture and discursive practices. According to Risse, agents (member states and later EU institutions) construct their social environment which consists of rules, norms, institutions, etc. (idem 2004, 160). This social environment determines ‘who we are’ and shape our interests and political preferences. Previous institutions, legislation, norms and rules define the actor’s interests for future institutional decisions –the agents and structure are mutually constitutive. European integration and European rules and laws therefore influence national policies, member states’ practices, and even their political structures. But national policies have influenced EU policies as well. Risse argues that agents are not trying to ‘maximize (…) one’s interests and preferences’ (idem, 163). The EU has become part of the actor’s social and political environment and are thus part of the solution to certain political situations: ‘(…) constructivists emphasise that the EU deeply affects discursive and behavioural practices, that is has become part of the “social furniture” with which social and political actors have to deal on a daily basis’.

In this study, this is particularly relevant in relation to the EU’s competition policies and banking regulation. For instance, national policies of nationalisations, bail-outs and fiscal stimulus packages cannot be carried out unlimited, unrestricted, and certainly not without approval and supervision of the Commission. The member states’ options to stabilise their financial sectors are thus restricted by previously established European rules and norms. If a crisis situation occurs which surfaces the shortcomings of current legislation, the actors will decide to change or adjust institutions and structures so that it will work more efficient in the future. This contrasts the historical institutionalist arguments concerning lock-ins and path-dependency (Pierson 2000). Decisions taken in the past become ‘locked in’ and will influence future policy-making. Once on that road, past decisions will constrain future policy options which makes it all the more difficult to deviate from that path over time thus initiating a process of path-dependency. These phenomena do not only apply to policy-making decisions but also to institutions. This study, however, argues that this crisis is a turning point in the punctuated equilibrium debate and that actors can change existing norms in certain situations. Actors will try to change prior existing regulations and structures since these no longer fulfil the needs of the actors. This should also be reflected later in the analysis of the empirical cases. The actors should demand new and improved banking regulations and the Commission should present some proposals.

Policy learning in this perspective should entail a process in which the ‘agent’s interests and identities are shaped through and during interaction’ (Checkel 2001). Checkel, a prominent scholar in policy learning, contrasts in his article the constructivist process of social learning to the rationalist approach. The rationalist approach is argued to be an individualist approach in which simple learning and manipulation are emphasised. Simple learning is described as a process ‘where actors acquire information as a result of interaction’ which alters the actor’s strategy but not its preferences. As described above, in the constructivist approach the agent’s interests can change as a result of social interaction and collection of new information –the mutual constitution of structure and agent. The social interaction takes place in epistemic communities, which will be discussed below.

Unfortunately, Checkel argues that the constructivists have not theorised these processes of policy learning (2001). Checkel tries to bridge this gap by formulating five hypotheses concerning persuasion and social interaction (it is not necessary to repeat them here). Argumentative persuasion is suggested to be the solution. According to Checkel, ‘argumentative persuasion is a social process of interaction that involves changing attitudes about cause and effect in the absence of overt coercion’. These social processes can feed back into the agents and alter their preferences. Since structure and agents are mutually constitutive, these changes in preferences will eventually be reflected in the structure. The resulting changes in the structure will in their turn affect agents' policy options. If the structure can no longer live up to the expectations of the agents (for instance, in case of a crisis), the agents will try to reform the existing rules, norms and institutions which are part of the structure. In sum, policy learning according to the constructivists should occur through deliberation and debate in epistemic communities where actors convince other actors through argumentation. For further reading on the hypotheses, I refer to Checkel's contribution (2001).

Within the field of policy change, Haas also emphasises the importance of epistemic communities for the collection and discussion of new information and knowledge (1992). The interests of a state are identified by epistemic communities which can even help propose policies. According to Haas, it is possible that policy-makers can acquire new knowledge and new insights which alters the interests of a state. Haas argues 'that control over knowledge and information is an important dimension of power and that diffusion of ideas and information can lead to new patterns of behaviour and prove to be an important determinant of international policy coordination'. Since the epistemic communities have 'control over knowledge and information', they seem to be most powerful and possibly play a crucial role in fundamental policy changes. Haas argues that epistemic communities influence decision-makers of states. The ideas of decision-makers affect decision-makers of other states during their deliberations. This could lead to convergence of states' interests which increases the chances of international cooperation. However, this is based on the preferences of the policy experts –people who have expertise in a certain policy area for which they are recognised and therefore asked for advice and opinions (Haas 1992). This gives them considerable power over the state's interests and therefore on the policy-making process. A good example of this process is probably the German €50 billion rescue plan for the economy announced early January 2009 (NRC.nl, last accessed at 19 January 2009). At first, Merkel refused to 'borrow her way out of the recession' but was later convinced of the necessity after national and European pressures. Experts believe that especially the bonus for turning in old cars in exchange for more environmental friendly vehicles will support the car industries which were already suffering.

According to Yee, the epistemic communities approach fails to acknowledge that ideas have their own ‘political dynamism’ and can influence policy-making (1996). The epistemic communities approach places these ‘ideational qualities’ on experts and their influence on the policy-making process. Of course, other approaches to policy changes are also possible. Haas also mentions the neorealist approach, the dependency theory-based approach and the poststructuralist approach (1992). Considering that a part of this study is concerned with policy learning in the EU, the epistemic communities approach seems to be better suited since one of the aims of this study is to see if there are any changes in policy-styles of state administrators and European institutions –which is considered one of the effects of the ‘diffusion of information and learning’.

In short, the constructivist approach argues that actors create structures and that actors and their structures are mutually constitutive. The structure not only defines the agent’s interests but also constrains the agent’s policy-options. Agents, in their turn, change their environments and culture almost on a daily basis. However, as long as external pressures are absent, such as a financial crisis, it will not be possible to change prior existing norms and structures. Policy-makers need a window of opportunity leading to a situation in which actors realise that the existing institutions, rules, and norms no longer serve their interests. To solve this problem, the agents may decide to use this turning point and change the structure and will try to find the most appropriate solution to ‘update’ the institutions and legislation to their contemporary needs –the punctuated equilibrium moment.

In the current financial crisis, and following the constructivist’s approach, it can therefore be expected that the EU’s member states will try to change their common banking regulation and possibly the EU’s competition policies as well. Enlargement, Europeanisation and the introduction of the euro have drastically changed the member states’ environment and this crisis has made them painfully aware that especially the EU’s current banking regulation is no longer suited to manage the current reality of increasing cross-border operations. This will start-up a time-consuming processes of discursive practices in several epistemic communities on several political levels which could eventually result in a fundamental shift in European policy-making in this particular area. I argue that this financial crisis is a rare turning point to change prior existing norms and structures in relation to European banking regulation. This prediction brings us to the first hypothesis:

> Hypothesis 1: European financial and banking regulations have become dominant in domestic policy-making which constrains the member states' policy-options. This will lead to ad hoc macroeconomic responses at the national level but, at the same time, will initiate fundamental regulatory changes in policies at the European level.

*1.3 Financial crises*

In general, the European post-war macroeconomic debate is largely dominated by Keynesianism and monetarism. This is an interesting and lively debate but it is however not the aim of this study to give a full overview of this debate. Next follows a very short characterisation of both groups, which does hardly any justice to the complex nature of these theories. Second, it is also necessary to examine the various ways European governments have responded to financial crises in the past and how they can respond to a financial crisis today. In relation to that, Schmidt's typology of varieties of capitalism is useful to understand the expected responses of European governments to the current crisis as member states generally differ in their macroeconomic policy choices and therefore differ in policy outcomes (2002). Finally, the discussion will move to the European level and examine the potential problems in the relationship between the EU and the member states.

*1.3.1 Keynesianism vs. monetarism*

Keynesianism is typically characterised by countercyclical fiscal policy and, if necessary, strong governmental intervention to stimulate growth (Salant 1989, 33). Keynesians argue that the governments should increase their investments so that consumers' purchasing powers increase. The idea is that this will trickle down through the economy initiating the multiplier effect. In times of economic prosperity, the government should restrict its spending to restore a balanced budget but the state will continue regulating the economy. The latter macroeconomic theory, on the other hand, is characterised by its trust in the markets and competition to generate the best allocation of resources (Yergin and Stanislaw 2002, 128). State intervention is not considered desirable since this would only generate adverse effects on the economy. Rather, the monetarists prefer a policy of laissez-faire and believe that markets will eventually correct themselves.

This, of course, can be translated to financial policy as well. In case of a financial crisis, a Keynesian policy-maker will tend to intervene and stand ready to provide liquidity as a lender of last resort to ease the crisis out (Kindleberger 1978, 6). A monetarist, on the other hand, will focus on the stability of the money supply so that the money growth remains stable and predictable. Although not a supporter of monetarism, Kindleberger illustrates this perspective by arguing that, according to the monetarists, financial crises should run their course (1984, 276). The market will eventually provide liquidity at the right price. In other words, if the interest rate increases, then at some point someone will be willing again to lend capital for investments, as will be discussed below as well.

A large part of the literature concerning financial crises relates to the currency crises of Mexico in 1982 and 1994-1995 and Asia in 1997 (Krugman and Obstfeld 2006, 360; Valdez 2000, 340; Gillis [et al.] 2001, 540). This, however, is not relevant for this study and will therefore not be further discussed.

### *1.3.2 Crises cycles*

Kindleberger is a leading economic historian who has made many contributions concerning financial crises. In *Manias, Panics, and Crashes* Kindleberger describes the history of financial crises covering all aspects of speculation (1978). Kindleberger follows Minsky’s model to interpret the run-up and the processes of economic and financial crises (1978, 15). This is particularly helpful for the regulatory aspect of this study as it is important to understand the processes of an economic crisis in order to generate effective regulation to prevent future scenarios.

Minsky’s model describes the different stages and processes of financial crises. Kindleberger is able to generalise Minsky’s ideas and applies them to major banking crises of the past. For this study, it is sufficient to discuss how the panic in the financial sector can be stopped. Although a detailed discussion of Minsky's model is beyond the scope of this study, it is suggested that Minsky's ideas can be applied to the current financial crisis, as is shown by Whalen (2008), see the discussion below.

According to Kindleberger, there are three possibilities to stop a financial crisis (Kindleberger 1979, 20). First of all, governments can decide not to respond at all and wait until prices have plummeted. There will be a moment when prices are so low that someone will be tempted again to step in and move into less liquid assets, as already suggested above. Second, governments can decide for more drastic measures (regulation) such as the closure of trading and setting a limit on a price decline. Finally, a lender of last resort can intervene and make enough money available to meet the demand. At the moment, European governments especially seem to focus on the third option. This will also be further discussed below.

As already mentioned above, Minsky's ideas can still be applied today. Whalen considers Minsky as an authority in the field of liquidity crises and therefore regards his ideas relevant for the current crisis (2008, 92). In his article, Whalen attempts to explain the current financial crisis from Minsky's perspective. Whalen explains Minsky's ideas of the business cycle and how this can be applied to the current crisis. According to Whalen, the housing boom phase –'euphoria' or 'mania'– started around 2000 (idem, 101). The building up of debt continued to the midsummer of 2007, until the 'Minsky-moment'. The Minsky-moment occurs when investors realise that the object of mania has become over-extended –basically the moment when mania turns into panic (idem, 98). At the time of writing his article (mid-September) Whalen expected that the 'Minsky-meltdown' is not likely to occur –a situation of declining asset value which eventually will lead to a recession– since governments and banks have acted as a lender of last resort. Although the crisis is still continuing, Whalen is already able to analyse and explain the first stages of the crisis with the assistance of Minsky's model.

The main object of this study is the responses of governments to the financial crisis and to the resulting systemic instability. The circumstances of the current crisis will be discussed in chapter 3 and the concept of liquidity has already been briefly discussed in section 1.1. The only remaining questions are: (1) why did the financial market take such risks of trading in these subprime mortgages? And: (2) are there any negative consequences of the 'lender of last resort' systems? In relation to the first question, Gilles et. al. points at earlier occasions where this has happened, such as the currency crises in Asia of the '90s (2001, 508). This phenomenon is also known as 'herd behaviour'. It is argued that both lenders' and borrowers' irresponsible behaviour can be ascribed to ignorance. Concerning the second question, the idea of providing a lender of last resort safety net is often argued to encourage risky behaviour –which is called the 'moral hazard' problem. Even though the moral hazard problem seems to be a serious problem, governments are willing to accept this risk because they feel that systemic stability is more important; governments argue that the public, depositors and the national economy at large should be protected. One thing that is interesting, though, is the fact that the banking sector has become much more competitive in the last decade as a direct consequence of deregulation, increased number of players on the financial markets, and increase in scale (bankingreview.nl, last accessed at 1 June 2009). Although this is consistent with the monetarist macroeconomic trends after the 1980s, the deregulation also increased the moral hazard problem. The deregulation of the banking sector enabled the banks to shift their policies to more risky behaviour, for instance by setting-up the bonus systems and trade in securitisations. This causes certain tensions especially in the managed and state capitalist countries as the public policy-styles of these governments are traditionally more intervening, as we will see below. This study will show that the managed capitalist countries in particular relied on traditional patterns of public policy-making and intervened in the macroeconomic policy area. To curb future risky behaviour in the banking sector (the permanent response), the member states –although the Netherlands and Germany more actively than the UK– now turn to the European level to improve regulation instead of adjusting regulation at the national level.

### *1.3.3 Responses*

Now that the processes of the economic crisis cycles have been examined, the next thing to discuss is the various ways of how governments can respond to economic and financial crises. At the member state level, Schmidt's ideal-typical models of capitalism structures

and explains the different responses of member states to the post-war economic crisis in their countries as a consequence of globalisation and Europeanisation (2002).
How do governments respond to the crisis? Kindleberger already briefly referred to these policy choices which will now be discussed in more detail. There are three possible responses to the crisis: keynesianism, not responding at all, or more/improved regulation.

The first option, Keynesianism, argues that the government is ultimately responsible for a country's economic performance (Hall 1989, 4). In periods of economic downturn, Keynes argues that governments should strive to increase aggregate demand of consumers by increasing its own expenditures. This will trigger the multiplier effect as the increased purchasing power of consumers trickles down through the economy. An example of this effect is Roosevelt's New Deal in 1933 which helped the American economy to recover from the Great Depression (although it is also argued that Keynes' influence on Roosevelt's policies at that time was limited) (idem, 28). An even better (and more local) example of government intervention is the 'Amsterdamse Bos' (Amsterdam Wood) in the Netherlands (Amsterdamse Bos website, last accessed at 16th December 2008). The planting of the forest began in 1934 and functioned as one of the largest employment projects of the Dutch government as the Dutch economy was also hit by the Great Depression. During the crisis years, this project employed about 20.000 people.

The second option is not responding at all. According to the Chicago School of monetarists, 'authorities are universally stupid and the market always intelligent' (Kindleberger 1978, 143-4). This view argues that it is best to let the crisis run its course and eliminate all bubbles which caused the crisis while the government ensures a balanced budget. Eventually, it is suggested that the economy will 'hit rock bottom' as unemployment rates increase, prices and costs decrease. But sooner or later, investments will start to pick-up again because investors will always want to take advantage of low asset prices (Gilles et. al. 2001, 568 and Gourevitch 1989, 90). However, this strategy also increases the risk of a deflationary crisis which will eradicate any chance of necessary investments to recover from the crisis (Kindleberger 1978, 140). Gourevitch argues that the deflation strategy was the dominant view prior to 1929 (1989, 90). It was argued that governments should even support this process by procyclical policy-making.

Nowadays, the fear of a deflationary crisis is about to become reality in the United States as the latest American inflation reports state a decrease in prices of 1,7% -a sign of possible deflation (RTLZ website, last accessed at 17th December 2008). In this scenario, investments will be postponed because companies and consumers anticipate on even lower prices in the future.

As stated above, governments are always inclined to intervene in an attempt to prevent bankruptcies, bank failures, and to secure price stability. It is unlikely that governments will not respond at all to crises as this will surely cause economic downturn. Relying on the competitive forces of the market will push the economy into a deep economic recession (Kindleberger 1978, 140) which governments will always try to avoid as a result of political and popular pressures.

Third, at times of crisis, there is always a cry for new, more or improved regulation. Not only to overcome the current crisis, but also to prevent future crises. Especially in the case of financial crises, new regulation is usually aimed at reducing risks and protectionism (Krugman and Obstfeld 2006, 632 and Hall 1989, 90). A call for more ***transparency*** of financial markets is quite typical in these circumstances. In the case of the current crisis, the G20 agreed that financial products and firms should improve required financial disclosures so that disproportionate risk-taking can be prevented in the future (G20 Declaration 15th November 2008). At the European level, a lively debate has occupied politicians in the corridors of political power for enhanced ***European cooperation*** in terms of improved banking supervision in Europe and crisis management (Europa-nu website, last accessed at 17th December 2008). In the past, policies of price support and state-aid to specific industries to stimulate demand were not uncommon. However, these measures are generally no longer accepted in the EU as a consequence of the EU's competition rules (see articles 81-89 TEU for the competition policies).

It is therefore all the more interesting that we will see a combination of not only macroeconomic and regulatory responses, but also state-aid and nationalisations. These responses should be dealt with separately as each response comes with different actors, legislations and responsibilities. The macroeconomic actions aimed at stabilising the economy to stimulate economic growth again. This is achieved through fiscal and monetary policies. However, the euro countries have no monetary tools to stimulate growth as this has been delegated to the ECB. This leaves them with fiscal policy instruments such as taxation and spending. However, this is also somewhat restricted by EU rules, such as the Stability and Growth Pact (SGP).

It were especially the state-aid actions and nationalisations that raised tensions between the national and European political levels. State-aid is heavily regulated through European regulation. The financial markets, on the other hand, are not. Although there was some regulation in this policy field, the structure of the legislations was not able to close the gap between national legislations. However, the national governments carry great responsibilities in terms of guaranteeing stability of the financial sector. The fact that European financial markets are heavily integrated –as is illustrated by the Fortis case– underlines that the governments also carry this responsibility towards other member states and does not stop at their borders. This, combined with the strict competition rules at the European level, resulted in a complex web of shared responsibilities across member states and limited policy-options that are spread across political levels.

These responses are also linked; state intervention will be hardly effective if the right macroeconomic measures conditions are not created. This reveals a symbiosis of the various political levels; the national level needs the European level to cooperate so that it can intervene, while at the same time the European level needs the national to cooperate with the regulatory reforms. This shows that all measures move in the same direction: towards stabilisation and recovery of the financial markets in the short term and reform of the basic principles and rules of the financial sector in the long term.

### *1.3.4 Macroeconomic and regulatory policies*

Now that the three possible responses have been discussed, it is important to establish what exactly determines the choices of states in terms of the scale and intensity of their responses to an economic crisis. The most important policy instruments used by the member states and the Commission to weather the crisis are macroeconomic and regulatory responses, state-aid, and nationalisations. Policy-making is more than finding the most effective response to a crisis; it is also an important part of political agendas and therefore affected by political influences of stakeholders, such as union leaders, leaders of the big industries (for example the car industry), academics, and in this study also representatives of the financial sector (Hall 1986, 4). Hall argues that institutions play a significant role in the 'definition and articulation of interests, the dissemination of ideas, the construction of market behaviour, and the determination of policy' in the economic policy-making process and that the institutional analysis is the best approach to explore the political environment in which policy is made (idem, 5, 19). In the discussion above in paragraph 1.2.1 it became clear that norms find their expression in institutions and structure behaviour and policy-options of stakeholders. These pre-existing norms will then determine whether states will follow an interventionist strategy in their macroeconomic or regulatory policies in times of economic crises (and their scale), or not.

This is also, at the same time, the link between macroeconomic policies and regulatory policies. Hall argues that '(…) national economic policy is influenced most significantly, first, by what a government is ***pressed*** to do, and secondly, by what it *can* do in the economic sphere' (emphasis in original) (1986, 232). In other words, governments need legislation to provide them with sufficient and effective instruments to implement macroeconomic policies. This study will show that the different public policy tools (i.e. macroeconomic policy-making, nationalisations, state interventions, and regulatory policy-making) used to combat the financial crisis, all move in the same direction: away from market-oriented principles towards greater protection of consumers and economic and financial stability. This is an important conclusion because it indicates a change in ideas and beliefs about the role of the state and, perhaps more importantly, the future role of the EU in European financial policy-making. The changing ideas on the role of the state could not have been better illustrated by the UK which had to implement temporary legislation to enable the government to nationalise banks (this will be discussed in more detail in paragraph 3.4).

In the post-war era, the UK has not been that much of an interventionist state. Not surprisingly, the Conservative Party has always advocated an 'unimpeded operation of the market mechanisms' which was probably best illustrated by Margaret Thatcher (Hall 1986, 64). These laissez-faire and deregulatory strategies of the Conservative policy-makers and advisors are influenced by stakeholders in industries which financially support the Conservative Party. Obviously, it is not in the best interest of these businesses to increase state intervention in their industrial sector. The Labour Party has been much more interventionist in their policies as their priorities traditionally lie in reducing unemployment and are open to nationalisations. Interestingly, the unions –the biggest sponsor of the Labour Party– generally oppose any initiative to regulate industries because they see this 'as a threat to their autonomy in the workplace' (idem, 65). With respect to the regulatory issue, Hall concludes that the UK's rigid institutional structure heavily constrains actions of the government. It is therefore expected that during this financial crisis the UK will also oppose any national or European regulatory measures in the financial sector to curb risks in the future.

Also in terms of macroeconomic policies the UK has been somewhat reluctant to play an active role (Hall 1986, 51). Just after World War II, the UK decided to rely on Keynesianism by stimulating the demand side to reach higher levels of investment which would, hopefully, result in full employment. The government used its fiscal and monetary powers to influence the outcome of these policies. Unfortunately, this proved incompatible with another priority of the government: a high exchange rate. Periods of small economic growth and deflationary actions followed each other until Thatcher renounced this strategy after which the exchange rate rose. This shows, as Hall concludes, that again rigid institutions influence the macroeconomic policy-making which makes it impossible to increase state intervention on a structural basis. This is also illustrated by Schmidt's model (see below). Even though the Labour party has been in power for the past decade, the UK is still considered to be a market capitalist state and has moved even further in that direction in the past few years which means even less state interference in macroeconomic policies. Following this line of thought, it should therefore not be expected that the government will interfere on a large scale –if even at all– in the current financial crisis.

The governments of the Netherlands and Germany have been much more active in both their macroeconomic and regulatory policies than the UK. This is also illustrated by Schmidt's model, which will be discussed below. Just like the UK, the Netherlands and Germany owned many businesses through which they were able to interfere in many industrial sectors. Unlike the UK, the Netherlands and Germany did not privatise them until they were forced to do this as a consequence of a combination of economic crises and Europeanisation (Schmidt 2002, 180). This is also illustrated by figure 4.1, which shows that over time the Netherlands and Germany have deregulated considerably. However, compared to the UK, it can be expected that the Netherlands and Germany will promote state interference on a much bigger scale, both in terms of macroeconomic policy-making and regulatory policies. The reason for this is that these countries have a history of an interventionist strategy. Pre-existing norms legitimise an increase in state interference –especially in terms of regulatory policy– either at the national or at the European level to support their industries in times of crisis and curb risk-taking in the future. The call of these countries for a more active state in the financial sector will be seen in $T_2$ and most likely at the European level as the EU has gained more power in this industry. This discussion will be combined with Schmidt's model and summarised in figure 1.2, see below.

### *1.3.5 Schmidt's model*

Now that we have examined the different options to resolve a crisis, we can continue to explore the different responses at the national level of European governments in past economic crises. According to Schmidt, all European countries have been confronted with severe economic shocks in the post-war period which generated major changes in the economic policy-making and policy-styles of each country (2002, 5). The main pressures leading to these changes were globalisation and Europeanisation.

The three ideal-typical models are:

- market capitalism
- managed capitalism
- state capitalism

*Market capitalism*

First, in Europe Britain comes closest to the ideal-typical model of market capitalist economy. Market capitalism is characterised by only minimal state interference in industries so that businesses have a higher responsiveness to changing conditions in the market (Schmidt 2002, 133). The government will only interfere in case of disputes and will set only minimal rules, of which the supervision is delegated to 'semi-independent regulatory agencies' (idem, 113). Business relations are market-driven and therefore highly competitive and contractual. Firms operating in the market capitalist economy have easy access to the financial markets which stimulates innovation and higher profits but the downside is that these finances are often very distant and focused on the short-term. In addition, the flexible labour market and decentralised wage-bargaining system enables firms to adjust their workforce to changing market conditions. The wage-bargaining is individualistic and takes place between individual employers and employees. Obviously, there are also disadvantages. Since the labour-market is very flexible, the workforce tends to be dominated by lower-skilled employees. As a result, Britain has been confronted by an increase in competition from other low-wage countries in Asia. The wage mechanism itself is not of importance for this study; it is an illustration of the flexible labour market and known to contrast sharply with the managed capitalist countries. However, because of this flexible labour system it can be expected that the UK will be confronted with a sharp increase in, and ultimately end up with, higher levels of unemployment. At the beginning of an economic crisis, this is a major downside. But on the other hand, when the economy starts to pick up again unemployment rates are also likely to drop much faster than in other countries.  In addition, firms will generally speaking not be supported or bailed-out by the state in economic downturn. This will be an interesting point later this study. How will the government respond to these pressures and will this affect the policy style of the UK?

*Managed capitalism*

Second, managed capitalism is illustrated in Schmidt's model by Germany (2002, 5). In contrast to market capitalism, firms in a managed capitalist economy benefit from greater stability as a result of collaborative inter-firm relations (Schmidt 2002, 136). These relations are established by and run through non-market institutions which facilitate exchanges of information and cooperation. As a result, business relations are 'non-market managed'. The industry finds its funds at a close distance to the industry which has the advantage that it is generally focused on the long-term. The state is an 'enabling facilitator' in organising business activity which results from the closer relation between the government and industries. Also, the government's involvement in labour-management relations, labour regulation, and collective wage-bargaining has resulted in high-skilled and more productive workers. However, an interventionist government and collaborative inter-firm relations also have major downsides. It generates less flexible labour-market conditions, more government regulations, and more time is needed for the economy to adapt to new market conditions.

*State capitalism*

Third, France is used to illustrate the ideal-typical model of state capitalism. This type of capitalism can be characterised as 'an interventionist state organising inter-firm collaboration and imposing management-labour cooperation' (Schmidt 2002, 5). Business relations are highly organised in which funding for industries is organised by the state (idem, 113). The state is characterised as an 'interventionist leader', controls the wage bargaining process, and is very active in terms of labour regulation. On the one hand, state capitalist countries had the best of both previously described worlds. Namely, the market capitalism's fast reaction capacity to changing market conditions by providing 'patient' financial resources for innovations –especially in economic downturn– and the coordinated actions of managed capitalism by establishing inter-firm networks to exchange information (Schmidt 2002, 137). On the other hand, state capitalism also produced the worst outcomes of both market and managed capitalism. Although businesses had a shorter response time to changing market conditions than in managed capitalist countries, it still did not have sufficient innovative capacity. The labour-market proved to be anything but flexible which resulted in a high-waged but low-skilled workforce.

Given the fact that especially managed and state capitalist countries traditionally have stronger relations with industries, the EU Commission has been very suspicious of state-aid actions (Schmidt 2002, 180). The strict competition policies of the EU are designed to protect the Single Market and secure the level playing field. Strong relations between the government of a country and its industries potentially interfere with these principles. This raises tensions between the traditional policy-styles of the member states and the EU competitions policies even though the member states already reformed this considerably. The latest actions of state-aid in 2008 illustrate these tensions as the Commission demands a full report on these actions and carefully monitors all actions taken by member states.

Having set the rough outlines of the three ideal-typical models of capitalism, I will now briefly discuss how Britain, Germany and France recovered from their economic crises and how their reforms affected their policy-styles. In general, all three countries were experiencing rising unemployment rates, rising inflation rates and increasing competition in the capital and product markets as a result of the pressures of globalisation and Europeanisation, decreasing productivity and lacking investments (Schmidt 2002, 147). The driving forces behind these reforms are the mediating factors –the factors which determine the success of the attempts to reform–: economic vulnerability, political institutional capacity, policy legacies, policy preferences and discourse (idem, 61). The economic vulnerability is the most important factor as economic setbacks allow policy-makers to use the situation as an opportunity to reform public policies. This is consistent with the discussion of punctuated equilibrium in paragraph 1.2.1 where it was argued that external pressures can be used by policy-makers to implement new norms. Without the factor of economic vulnerability –the external crisis– it is virtually impossible for policy-makers to adjust public policy. The political institutional capacity also plays a significant role. In managed capitalist countries, such as Germany, the political systems are fragmented and based on coalitions. Generally speaking, this can generate only incremental changes and it is thus more difficult to radically change policies. The political system of the UK, however, is characterised by its majoritarian governance which makes radical changes easier. These factors are part of the mechanism which can cause change in public policies of the member states.

The turning point of British macroeconomic policy-making was in 1979, when Thatcher was elected Prime Minister (Schmidt 2002, 148). Thatcher immediately started ‘radical therapy’ and tightened monetary policies resulting in an appreciation of the pound sterling which obviously harmed the export industry resulting in many bankruptcies and an increase in unemployment rates. In addition, financial markets were deregulated, which caused a rapid expansion of the financial markets, and public enterprises were privatised (‘deregulation of industries’). These measures, in combination with ‘market-reliant labour relations’ and the ‘deregulation of industrial relations’, brought about an increase in transparency and higher profits for firms which managed to survive (idem, 163). These policies stand in sharp contrast with those immediately after 1945. In this period, up until Thatcher’s radical therapy, the UK also turned to state-aid en state ownership in times of crisis. After overcoming the initial shocks of Thatcher’s ‘radical therapy’, the economy eventually recovered and unemployment rates decreased and firm profits rose again. In terms of Schmidt’s model, the UK has moved even closer to the ideal-typical model of market capitalism. Business relations have become even more market-driven, funding of industries has become more distant and more short-term in its focus (idem, 142). This is the situation of the political system in the beginning of $T_1$. It can be expected that in $T_2$, when the financial crisis is raging at full speed, the government will only provide financial assistance on a very basic level and only in the macroeconomic policy field. As already discussed in paragraph 1.3.4, the UK’s pre-existing norms do not legitimise massive state intervention in times of crisis, which is illustrated by the rigidness of its institutions. The UK will be most hesitant to implement regulatory measures to prevent future crises.

As for Germany, the turning point in macroeconomic policy-making was much later: after the reunification in the 1990s (Schmidt 2002, 165). Germany was less affected by the oil crises of the 1970s and the pressures of globalisation and Europeanisation. However, due to the costs of the reunification the economy took a nose-dive and found itself in a deep economic recession. In contrast to the UK, Germany has taken more time to reform its policy-style, mainly because many of the reforms had to be negotiated, as is characteristic for a managed capitalist state. The main reforming elements were deregulation and privatisation, although not on such a massive scale as in Britain (idem, 180). Interestingly, some big German industries chose to follow a different path than the government. Whereas the government tried to remain as loyal as possible to the managed capitalist policy-style, some firms decided to implement measures closer related to the market capitalist variety. For instance, they internationalised many of their operations to reduce labour costs, larger businesses adopted market-oriented (internal) practices, and turned more and more to the deregulated capital market for investment capital (idem, 173). Although Germany obviously adopted more market-oriented elements, the government continued to support its businesses and is therefore more open to bail-out firms in financial trouble than the UK's government. This divergence between the government and the businesses in that period is a remarkable trend because it seems as if some businesses are detaching themselves from the government to reap the benefits of a more flexible market capitalist strategy instead of hiding under the safer governmental umbrella.

As can be seen in figure 4.1, Germany and the Netherlands have moved upwards in the direction of market capitalism. Especially the distant funding of industries has moved away which caused it to become less focused on long-term results (idem, 142). The result of these policy changes is what we see in $T_1$. For $T_2$ it can be expected that the government will try to weather the crisis through both macroeconomic policies –financial support and bail-outs– and regulation –especially to protect the workers and curb risk-taking by financial institutions in the future. These expectations are similar to what has been discussed in paragraph 1.3.4. The previously existing norms and practices legitimise state intervention in this new crisis, especially considering its severity.

France's turning point was in 1983, only two years after the Socialist victory. Initially, Mitterrand returned to neo-Keynesian macroeconomic policy-making to battle the economic downturn (Schmidt 2002, 183). In 1983, however, it became obvious that a return to state capitalism was not the solution. Prime Minister Pierre Mauroy and Minister of Finance Jacques Delors successfully advised Mitterrand to abandon the traditional socialist economic policies in favour of market economic principles. Over night, the government implemented market-oriented measures such as labour-market decentralisation to increase the flexibility of the labour market, liberalisation of the financial markets to ensure access to capital for firms, privatisation of national champions, and deregulation of industries. One should realise that the reforms were state-led and 'state-cushioned', which somewhat softened the impact on its industries, in contrast to the UK's strategy (idem, 190). This proved to be a successful strategy as most privatised companies were most competitive in the following decades. The state also implemented some elements of managed capitalist countries. For example, the government arranged financial stability for French companies by bringing in banks and insurance companies as shareholders.

In sum, all three ideal-typical model of capitalism implemented market-oriented elements such as privatisation, deregulation, and decentralisation of the labour-market. Schmidt emphases, however, that Germany and France have not transformed themselves into market capitalist countries, the three varieties remain (2002, 141). Britain has moved closer to the ideal-typical model of market capitalism whereas Germany and France only introduced liberal elements in their macroeconomic policy-making. This observation is consistent with the earlier structure-agent discussion in paragraph 1.2.2. It was argued that prior existing institutions, legislation, norms and rules continue to shape actor preferences and that the EU and its institutions have become part of their ‘social furniture’ (Risse 2004, 163). On this, Schmidt argues that national policies influenced EU policy-making as often as the other way around (2002, 15). So, even though the member states reformed their public policy-making as a consequence of the pressures of globalisation and Europeanisation, the policy-styles of the member states remain distinct as their previous different policy-styles continue to influence interests and preferences preventing convergence to the market-capitalist variety.

Schmidt summed up the ideal-typical characteristics of her models in table 3.1 (idem, 113). In table 3.6 the changes of the characteristics in the new Millennium are summed up to enable the reader to compare the models over time. This change is then illustrated in fig. 3.1 (idem, 144). Schmidt argues that it is highly unlikely that these three models will ever converge to one model of market capitalism as all European countries differ significantly in their political systems and economic structures which are both highly path-dependent. In this respect, it will be interesting to examine how member states are responding to this crisis. Are member states responding in a similar way? Therefore, I will reproduce this figure and add the findings of this study. This will illustrate the effect of the crisis on Schmidt’s theory. Because this study is only limited, I will mainly focus on just a few characteristics: ‘industry-finance’, ‘investment’, and ‘government relations’. Obviously, the cause of the financial crisis is that the financial sector lost its access to its funding which it needs on a daily basis. The issue will be to explore how and when governments will respond to this. I will look for both macroeconomic and regulatory responses to, for instance, stimulate the inter-bank lending market.

A final remark on state capitalism. Schmidt argues that although the French macroeconomic policy-making has undergone the most significant change away from state capitalism, the state remains an important market-shaping factor (2002, 191). Schmidt argues that this ideal-typical model should nowadays be called state-enhanced capitalism as it does neither fit the profile of market capitalism nor managed capitalism.

Based on Schmidt's model, the following hypothesis can be derived:

> Hypothesis 2: Since previous economic crises caused permanent shifts in policies of managed capitalism countries towards market capitalism and considering the fact that the most important mediating factor –economic vulnerability– is present, it can be expected that the German and Dutch policy-styles will again make a permanent shift towards market capitalism as a consequence of the global and enormous scale of this crisis.

If our discussion of Schmidt's model and the discussion about the macroeconomic and regulatory policies of paragraph 1.3.4 are combined, this can be summed up in the following matrix (since this study only includes market and managed capitalism, I omitted state capitalism):

| **Figure 1.1** | Macroeconomic policies | Regulatory policies |
|---|---|---|
| Market capitalism | - minimal financial support for industries<br>- privatisations over the past two decades; bail-outs and future nationalisations highly unlikely<br>- minimal supply side economic stimulation packages<br>- distant industry-funding | - minimal state interference<br>- state sets rules but are organised by semi-government agencies (at arm's length<br>- flexible labour conditions and individual wage bargaining<br>- not in favour of regulatory measures in financial sector |
| Managed capitalism | - many public owned | - intervening state |

| | | |
|---|---|---|
| | enterprises: privatised only recently<br>- many economic stimulation packages in the past<br>- possibility of nationalisations and bail-outs<br>- close industry-funding | - protecting workers and collective wage bargaining<br>- regulation to curb risk-taking in financial sector<br>- negotiated state relations |

Schmidt's ideal-typical models of capitalism play a significant role in this study. Although Schmidt's model covers the case studies of this research, obviously, the theory of varieties of capitalism also has its shortcomings. The typology of capitalism as developed by Hall and Soskice, only recognises 'two polar ideal types of Western political economies: liberal market economies and co-ordinated market economies' (Mykhnenko 2005). Although this approach is widely accepted by political economists, it is exactly this 'binary classification' and its limited scope –i.e. the West– that critics focus on. Schmidt responded to these criticisms by presenting her three ideal-typical models of (European) capitalism (2002). Needless to say, this model also does not cover the sheer complexity of European political economies. For instance, it does not include the Scandinavian countries, Mediterranean countries, or any of the Eastern European countries. In 2003, Amable responded to these critiques and presented his 'diversity of capitalism' model (Mykhnenko 2005). This model includes five varieties of capitalism: 'the market-based Anglo-Saxon model, Asian capitalism, the Continental European model, the social-democratic Scandinavian model, and the South European (Mediterranean) model'. In my opinion, this model still does not cover all global capitalist political economies (if that is even possible). Mykhnenko makes a good point that the former communist Eastern European countries should be classified as a separate type of capitalism (2005). Mykhnenko argues that the post-communist countries have developed a type of capitalism that 'posses a large number of similarities with respect to specific models of modern capitalism identified in the literature; yet, none is fully analogous to them'.

### *1.3.6 European level*

Also at the European level, the crisis has not gone by unnoticed. The current financial crisis is one of the first major crises to hit the eurozone putting the relationship between the EU Commission and the member states under severe pressure. One the one hand, the member states try to protect their own economies by taking state-aid measures such as nationalisations of banks. On the other hand, these member states are severely constrained by rules, norms and institutional values at the European level. These rules, norms and institutional values constrain the possible policy-options for the member states (Hay 1995, 201). The existing European rules and norms have served their goal sufficiently for a long period of time. However, in crises like these, the member states feel the necessity to redefine these rules and norms and adapt them to their contemporary needs.

This agent-structure approach illustrates the conflicts between the EU and the member states since different actors are promoting competing norms and interests. The existing structure no longer fits the needs of the member states and their demands for improved European regulation in this banking policy area points at convergence of expectations at the national level. Over the past decades, the EU Commission has favoured a market capitalist approach by promoting the Single Market through liberalisation, deregulation and condemning state interference (Helleiner 1994, 157). A common policy-approach among the member states to these trends was most important to the EU Commission as this was necessary to establish the Single Market. At the moment, the EU Commission seems to be occupied by avoiding divergence of member states' policy-outcomes as they try to protect their national economies. A wide range of member states' policy-options, such as state-aid, nationalisations of banks, recapitalisations of banks and insurance companies, emergency funds, and other measures taken by the member states, make it all the more difficult for the EU to avoid divergence and they certainly do not reinforce EU policies. Although member states are pushing hard to reform European rules and norms, it seems that the EU is moving at glacial pace in producing new regulation which should accommodate the member states' new wishes.

The crisis induced responses of governments discussed in this study focus on macroeconomic and regulatory policies. The reader needs to be aware of the different types of responses and their potential outcomes in these policy-areas. The study will show that member states' responses in the competition and macroeconomic policy-areas to maintain systemic stability and support the economy are temporary actions which are accommodated by the Commission. The Commission's accommodative actions are small adjustments of already existing legislations and are not fundamental shifts in policies (see section 2.2). In contrast, the regulatory responses, such as the member states' demands for bank regulation or the decision to set-up a European supervisory agency for credit rating agencies, build up new structures and are therefore permanent changes in policies. Naturally, this is much harder to accomplish as member states have conflicting interests. However, the crisis has revealed a convergence of interests which will enable the member states to adjust the European banking regulation. As stated earlier, the epistemic communities play an important role in defining actors' interests, both on the national and European level. Deliberation processes and control over knowledge and ideas can eventually lead to certain behaviour and policy coordination. It is not unthinkable that policy-makers of the European level can influence domestic policy-makers –and thus influence the state's interests– and vice versa. But this process takes time and many actors are involved nowadays. It should be expected that fundamental changes will take very small steps at the time.

## 2. Methodology

### *2.1 Methods, actors and time frame*

This study is based on a qualitative research design in which I will observe processes of policy shifts and policy learning of European governments which might change their policy-styles. The set-up of this study is a comparative ideational case study which includes four actors: the Dutch, German and UK government and the EU institutions –the Commission in particular. I have chosen these three member states because the structures of their banking systems, the timing of their responses, and their resources available differ considerably. In addition, their economies –and therefore their responses– can be placed in two of Schmidt's ideal-typical models: the UK, of course, in the market capitalist category, and the Netherlands and Germany in the managed capitalist category. Different responses can be expected between these two categories and probably even within the managed capitalist category. Smaller countries are well-known for their flexibility and rapid adjustment to external pressures. I have not included a state capitalist example because, as stated earlier, Schmidt argues that this variant today only exists in theory, even though France cannot be placed in one of the other variants of capitalism (Schmidt 2002, 191).

To structure the results of the comparative case study, two time periods have been selected: $T_1$: April 2008-August 2008; and $T_2$: September 2008-December 2008. This empirical aspect of this study should demonstrate if (I) there is any convergence or divergence between member states' policy-outputs and (II) if the EU has sufficient institutional capacity for a policy shift at the European level and generate new legislation. Although this last aspect cannot actually be observed in this short time frame, one can look at the initiatives and goals of the various stakeholders at the European level.

### *2.2 Operationalisation*

It needs to be specified what makes government responses 'ad hoc' and what gives them a more permanent character. In my opinion, two elements are crucial to determine whether a response of the government is to be called ad hoc or permanent. First of all, one should wonder whether the proposed policies require new legislation or adjustment of existing rules and laws. If the proposal does not require any new legislation because the government can find some room for manoeuvre within existing legislation, the response can be considered an ad hoc response. On the European level, this type of response is characterised by a broader interpretation or small adjustment of existing rules and laws to accommodate and support member states to prevent massive failure of their financial sectors and avoid economic downturn. Generally speaking, responses of a permanent character signal a fundamental policy shift and need to overcome much higher barriers and will take much longer to be implemented because they are aimed at building up new structures. These policy shifts will not be very revolutionary but rather small, incremental steps as member states' preferences are likely to differ considerably which makes it more difficult to reach consensus.

Second, one should explore the government's intentions: did the government bind itself to a time frame (I)? Also, if the proposed policy is aimed at avoiding similar situations in the future, this policy proposal will initiate a fundamental policy shift and can thus be considered a permanent response (II). In the case of ad hoc responses, the government's intentions and the implemented policies have a limited, short-term time frame which is usually clearly indicated by the government. Ad hoc responses are quick decisions and *necessary* to stabilise the financial sector whereas permanent and fundamental shifts in policies need almost endless deliberations and take much longer to reach agreement.

As already discussed in paragraph 1.2.1, norms are the underlying fundamental beliefs and are deeply embedded in a state's institutions and policies (Meyer 2006, 20, 25). Above the surface, these underlying norms find their expression in rules which dictate the appropriate response to a (crisis) situation. Institutional rules, then, constrain behaviour and policy-choices of actors in policy areas because the norms embedded in these institutional rules dictate policy options and the instruments available (Héritier 2007, 6). Consequently, norms also determine outcomes of policies, even though this may contradict policy preferences of some stakeholders. When policy preferences –or ideas– of stakeholders contradict the underlying pre-existing norms, pressure will start to build up. The stakeholders will try through the epistemic communities and discursive practices to convince other stakeholders and look for a window of opportunity to change the pre-existing rules and norms and replace them by their own ideas.

### *2.3 Data collection*

I will gather information to corroborate the findings of my case study from two sources: newspapers and official government documents. First of all, I will collect data from financial newspapers. I expect that financial newspapers provide a more detailed overview of the governments' actions and their consequences. I am aware of the fact that the political interests of financial newspapers are generally located on the left side of the political spectrum. However, for this study I am only interested in governments' actions and their motivations. There is no place in this study for any value judgment of these actions whatsoever unless it illustrates an important or interesting discussion within a member state or between member states and the Commission.

Unfortunately, media archives of the University of Twente library offer only limited access to newspaper archives. I also have limited language access which forces me to rely on newspapers written in Dutch or English. Therefore I decided to rely for the German data on the *Financial Times* since it has many editions –not only a London edition, but also a Europe, Asia, and USA edition – and a German spin-off (*Financial Times Deutschland*) to which it often refers. Data concerning actions of the Dutch government will be collected from *Het Financiële Dagblad*, which presents itself as the most important financial newspaper in the Netherlands. Data concerning the UK government will be collected from the *Financial Times* as well. The *Financial Times* is a liberal international business newspaper and well known for its excellent quality standards. The data collection concerning actions of the EU will be more challenging since the printed media tend not to write too much on this. In this case, I expect to rely on press releases of EU institutions published on their websites.

The second source for data collection is official documents published by the Dutch, German and UK governments and European institutions. Not only do these documents mirror the government's action plans, but they can also provide unique insights in the government's intentions in terms of the temporary or durable character of their policy shifts.

## 3. Analysis

It is difficult to determine the exact origins of the current financial crisis since contemporary financial markets are extremely complex and globally interwoven systems. It would, for example, be impossible to determine who or what is responsible. No specific country or any institution can be blamed. As the effects of the credit crisis work their way through the entire global economy, governments anxiously try to restore systemic stability using as many instruments as they possibly can use. Next follows a brief analysis of how the current crisis has arisen, how it transformed itself into a liquidity crisis and, more importantly, how it could spill-over to the European financial system. For this study, it is important to understand the fundamental problems underlying the crisis to determine whether governments have tackled the problem or if they only planned to weather the crisis. This is, however, only a concise and simplified summary of the complex processes which initiated the domino effect through the global financial system. For a full and comprehensive overview of all and more complex processes, I refer to Kragt (2008) *De krediet crisis. De implosie op de financiële markten van binnenuit bekeken*; and Sherman and Tana (2008) 'The Subprime Crisis: Lessons for Global Business'. The literature above mentioned explain how the failure of almost an entire system unfolded. Understanding this series of events is crucial as they point at how and why existing norms at both the national and the European level are challenged because the crisis raises questions about the current banking regulation, and why such complex financial instruments were tolerated and how the acute liquidity problem could arise.

### *3.1 From mortgage delinquency to global disaster*

It makes sense to start on the other side of the Atlantic, where the increase of house prices stagnated in 2006 (Kragt 2008, 54). Prior to the crisis, subprime-status consumers were aggressively sold expensive mortgages with teaser rates for the first years of their mortgage. These subprime mortgages were issued in expectation of an ever rising increase of house prices so that by the time the teaser rate period had expired, the customer could be sold an even higher mortgage. This process caused the housing bubble in the United States. However, the implicit assumption that house prices would ever increase proved to be fatal. In 2006, house prices stagnated and expiring mortgages could not be renewed and delinquency rates skyrocketed.

Institutions in the subprime loan business run higher risks for delinquencies and, as a consequence, higher returns to investments can be expected. However, to reduce their own risks these institutions decided to sell their subprime loans to other actors. This is known as the securitisation process (Wyplosz 2007, 17). The ultimate owner of the loan will bear the costs when the mortgage turns sour. Wyplosz argues that, under normal circumstances, the financial institutions should be able to bear this strain since the total size of bad subprime mortgages is usually not that substantial.

One might wonder how a situation of subprime mortgage delinquencies in the United States could result in a situation of global financial systemic instability. The securitisation process certainly did not limit itself to the United States. Investment banks from all over the world participated in this course of action which ultimately resulted in a liquidity pandemic (Kragt 2007, 66). As mentioned earlier, the banking sector was actively involved in the securitisation process. These were financed by short-term investments –which mature between 90 and 180 days- and were typically issued by banks. In 2007, money market funds lost their interest in these products as a consequence of poor performances. This caused a dramatic decrease of the value of these funds which, as a result, affected the money market funds as their intrinsic value decreased (Kragt 2008, 83). In addition, the interest rate of the inter-bank lending market increased sharply. This made new investments more expensive which also had a negative effect on the money market funds. Money market funds found themselves with no other option than to put their capital in the bank, preferably in the form of short-term deposits instead of long-term deposits or bonds. This enabled the money market funds to withdraw their capital within one day, should the bank prove unstable. This behaviour of the money market funds initiated the global liquidity crisis (Kragt 2008, 88).

We will now turn to the empirical cases of the Netherlands, Germany, the United Kingdom, and the European level. In the next paragraphs follows a systematic analysis of macroeconomic and regulatory government responses to the financial crisis. As will become clear, all of the countries were dealing with many of the same problems. The following issues will be dealt with in the analysis of each country.

On the macroeconomic aspect, the problems seem to centre on the problems at the inter-bank lending market which already started to appear in $T_1$. Many banks, especially in Germany and the UK, were experiencing great difficulty finding sufficient financers leading to losses, write-downs, and bankruptcies. This forced the governments to intervene with capital injections and even with nationalisations. This problem escalated in $T_2$ and led to state intervention in all three countries. The frozen inter-bank lending market also caused a dramatic decrease in capital lending by banks to SMEs which became one of the main issues of public and political debates. A decrease in lending to SMEs will make it impossible to make investments, which will deepen the economic crisis. All three countries threatened to compel banks to maintain lending to SMEs, in particular those receiving state-aid.

On the regulatory aspect most initiatives were taken at the European level as a response to the economic vulnerability at the national level. The initiatives ranged from the set-up of voluntary discussion structures to prevent spill-over effects between member states, improving legislation for credit rating agencies including the set-up of a Committee of European Securities Regulators, and the set-up of colleges to supervise financial institutions in cross-border operations. On the national level, the most remarkable initiative came from the UK to enable it to nationalise Northern Rock. Before, it had no tools for such actions and an emergency regulation was needed to secure systemic stability. This emergency act will be replaced later by permanent regulation to enable the government to nationalise banks in times of crisis. This change was relatively easy to achieve as the UK's political system is one of majority governance. The EU's political system, however, is fragmented and with many vetoes. This makes radical change difficult and depends on a sequence of incremental changes over time.

### *3.2 The Netherlands*

*$T_1$: April 2008 – August 2008*

*Macroeconomic conditions*

Although not directly related to the global financial crisis, one of the main concerns in the Netherlands early 2008 was the increasing inflation rate. This increase was primarily caused by skyrocketing global oil, energy, and food prices. It was expected in April 2008 that the Dutch average inflation rate in 2008 would hit 3% (*Het Financiële Dagblad*, 19 April 2008). The Dutch government expressed its concerns that the increasing inflation rates might result in a price/wage spiral which would not only deteriorate the Dutch trading position in the global economy but would also be, considering the turbulent economic conditions, a highly unwelcome incident.

While the financial sector in the United States had been in a state of crisis for several months, the Dutch financial markets had not yet experienced such serious problems in $T_1$, although the first warning signs that the financial crisis would eventually also hit the Netherlands appeared. Early May 2008, Hypotrust, a Dutch mortgage company, announced that it would no longer provide mortgages to consumers with a negative credit score registered by BKR (Bureau Krediet Registratie)[1] (*Het Financiële Dagblad*, 2 May 2008). Hypotrust claimed that as a direct result of the financial crisis it experienced great difficulty finding sufficient financers. Hypotrust was not the first mortgage company experiencing problems; GMAC (General Motors Acceptance Company) announced on 11 March 2008 that it planned to withdraw all its financial activities in the Netherlands as a consequence of the financial crisis (GMAC website, last accessed at 7 January 2008).[2]

Nout Wellink, president of the Dutch Central Bank, predicted already in May 2008 that the global financial turmoil would continue to spill over to the European financial markets, and that especially open economies such as the Dutch economy are likely to experience setbacks (*Het Financiële Dagblad*, 16 May 2008b). Indeed, banks in

[1] Collects and supplies consumers' credit information to associated companies. For more information: www.bkr.nl.
[2] On 24 December 2008, GMAC gained access to US government aid to avoid bankruptcy (*Trouw*, 30 December 2008).

the eurozone became more stringent in approving loans for consumers and companies, however, this did not bring the issue of loans to a complete standstill. On the contrary, despite the crisis in the financial markets, Dutch banks issued more loans to companies in this period (***Het Financiële Dagblad***, 19 June 2008). Quite remarkable, considering that at that time Dutch banks had already been faced with increasing losses: ***Het Financiële Dagblad*** claims that in the Netherlands the total number of bank losses went up to almost €15 billion at that time (idem).

Although ***Het Financiële Dagblad*** claimed that conditions on the Dutch financial market had already improved and that 'normal' liquidity levels were restoring (16 May 2008a), the first signs of a spill-over effect to the housing market appeared. Investors postponed their investments in real estate and banks increasingly became more reluctant to take risks (***Het Financiële Dagblad***, 19 May 2008). Also, banks tried to increase their margins. On the one hand, the interest rate on the capital market had decreased since July 2008, but on the other hand, the interest rates on mortgages were increasing (***Het Financiële Dagblad***, 9 August 2008). The financial institutions argued that it was more difficult and more expensive to raise capital since the start of the financial crisis. Banks and other financial institutions were confronted with higher costs on the inter-bank lending market and passed them through to their clients.

Overall, the Netherlands seemed little affected by the global financial crisis in $T_1$. Inflation and interest rates increased significantly and several mortgage companies, aiming at consumers with bad credit scores, were no longer active on the Dutch market. No governmental interference took place in this period, although Nout Wellink warned on several clear occasions that the dangers of the financial crisis had not yet gone and that the Dutch economy was likely to be hit. The biggest concern in $T_1$ was the drying up of the inter-bank lending market as a result of increasing costs.

*$T_2$: September 2008 – December 2008*

*Macroeconomic policies and state intervention*

Signs of the global financial crisis slowly started to appear in the Netherlands in $T_1$: a drying up of the inter-bank lending market, risk averting behaviour of banks, and increasing interest rates on mortgages. However, it was not until September 2008 that the problems in the financial sector reached their high point. This was also the time when the Dutch government actively started to interfere to avoid bankruptcies in the banking sector. The main actions taken by the Dutch government were state-aid actions. The government injected capital in several financial institutions to stabilise them and to try to restore public trust. These state-aid actions raised tensions with the European level because they conflicted with European competition rules. Early 2009 the government also presented a plan with macroeconomic stabilisation measures, such as the scrappage programme, but this is outside the time frame of this study. As will be argued below, the state interventions and nationalisations in the banking sector did not mark a policy shift as the intentions of the Dutch government were temporary (Kamerbrief, 21 November 2008). The government acted in these interventions, and especially the intervention concerning Fortis, as a lender of last resort. Because the Dutch government did not have any permanent intentions and did not implement new regulations, this cannot be seen as a change in policy-styles. The Netherlands relied on its traditional public policy patterns which caused tensions with European competition rules.

The main event in this period was the rescue operation to bail-out Fortis. After the announcement in June 2008 that it needed to raise extra capital as a buffer against the financial crisis followed by several rumours concerning the bank's solvency in the months after, its share value plummeted (NRC.nl, last accessed at 7 February 2009). In a response to the solvency rumours, business customers started to withdraw their capital on 26 September 2008 which resulted in the actual liquidity problems. Initially, the Benelux countries came to the rescue and invested €11.2 billion in Fortis. Belgium injected €4.7 billion and received in return 49% of the Belgian Fortis Bank shares. The Dutch government injected €4 billion and received in return 49% of the shares in Fortis Bank Nederland Holding (***Het Financiële Dagblad***, 30 September 2008).

Three countries cooperating to prevent bankruptcy of one single bank shows how incredibly interwoven the European financial markets are nowadays. These financial injections were, however, not enough to save Fortis. On the third of October 2008 it was announced that the Dutch government had also purchased the remaining parts of Fortis Bank Nederland Holding (***Het Financiële Dagblad***, 4 October 2008). This decision of the Dutch government was motivated by two main reasons. First, the liquidity injection announced on 28 September 2008 was not able to provide sufficient liquidity to the bank. As in the weeks before, several major clients had withdrawn their capital evaporating the effect of the liquidity injection. Second, the Dutch government intended to restore the bank's stability and credibility to prevent similar situations of massive cash withdrawals in the Netherlands (Kamerbrief, 21 November 2008). A bankruptcy of any bank the size of the Fortis bank would initiate a domino effect through the country's financial system generating a situation of complete system failure. The consequences would have been dramatic as this would have triggered an economic recession not only in the Netherlands, but in the rest of Europe as well.

The bail-out and nationalisation of Fortis and ABN Amro (ABN: Algemene Bank Nederland/ AMRO: Amsterdam-Rotterdam Bank), were obviously rather unexpected emergency measures. The Dutch government clearly stated that its intentions were only temporary (Kamerbrief, 21 November 2008). The government will continue to participate in the companies until a reasonable opportunity has been found to place the companies back into private ownership. The prospect of the banking division is that it will not be sold any sooner than 2011. The government feels that its participation for the next years is necessary to oversee the reorganisation process and to guarantee gain for their taxpayers. The insurance divisions of Fortis and ABN Amro are likely to be put up for sale sooner because they are sound and healthy businesses.

However, this was not the only crisis induced response of the Dutch government. Soon after the nationalisation of Fortis, the Dutch government announced additional measures specifically designed to stabilise the country's capital markets (***Het Financiële Dagblad***, 11 October 2008). The emergency package did not include any surprise elements; additional nationalisations were one of the possibilities –and fortunately not necessary–, although of course considered undesirable by politicians and the banking sector. It does not need further explanation that state interference compromises the banks credibility and future strategies. Other measures were liquidity injections and governmental lending guarantees for new loans. An emergency fund of €20 billion was set-up to provide a capital buffer to banks and other financial institutions by increasing their capital ratios because they faced liquidity problems as a consequence of the frozen inter-bank lending market. The conditions to gain access to this fund are strict. The interest rate was 8,5%, in exchange for the capital injection the government will receive 'non-voting securities' which can be repurchased by the bank for approximately 150% of the initial share value. In addition, two advisors which hold a veto power will be installed in the boardroom, boardroom members will not receive any form of bonus by the end of the year, and no dividend will be paid in 2008 (*Het Financiële Dagblad*, 14 November 2008).

The €20 billion capital fund will remain in place for only *one* year. Banks and financial institutions applying for capital have to accept strict conditions, as stated earlier. According to the government, the conditions were designed to make it more appealing for the applicant to exchange the state's capital injections for capital from the capital markets (Kamerbrief, 20 October 2008). For example, after a period of three years, the 'non-voting securities' purchased by the government in exchange for the capital injection, will turn into 'normal' shares. This means that it is no longer the applicant who determines when the loan is repaid but the government. Indirectly, this suggests a limited time frame for this type of measure. In addition, one of the conditions states that the state will increasingly benefit from the yearly dividend payments. If dividends are paid in the upcoming years, the state will receive 110% of the dividend payments in 2009 and will gradually increase to 125% in 2011 (Kamerbrief, 29 October 20008). This is certainly an incentive for applicants to return to private investors as soon as possible. Evidently, this also implies a short-term measure; the government is not seeking to remain shareholder for a long period of time but will, on the other hand, benefit greatly if it does.

This capital fund proved to be a 'hit'. In total, two banks and one financial institution applied for a capital injection. On 19 October 2008 ING announced that it had applied for €10 billion of this capital fund. ING claimed that it followed the European trend in the banking sector to increase its capital buffer against the financial crisis (*Het Financiële Dagblad*, 18 October 2008). Several days later, Aegon announced that it was also applying for €3 billion of the Dutch emergency fund to protect itself from unstable stock exchanges (*Het Financiële Dagblad*, 29 October 2008). The third candidate to apply for capital support was SNS REAAL. This bank 'only' received €750 million from the government to strengthen its capital buffer (*Het Financiële Dagblad*, 14 November 2008).

Despite these earlier mentioned measures, the inter-bank lending market was still suffering from a liquidity dry spell which increased the risk of a spilling-over effect to the real economy. By the end of October 2008, the government presented a second plan of €200 billion in an attempt to avert an economic recession. The government planned to guarantee new loans of banks to increase lending on the inter-bank lending market (*Het Financiële Dagblad*, 19 November 2008). These guarantees should assure lending parties that their loans will be repaid in case borrowing parties go bankrupt. Again, the conditions were strict: the costs of applying for this guarantee are up to 1% of the total amount the government covers. The lending guarantees only apply to loans for the duration of three months and to a maximum of three years so that this will not overlap the guarantee system of the ECB (*Het Financiële Dagblad*, 22 October 2008). Obviously, insurance companies complained about the possible market disruptions caused by state support to competing companies. The Dutch Ministry of Finance is aware of this problem and formulated a code of conduct to avoid uncompetitive practices and took into account Northern Rock's self-imposed code of conduct after its nationalisation in February 2008 (*Het Financiële Dagblad*, 27 October 2008). The duration of this guarantee scheme is limited; it will only be available until 31 December 2009 (Kamerbrief, 21 October 2008).

*Regulations*

Unfortunately, these measures were not able to kick-start the financial sector; banks remained reluctant to give out new loans which caused the financial crisis to spill-over to the real economy. The Dutch government responded again by presenting a third emergency plan to help businesses weather the crisis (*Het Financiële Dagblad*, 22 November 2008). This time, it was a combination of macroeconomic stimulus packages to support the demand side and temporary regulations to avoid rising unemployment rates. This new plan is based on the European guideline to invest 1% of the member state's GDP to prevent an economic recession. The plan included two elements worthy of note. First, the government plans to bring forward investments in infrastructure to stimulate employment in this sector. Second, the government offered companies coping with a drop in demand for their products, to reduce its employees' working hours by allowing part-time lay-offs. The companies are allowed to reduce the working hours of their workers which are then entitled to part-time unemployment benefits. In exchange for this support to companies, the workers should be offered extra training to be fully prepared when the economy starts to recover. This measure is to prevent massive lay-offs, bankruptcies, and increasing unemployment rates.

As will be discussed in the following paragraphs, banks in Germany and the UK were very hesitant to lend capital to small and medium enterprises (SMEs). This issue became a hot topic in political and public debates considering that many of these banks received state-aid. This was also one of the main issues of the Dutch public debate; many businesses were complaining that since the nationalisation of Fortis, banks had become more reluctant to lend capital for innovation (*Het Financiële Dagblad*, 24 November 2008). However, Minister of Finance Bos argued in December 2008 that there were no signs yet that lending to SMEs had dramatically decreased but that this issue would be investigated (fd.nl, last accessed at 2 June 2009). Bos explained the slight decrease in lending to SMEs by pointing at the upcoming economic downturn which influenced the profit prospects of companies. This made them less eligible for loans of banks. This led to a dispute with his colleague, Minister of Economic Affairs Ms. Van Der Hoeven, who argued that banks should be compelled to lend capital to SMEs to secure investments during the economic downturn. The banks defended themselves by pointing at the increased costs of raising capital at the capital markets, the higher capital-ratio requirements, and a decrease in applications of loans as a result of the prospects of an economic crisis (*Het Financiële Dagblad*, 27 November 2009).

*At the European level*

The Dutch government has clearly stated that these macroeconomic and regulatory measures at the national level are only temporary. Early November 2008, the Dutch government set out in the *Financial Times Deutschland* its views on *permanent* reforms of the financial sector to ensure stability of the financial sector and to protect depositors (pvda.nl, last accessed at 20 July 2009). In order to accomplish this, the Dutch government proposes to close the gap between national and international financial supervisors by improving their coordination. Interestingly, the article explicitly mentions that Gordon Brown agrees with this viewpoint which indicates broad consensus in

Europe and that it is time to improve cooperation in this policy area. Balkenende and Bos (respectively Prime-Minister and Minster of Finance, authors of the article) acknowledge that European financial supervision is fragmented. They argue that the EU would benefit from a common, integrated European supervision and crisis management structure but that this would not necessarily imply more regulation.

These statements point towards acceptance and willingness of the Dutch government that European supervisory authorities have to play a bigger role in the financial sector as a direct result of the increasing number of banks operating internationally. This is typical for managed capitalist countries since they generally support the idea of a strong state. In this case, they feel that this should take place at the European level as they think that the EU is much better equipped to close the gap between financial institutions operating internationally and supervisors operating only nationally –this is in accordance with the principles of subsidiarity. Although the authors do not elaborate on the idea of an integrated European supervisory structure, the use of the word ***integrated*** reveals that they feel that member states should reckon with the possibility of a ***single*** supervisor. This would be a drastic reform of the European financial sector and a long and difficult process.

In short, the financial crisis was already looming on the Dutch horizon in $T_1$ until it finally hit in $T_2$. The government was quick to respond and emergency plans rapidly followed one after another. The main problem seemed to be on the inter-bank lending market. Banks remained reluctant to lend other banks and businesses capital. This behaviour is likely to initiate an economic recession since businesses are not able to raise sufficient capital to make the necessary investments. The responses of the Dutch government mainly consisted of state-aid actions aimed at stimulating the inter-bank lending market to avoid spill-over effects to the real economy. As already discussed in paragraph 1.3.3, these actions raised tensions between the national and European political level. Because the European competition policies restrict member states to intervene, the Dutch government was confronted with a rather complex situation. The government needed to stabilise the financial sector. But in doing that, it violated European competition rules, risking punishment. This illustrates how the different responsibilities spread across the political levels can raise tensions.

As has become clear, all the above summarised government responses on the national level have a limited time frame. The time frame of the measures varies between one to three years. The government has made clear on several occasions that it does not plan to participate in the state-aid companies for an extended period of time. In addition, no new legislation is proposed which marks a fundamental shift in domestic financial market policy-making, as was suggested by hypothesis 2. We can conclude that the domestic crisis induced responses in this time frame are only ad hoc responses and do not mark a permanent shift in financial policy-making. However, the government relied on traditional patterns of macroeconomic responses to overcome the financial and economic crises. This is a remarkable observation considering the change in policy-styles after the 1980s shifted the Netherlands towards to market capitalism. The position of the Netherlands in the bank regulation debate at the European level will be critical to determine the final position of the Netherlands in Schmidt's model, which is discussed below. The Netherlands is an active participant in the discussions at the European level on how to tackle the current financial crisis and what regulation might be effective to prevent such situations in the future.

### *3.3 Germany*

#### *$T_1$: April 2008 – August 2008*

#### *Macroeconomic policies and state-aid*

The global financial turmoil produced at first a somewhat mixed image in Germany. On the one hand, there were clear signs that the German financial sector would not be overlooked by the financial crisis. For instance, in April 2008 the Weserbank was the first bank in Germany forced to close to protect its remaining assets because it was not able to raise the necessary capital on the financial markets (*Financial Times*, 10 April 2008). Other banks and financial institutions were also in trouble and were forced to make significant write-downs or even had to rely on bail-outs. Already in July and August 2007, IKB (Industriekreditbank) and SachsenLB almost collapsed and IKB even had to be bailed-out by the government to secure systemic stability (*Financial Times*, 16 May 2008a).

On the other hand, the economy and the financial markets seemed to be in a surprisingly good condition. Even though the euro remained strong, inflation rates in the eurozone were rising, oil prices going through the roof, and the US economy slowed down, an abrupt slowdown of the German economy was not expected soon (*Financial Times*, 25 April 2008). The strength of the German economy was mainly reflected by decreasing unemployment rates early 2008 and high levels of lending to companies by the financial sector (*Financial Times*, 14 April 2008). Obviously, the German economy was not completely unaffected. The strong euro reduced global demands for German export products (*Financial Times*, 24 April 2008), but the slowdown of the German economy proved more gradual than other eurozone countries (idem, 22 May 2008a).

Despite this, the German economy managed to show a remarkable growth in the first months of the year, compared to other eurozone countries. This posed serious problems to the European Central Bank (ECB) because not only did other member states' growth lagged behind or did not grow at all (*Financial Times*, 16 May 2008b), Germany's unexpected spectacular economic growth was also accompanied by skyrocketing inflation rates (idem, 29 May, 2008). This will, however, discussed in paragraph 3.5.

Finally, Germany is also confronted with its own banking soap operas. By the end of 2007, IKB Deutsche Industriebank had to announce enormous losses as a result of 'unsuccessful speculation on the US mortgage market' (*Financial Times Deutschland*, 5 August 2008). The bank almost collapsed and could only be saved by a bail-out of €9 billion. A lawsuit followed to get the investors compensation for their losses as the bank, according to the law firm representing the investors, 'failed, last year, to inform investors promptly of its difficulties'. After demands of the opposition party for an official investigation to the circumstances of the crisis the bank got itself into (idem, 23 June 2008), the bank was finally sold by the government to Lone Star (idem, 22 August 2008).

There were also problems with the Landesbanken. Already in April 2008 it was reported that these banks had lost billions in the United States as a result of poor management and the credit crisis (*Het Financiële Dagblad*, 7 April 2008). German politicians, such as Renate Künast, proposed that the remaining eight Landesbanken were combined into one bank. This would help support the regional economy, and would help them weather the financial crisis. This shows that politicians are using the economic vulnerability to gather institutional capacity to reform the system of the Landesbanken. The enormous losses and write-downs of these banks increase the pressure to merge with other banks to only one Landesbank. However, the government is not interested in privatising the state owned Landesbanken as they are also important economic tools of the regional governments (idem). This is therefore not a change in policy style towards market capitalism because otherwise the government would have privatised the Landesbanken.

*Regulations*

The German government held discussions similar as in other countries concerning curbing boardroom remunerations (*Financial Times*, 22 May 2008b). Merkel has supported this European trend, putting her at odds with most of her own party members as they regard this plan to be too interventionist. Fortunately, her ally, Peter Müller premier of the state of Saarland and also a member of the CDU, argues that '"people will lose trust in the social market economy" if executive pay became excessive and out of proportion to that of ordinary employees'.

The impact of the global financial turmoil on the German financial sector has made a group of economic experts reconsider the country's public banking sector structure (*Financial Times Deutschland*, 17 June 2008). This group argues that the government should privatise the public sector regional banks, which are in possession of the German Federal States –this concerns the discussion of the Landesbanken above. It is particularly this group of banks that has been hit hard by the credit crisis and is supposed to be the weak point of the country's financial system. The group of economic experts maintain that the Federal States' interests are, obviously, 'motivated by local political concerns'. It is therefore impossible that the strategy of these banks is exclusively determined by competitive market interests. Privatisation of the public sector banks should free these banks from political interference so that the banks can entirely focus on making profits which will benefit the public.

In my opinion, this is an interesting point of view because, in contrast to the above discussion, this would imply a change in policy style. Privatisation of the Landesbanken would bring Germany a step closer to the market capitalist countries as the government would lose direct control over a large part of the banking sector. This would therefore imply a change in norms because the government believes it would be in the best interest of the financial system that the Landesbanken relied on market-oriented principles. This would then result in a change in financial policy-making –a change in rules as a consequence of the change of the underlying norms. However, such radical change in the national banking structures would be difficult to achieve. Although the economic vulnerability has brought this issue out in public debate, it would be difficult to make the actual adjustments as a result of the German federal system. This makes radical changes difficult because the fragmented system has many vetoes.

*$T_2$: September 2008 – December 2008*

*State-aid*

The next rescue operation was the €50 billion liquidity crisis of Hypo Real Estate (HRE), which was unable to raise this capital on its own as a result of the dry up of the German inter-bank lending market (*Financial Times*, 30 September 2008a). The Bundesbank cooperated with several private banks to provide €35 billion; HRE was to find investors for the remaining €15 billion to cover its funding requirements. Not surprisingly, already a few days later the government had to bail-out HRE a second time and injected the remaining €15 billion (*Financial Times*, 6 October 2008b). HRE is one of Germany's biggest lenders; a collapse would not only have serious consequences for the German financial markets, but also for the European financial markets.

A week after the second bail-out of HRE the German government agreed on a €400 billion bank rescue plan (*Financial Times*, 13 October 2008). €100 billion is, in exchange for shares, reserved for fresh capital injections in both state owned and commercial banks as well as insurance companies. All participants will have to agree to governmental interference in the company to ban dividend payments, to restrict boardroom remunerations and force the banks start lending again to SMEs (idem, 21 October 2008). As discussed earlier, a similar discussion concerning the lending to SMEs took place in the Netherlands and the UK. The remaining €300 billion of the bail-out plan is reserved for lending guarantees to stimulate the inter-bank lending market and lending to SMEs (Steinbrück, 15 October 2008).

The plan was aimed at restoring public and commercial trust in the German financial sector while at the same time an attempt to defrost the inter-bank lending market (Bundesministerium der Finanzen, last accessed at 7 February 2009a). Financial institutions applying for the bail-out or lending guarantees need to agree to strict conditions comparable to the Dutch rescue package for the banking sector. Similar as in the Netherlands, the above conditions stimulate the financial institution to return to the private markets to raise their capital as soon as possible. This rescue fund to stabilise the financial sector is therefore not designed to be permanent and did not initiate a fundamental shift in Germany's financial sector policies.

Initially, the plan was not that great a success. Financial institutions were reluctant to tap the fund because they feared the stigmatising effects of the scheme (*Financial Times*, 21 October 2008). The initial plan stated that banks had to make available to the government their entire business model to make sure that the institution was no longer active in risky lending. The government softened this requirement somewhat so that banks only had to provide details of their business model. Even after these alterations, financial institutions kept avoiding the government rescue scheme (idem, 13 December 2008). Germany found itself in a similar situation in which the conditions of the inter-bank lending market remained poor. Despite the government guarantees, German banks were still reluctant to provide small businesses with sufficient capital.  This is illustrated by the case of BayernLB, in which the state of Bavaria offered to bail-out the bank in cooperation with Soffin (Sonderfonds Finanzmarktstabilisierung), the country's financial markets stabilisation fund (idem, 1 December 2008). This way, BayernLB intended to prevent government consolidation.

*Macroeconomic policies*

The German government was also heavily criticised by the country's leading industrials for its indecisiveness to take measures to tackle the potential economic crisis (*Financial Times*, 28 April 2008). Unlike its European counterparts, such as the UK, Germany –and especially Angela Merkel– is not very keen on ‘spending its way out of recession’ (*Financial Times*, 20 November 2008). First of all, it is argued that Germany has a rather high savings ratio; any fiscal stimulation measure would end up at the bank instead of being spent. In relation to this, the German government prefers what is called ‘leverage’ measures. It views small incentives to produce a disproportionate rise in (consumer) investments, such as the temporary lifting of car taxes, to be much more effective. Finally, a fiscal stimulus package would not tackle the main cause of the country’s downturn: a dramatic decrease in demand for its export products.

However, as mentioned above, the downturn of the German economy was inevitable as it was dragged down with the global economic recession. As a result, Germany announced its economic rescue package of a whopping €50 billion in January 2009 (NRC.nl, last accessed at 19 January 2009). The rescue measures include: an increase in the personal allowance of taxpayers, increased investments in the infrastructure and a scrappage programme for environmental unfriendly cars. The timing of this stimulus package is rather remarkable, approximately nine months before elections will take place.

The German Minister of Finance stated that the measures of the economic rescue package will only be in place for the short or medium-term –until 2010– but will have long-term results (Bundesministerium der Finanzen, last accessed at 7 February 2008b). The Minister argues that the measures aim at strengthening Germany’s economy and will contribute to the modernisation process so that the country’s economy will emerge stronger from the global economic crisis. This clearly indicates that the government does not have any long-term intentions to support the economy. Some of the measures can only be used on one occasion –such as the bonus for parents– whereas for other measures a clear time frame has been formulated (2010 at the latest). Considering the limited time frame, the economic rescue package should be considered an ad hoc response which, hopefully, will have long-term effects in the future.

*At the European level*

At the European level, the German government presents itself as quite progressive. The government supports the colleges of supervisors in cross-border banking, and agrees with the French government that a similar system of supervisors should be set-up for cross-border insurance activities (Steinbrück, 15 October 2008). However, within Germany opposition is growing to these ideas. The Bundesbank opposes the ideas of the De Larosière committee to strengthen the supervisory bodies of the banking, insurance, and securities sectors, although more cooperation would be welcomed (eurointelligence.com, last accessed at 17 July 2009). This article predicts that the Bundesbank views will play a significant role in Germany's European position on this issue. The German government also strongly supports a bigger role for the International Monetary Fund (IMF) with a mandate to lay down and supervise ground rules for the global financial markets (Steinbrück, 15 October 2008).

The position of the German government to support European cross-border supervisory groups and even extending them to the insurance sector is similar to that of the Netherlands. Both governments agree that the European level should be part of the permanent solution as a result of the increasing interwoven financial markets. They both agree that this cannot but result in European action in the form of improved regulation and cooperation to prevent such crises in the future. The government's position with regard to proposed reforms of the IMF which are mentioned in the article fit into this picture (Steinbrück, 15 October 2008). This position implies that the national government would lose some of its powers to the European or even international level. This is a change of public policy-making even though the proposed changes in the, for example, De Larosière report are only small changes (this will be discussed in paragraph 3.5). Because Germany, as a managed capitalist country, supports a stronger state, these proposed changes cannot be considered a radical change in public policy-making –this refers to the punctuated equilibrium debate– but should be considered part of a sequence of incremental changes.

It is clear that the German responses at the national level are dominated by temporary responses. The responses of the German government mainly consist of state-aid actions to stabilise the financial sector and some macroeconomic initiatives to stabilise the economy (more than the Netherlands at that time). The nationalisations and capital injections are only temporary actions which are severely constrained by the rules and norms of the European level. It is not the intention of the government to provide state-aid to financial sector for a long period of time.

This is different for the system of the Landesbanken. The financial crisis has opened the discussion considering the future of the Landesbanken. Politicians argue that they should merge into one bank which would be better equipped to weather the crisis. The other option discussed above is to nationalise these banks so that they would be freed from political constraints. Whatever the outcome of this debate, any regulatory change would have a deep and permanent impact on the German financial policies. Either way, it would result in a loss of political constraint for the Landesbanken. The interests of the Landesbanken would be more dictated by competitive market interests. In addition, Germany realises that the complexity and size of the European capital markets have increased and that improved regulation at the European level is needed to control and supervise cross-border financial operations. As we have seen, Germany is one of the member states supporting improving and extending financial regulation at the European level. This can be seen as a pushing factor for European integration. These conclusions therefore do not support the second hypothesis proposed in the introduction. There are no signs that Germany's policy-style will move towards market capitalism as it did in the 1990s. Instead, it seems that Germany will make a small step back towards managed capitalism.

### *3.4 The United Kingdom*

#### *$T_1$: April 2008 – August 2008*

#### *Macroeconomic policies and state-aid*

Although on the continent the financial crisis did not escalate until September 2008, the UK has been struggling with the consequences somewhat longer than the rest of Europe. At this time, the responses of the UK government only consisted of state-aid actions and nationalisations. The macroeconomic measures were taken in $T_2$. For the first time since the 1970s a private company had been nationalised. Already in September 2007, Northern Rock was given a liquidity injection by the Bank of England (BoE) because investors proved reluctant to provide short-term loans to the banking industry (*Financial*

*Times*, 14 September 2007). The main concerns were that the liquidity problems at Northern Rock would spill-over to other financial institutions as well and cause massive systemic failures. The September 2007 bail-out was followed by a bank-run and several failed attempts to sell the bank to a private party when, after five months, the UK government finally decided to nationalise Northern Rock in an attempt to restore public trust and to prevent the bank from falling over (*Financial Times*, 18 February 2008). The Chancellor, however, clearly stated that this nationalisation is only temporary; the loan provided by the BoE will have to be repaid by the end of 2010 and the lending guarantees will be released by 2011 (HM Treasury, 31 March 2008).

Already in April 2008, the UK's inter-bank lending market was paralysed as Libor (London inter-bank offered rate) remained high even though the BoE cut its interest rate in expectation that it would work its way to the rest of the banking system and economy through the Libor. The UK government tried to play an active role in bringing down the inter-bank interest rates. For instance, it called bank representatives to meetings to discuss the problems in the mortgage markets (*The Sunday Telegraph*, 13 April 2008). During these meetings, banks warned the government that especially smaller mortgage companies are probably not able to continue their activities in the mortgage market unless the government intervenes.

The government was willing to intervene and 'unblock [the] inter-bank lending market' (*Financial Times*, 22 April 2008). The BoE's offer was to acquire, in return for Treasury bills, UK banks' mortgage-backed loans for a maximum period of three years. Mr. King, governor of the BoE, argued that this would 'take the liquidity issue off the table in a decisive way'. The aim of the approximately £50 billion liquidity injection was to 'protect consumers from the banks', to restore trust and support in the bank system, and to reopen the mortgage markets to consumers (HM Treasury, 21 April 2008).

*Regulations*

To nationalise Northern Rock, the government had to agree on new legislation to enable the government to put Northern Rock into public ownership (HM Treasury, 17 February 2008). Prior to the global financial turmoil, the UK did not have any possibilities to put commercial enterprises into public ownership. The *Banking (Special Provisions) Act*

*2008* is designed to fill this gap until permanent legislation for similar scenarios in the future is implemented. The *Banking (Special Provisions) Act 2008* enables the Treasury to nationalise banks or financial institutions if this is considered necessary to secure stability of the country's financial stability and to protect the interests of the public (HM Treasury, *The Banking (Special Provisions) Act 2008*). Although this Act is only temporary, as was stated by the Chancellor, permanent legislation is under its way (this resulted in the *Banking Act 2009*, adopted was in February 2009). This indicates the government's willingness for a permanent change in banking policies as a result of a change in norms. If we interpret this in terms of Schimdt's model of varieties of capitalism, this will mean a small step away from market capitalism, as the government creates an opportunity to intervene in the financial sector if necessary. The UK's financial policy-making, however, will remain within the sphere of market capitalism. In short, although the government had to bring forward legislation to enable the government to nationalise Northern Rock, the clear time frame formulated by the Chancellor indicates that this is only a temporary measure. However, this situation also caused the Chancellor to consider permanent legislation for future scenarios.

The Chancellor also announced plans to reform the BoE. Apart from new appointments in the board of governors, the BoE was also to create a new financial stabilisation committee –although this committee will only be a 'source of expert advice and credibility' and will not have any power to make decisions– and to oversee the implementation of the Special Resolution Regime (SRR) (*Financial Times*, 20 June 2008). The SRR will have the power to take over control of failing banks and secure depositors' savings before the remaining parts are sold to private companies (*Financial Times*, 7 May 2008). These measures were designed to prevent similar situations of the earlier mentioned Northern Rock bank-run. Another bank-run would pose a serious threat to the systemic stability of the financial markets. The plan also included setting-up a multi-billion bank resolution fund to protect ***shareholders***' interests in case of government intervention (*Financial Times*, 23 July 2008). The protection of the shareholders' interests is remarkable since it is the first time that this is taken into consideration.

*T2 September 2008 – December 2008*

*Macroeconomic policies*

As pointed out above, the financial crisis in the UK started much earlier than on the continent. The UK has been hit hard by the global financial and economic crisis. As far as the UK is concerned, the fall of 2008 is mainly characterised by fighting an economic recession which resulted from severe problems in the banking sector. Gordon Brown is convinced that borrowing his way out is the best way to overcome the economic crisis (Telegraph.co.uk, last accessed at 8 February 2009a) and that fiscal policies should support economic growth (Telegraph.co.uk, last accessed at 8 February 2009b). Gordon Brown is convinced that following a Keynesian path by increasing government investments and lowering taxes is ‘the right strategy to pursue’ (Telegraph.co.uk, last accessed at 8 February 2009a).

However, the Chancellor, Mr. Darling, has announced that as a soon as the recession had past, the government should ‘live within its means again’ (Telegraph.co.uk, last accessed at 7 February 2009c). This phrase was earlier used by Margaret Thatcher when the UK’s financial policies shifted to monetarism. The Chancellor agrees that in the short-term borrowing is vital to support the economy and weather out the crisis. However, Darling fears that foreign investors are losing interest in the British economy as a result of increasing government debts. Darling therefore argues that in the medium-term public finances have to be balanced. This effectively means raising taxes and cuts in public spending after the next national elections as was announced in the pre-budget report (PBR) of November 2008.

The UK presented a wide-ranging plan to get the economy going again. The measures presented in the PBR are essentially aimed at increasing the consumer’s purchasing powers. Among other things, the measures included:

- VAT cut from 17,5% to 15%, the lowest level possible in the EU (costs: appr. £12,5 billion a year)
- £16 billion worth of ‘giveaway’ measures
- An increase of the personal allowance
- A three months grace period before repossession begins for home owners who have fallen into arrears with their mortgage repayments.

These measures are to be paid by an increase in tax rate from 40% to 45% of incomes of ₤150,000 by January 2011 –six months after the next national elections (*The Daily Telegraph*, 24 November 2008).

Again, as stated earlier, the Chancellor emphasised that these measures are only temporary and that the country should live within its means in the medium-term (HM Treasury, 24 November 2008). The PBR includes a ₤20 billion fiscal stimulus package which will remain in place at least until April 2010. It is expected that the country's current financial balance will return by 2016, in the meanwhile government deficits are likely to increase to 4.4% GDP next year. It is more than obvious that the duration of this emergency package is limited as the Chancellor is committed to the Code for Fiscal Stability which ensures sound and balanced fiscal policy.

Meanwhile, the Bank of England has also set its sights on averting a lengthy economic recession. After stubbornly maintaining its interest rates on 5% for a relatively long period of time, the interest rate eventually started to decrease and came down to 1,5% in January 2009 (*Financial Times*, 8 January 2009). The BoE argues that 'the very marked deterioration in the outlook for economic activity at home and abroad made its dramatic cuts necessary' (*The Daily Telegraph*, 7 November 2008).

Early November 2008, the interest rates on the wholesale market suddenly declined but it did not match the cuts in the interest rate of the BoE (*Financial Times*, 8 November 2008). Again, financial institutions refused to pass on the lower interest rates to consumers since they considered their profit margins already very small. Not surprisingly, this angered taxpayers given that it was the taxpayers' money which bailed-out not only, Northern Rock, but also Bradford & Bingley, RBS, HBOS and Lloyds TSB. The Chancellor had to intervene to push the mortgage rates down.

*State-aid*

The UK's policy mix to stabilise the financial system included state-aid, (part-) nationalisations, and capital injections. Northern Rock was not the only bank to be nationalised in 2008, Bradford & Bingley (B&B) was also nationalised in September 2008. (*Financial Times*, 29 September 2008). A bank-run resulted from reports stating an uncertain future for the bank. The government decided to nationalise B&B to stabilise the financial system and to protect the remaining depositors. Just a few days later, the UK government injected £50 billion in the financial system –in exchange for shares– with which it part-nationalised eight banks at the same time (FT.com, in depth UK banks, last accessed at 9 January 2009): Abbey, Barclays, HBOS (Halifax Bank of Scotland), HSBC (Hongkong and Shanghai Banking Corporation), Lloyds TSB (TSB: Trustee Savings Bank), Nationwide Building Society, RBS (Royal Bank of Scotland), and Standard Chartered. According to Brown, this extreme measure was necessary to 'prevent systemic failure of the banking system'. The government interfered to recapitalise the banks since capital markets had failed to do so. The British bail-out conditions have been an example to the Dutch government: dividend payments will be scrapped, several board directors will be appointed by the Treasury and executive payments will be restricted. Like in the Netherlands and in Germany, this will be an incentive for the banks to return to the private capital markets to raise capital. Therefore, the measures to recapitalise banks of the UK government are intended to be temporary.

Another debate is taking place between the Prime Minister and the British banking sector. As brought up earlier, several banks we (part) nationalised in 2008 and recapitalised but the financial sector failed to maintain credit lines to strong and healthy businesses on acceptable terms *(Financial Times*, 31 October 2008). Obviously, this has been a thorn in the side of the government considering large amounts of taxpayers' money have been invested to secure these credit lines, while at the same time the BoE has cut its interest rates significantly over the past few months. The tone of this debate got more hostile over time. However, financial institutions –including part nationalised banks– argue that rates on the wholesale market have remained high and it is therefore not possible to pass on to the consumers the BoE's cuts in interest rates. And in October 2008, Brown 'ordered' banks to benefit from the EU's emergency fund to support SMEs.

*Regulations*

Apart from bailing-out banks, the government is also concerned with (I) investigating the problems in the financial sector and (II) setting-up a new public company –UK Financial Investments Limited (UKFIL)– which will oversee the banks. The investigations are executed by the Commons Treasury Committee and will explore several aspects of the banking crisis. For instance, early October 2008, it was announced that the Commons Committee was to investigate the terms of the ₤400 billion bail-out to the street banks. The MPs investigations are mainly concerned with ‘the bankers’ remuneration and the risks to the taxpayers’ (*Financial Times*, 10 October 2008). Another investigation will concern the role of the media in relation to the banking crisis (*Financial Times*, 26 November 2008). The inquiry will reflect on ‘the role of the media in financial stability and whether journalists should operate under any form of reporting restrictions during banking crises’.

The second action taken by the government to secure the taxpayers’ money invested in the banking sector was the set-up of a new ‘arm’s length’ public company called UKFIL. UKFIL’s aim is ‘to ensure that nationalisation yields a profit’ (*Financial Times*, 4 November 2008). The UKFIL will not run the banks but is ‘to oversee an orderly and profitable retreat from nationalisation over several years’ and to make sure that banks will start lending again to other banks, SMEs and home owners. The set-up of this new public agency fits the ideal-typical model of market capitalism because it is a semi-independent regulatory agency which manages and oversees the rules set by the government (see also figure 1.1). This allows the government to interfere in the banking sector but in an indirect manner so that there will never be a strong connection between the government and the banks. This is therefore not a change in policy-style; in contrast, it is part of the traditional patterns of public policy-making.

*At the European level*

The UK government sees an important role for the European level with regard to the reform of the financial framework: ‘The Government believes that Europe’s ability to identify and manage system-wide prudential risks need to be enhanced’ (HM Treasury, July 2009). The UK government supports the conclusions and recommendations of the De Larosière report (this report will be discussed in more detail in the next paragraph) and underlines the importance of the establishment of the European System of Financial Supervision (ESFS), the set-up of the European Systemic Risk Board (ESRB) and the harmonisation of rules in this policy area. The UK government considers this a ‘significant reform’ of their financial system but necessary steps to strengthen the financial system to resist future pressures. As a market capitalist country, the UK was not very interested in setting-up a single European financial regulator (see also paragraph 3.5). Setting-up a single regulating agency would mean that all the member states would lose their powers in this policy area; as a market capitalist country, this is something the UK is reluctant to do. The ESFS, however, will operate according to the principles of proportionality and subsidiarity which means that almost none of their regulatory powers will be delegated to the European level. Although it seems only a small step to set-up the ESFS, in terms of Schmidt's model this will move the UK away from the ideal-type of market capitalism and a little closer to managed capitalism. The support to enhance the EU's prudential supervisory systems cannot be considered a change of norms as these changes are hardly any revolutionary when put to practice.

In sum, what we have seen is an interesting difference of opinion between Prime Minister Brown and Chancellor Darling; the former arguing almost unlimited borrowing to spend the country out of recession, the latter supporting a more restrictive and balanced budget in the medium-term although that might be painful in the long-term. Second, just like the Netherlands and Germany, most initiatives of the government are only temporary measures. Because the crisis started somewhat earlier than on the continent, we have seen more state-aid actions, nationalisations, and macroeconomic responses than in the Netherlands and Germany. The economic rescue plan, the recapitalisation of the banking sector, and the nationalisations can all be considered emergency responses to stabilise the country's financial sector. One revolutionary breakthrough is that the UK plans to adopt permanent legislation to intervene in the financial sector when necessary. The financial crisis revealed that the UK government lacked tools to intervene in the banking sector when necessary. The implementation of this new act which makes this possible was a radical change for the UK. The majority governance system allowed the government to achieve this change in such short time. Again, all these measures move in the same direction: to stabilise the financial sector in the short term and protect consumers in the long term by enabling the government to nationalise banks in trouble. In Schmidt's model, this will bring the UK a little closer to managed capitalism as the government no longer follows a 'hands-off' strategy but has taken a small step to open-up the possibilities to intervene in the private sector. This means that the second hypothesis is again proven to be false. The UK has not made a shift towards market capitalism in response to the crisis but rather a step towards managed capitalism.

### *3.5 European financial markets*

#### *Monetary policies*

In general, macroeconomic policy-making options at the European level are far more limited than those at the national level. The EU does not have any fiscal policy instruments, and it certainly cannot nationalise banks or provide state-aid to support the financial sector. The main instrument it has in the macroeconomic sphere, is its monetary policy-making with which it can adjust the interest rate and control the money supply but these powers are limited to the eurozone. The alternative macroeconomic response to stimulate the economy, although in an indirect way, is to allow the European Investment Bank (EIB) to lend more capital to SMEs. The most powerful tool the EU has to exert its influence is regulatory policy-making. Below, it will become clear that both the macroeconomic and regulatory powers are used to overcome the financial crisis and to prevent similar crises in the future. It can be seen that both macroeconomic and regulatory policy-making are moving in the same direction: towards increased European control of the financial sector through harmonised European rules to protect the consumers and economic stability, and away from market-oriented principles. This is an important observation as this proves that the EU is going through a change in public policy-making and no longer accommodates the member states' preferences to regulate at the national level as much as possible. The Commission is fully aware that this cannot be achieved overnight and therefore opts for a strategy of small adjustments and building upon already existing structures so the new structure would not conflict with existing national structures. This implies that the wishes of the managed capitalist countries, such as the Netherlands and Germany, are not included in the reform packages. These countries have called for more radical changes in which the state will play a bigger role to ensure optimal conditions for economic stability and consumer protection. The main focus of the new regulations of the financial sector is on full transparency, disclosure, and improved risk management. Especially when it comes to credit rating agencies, their rating methods, and strategies. So far, this has resulted in several new and improved Directives and Regulations, such as the Directive on capital requirements and the Directive on deposit guarantee schemes.

*T1: April 2008 – August 2008*

*Macroeconomic policies*

One of the main problems concerning particularly the eurozone was the diverging growth rates of its member states (*Financial Times*, 9 April 2008). Earlier, the German growth spurt of early 2008 was discussed. At the same time Germany's economy was sky-rocketing, Spain faced a situation of negative economic growth. In addition, the Euro's strength, rising oil and food prices, and declining value of assets have had contrasting effects on the economy. This clearly complicates the 'one size fits all' monetary policies of the ECB and puts the Stability and Growth Pact under severe pressure as budget deficits of some member states are most likely to rise well above the 3% maximum. The ECB warned that member states should be ready for a profound impact on their economies even though there had not yet been clear signs. Because the European economies were still lacking signs in April 2008 of broad-based slowdowns and inflation remained high, the ECB saw no chance to reduce its interest rate and had to stick to its interest rate of 4% until the economy started to cool down (idem, 11 April 2008). The ECB's slowdown warnings proved to be quite accurate as the eurozone economy contracted in the second quarter of 2008 –the first time since the launch of the euro (*Financial Times*, 15 August 2008). After the economy in the eurozone started to cool down, the ECB cut the interest rates to support member states' supporting macroeconomic policies.

Although the ECB's main goal is price stability, it has also made clear that it will make active use of its options to conduct open market operations to support the eurozone economy. Like the BoE and many national governments, the ECB has temporarily increased its number of liquidity injections in an attempt to stabilise the European financial sector (*Financial Times*, 1 April 2008). It was announced in April 2008 that the ECB had injected €15 billion 'in overnight funds to ease end-of-the-quarter tensions', but the ECB did not support ideas of buying up mortgage-backed securities to help the

European financial sector weather the storm (idem, 11 April 2008). However, the ECB's rather generous liquidity arrangement was abused by some financial institutions (idem, 25 August 2008). ECB policymakers had to redefine the arrangement as banks are said to deliberately taking up 'riskier collateral than envisaged to obtain funds from the ECB'. In addition, this behaviour of banks also stands in the way of the necessary readjustments of the financial markets.

*Regulations*

Already in April 2008, the EU member states agreed to cooperate with other member states, central banks and financial authorities to prevent the financial crisis to spill-over to other EU member states (*Financial Times*, 4 April 2008). As already discussed above, especially the managed capitalist countries are interested in setting-up European structures to coordinate and even regulate the European financial markets. They argue that the EU is better equipped to harmonise rules of the financial markets. The resulting agreement was not, however, a strong commitment. It only created a mandate to set-up a ***voluntary*** structure for meetings between finance ministers, central banks and supervisory authorities in European cross-border stability groups. In April 2008, the EU had not (yet) proposed a supranational financial regulator, like some member states such as France preferred. The issue of a supranational financial regulator will be discussed below in more detail. The member states also agreed to meet on a regular basis to discuss the financial crisis and to evaluate the effectiveness of each other's measures (*Financial Times*, 10 June 2008). However, the voluntary character of these policy-learning structures implies that the above two mentioned agreements are not permanent agreements. It is reasonable to expect that these voluntary structures will evaporate as soon as the financial and economic crises have passed.

As mentioned earlier, most EU member states, like the Netherlands and Germany, heavily criticised excessive boardroom remunerations. Although there have been calls for European legislation to curb executive remunerations, the member states agreed not to legislate this on a European level since countries such as the UK object to governmental interference in executive pay and bonuses (*Financial Times*, 10 June 2008). However, this issue has been addressed by the De Larosière report. Although the public debate focuses on the disproportionate remuneration levels (including the bonus system) of the financial sector, the De Larosière report points at the problems of the ***structure*** of the remunerations (De Larosière report 2009). The structure of the remunerations has proven to be one of the elements to encourage 'short-termism' at the expense of sound risk management and the focus on long-term performance. The Group has set out guidelines for potential future remuneration reforms, which include the principle that bonuses should be based on long-term performance. In the latest Commission proposal on credit rating agencies (discussed below), the Commission does in fact state that the remuneration of the independent board members of the credit rating agencies should not depend on performance (COM (2008) 704 final). Although this regulation does not reform the remuneration system as a whole, it is quite remarkable that the Commission succeeded on this issue considering the objections of some of its member states, such as the United Kingdom.

The EU also took several regulatory initiatives with the intention to avoid the possibility of similar scenarios in the future. One of those initiatives was to strengthen the EU's financial 'early warning systems' (***Financial Times***, 2 April 2008). The plan comprised the following ideas: 'Rules to limit the risk stemming from large bank exposures; capital requirements for default risk in banks' trading books; and technical changes to the securitisation framework' and was to be included in the reform proposals of the Basel II capital requirements directive which is expected to be finalised in April 2009. Although these reforms will be permanent and aim at avoiding similar situations in the future, they can hardly be considered any revolutionary. The proposed measures are permanent adjustments of existing European regulations by increasing the minimum standards in banking regulation. Although these measures aim at building up new structures, this proposal alone will not initiate a shift in Europe's policy-style.

Another plan was proposed in August 2008 to reform the legislation concerning the credit rating agencies (the Commission's proposal to regulate the credit rating agencies was adopted in November 2008) . The Commission argued that the former system of self-regulation clearly had failed and denounced the irresponsible behaviour of the rating agencies which was an important factor in the run-up to the crisis (***Financial Times***, 1 August 2008). The Commission plans to set-up a single supervisory regime which should formulate ‘exacting regulatory requirements’. Credit rating agencies should then be subject to these requirements to operate on the European financial markets. The Commission intends to set-up a special authority within the Committee of European Securities Regulators (CESR) which will function as the coordinating organisation to which rating agencies should apply if they are interested to operate in Europe (COM (2008) 704 final, Regulation on credit rating agencies). This Committee then needs to determine which member state qualifies best to supervise this agency. If supervision and the necessary measures in crisis situations taken by a member state prove ineffective, the regulators of other member states will always have the power to intervene. The rating agencies will have to ‘disclose the models, methodologies and key assumptions underlying their ratings; make an internal assessment of the quality of the ratings and publish an annual transparency report’ (*Financial Times*, 13 November 2008). In addition, the EU also demands that the boards of the agencies include at least three independent executives ‘whose remuneration is not tied to business performance’. At least one of these three directors should be a specialist on securitisation and structured finance, products which are blamed to cause the current financial crisis. The main goal of this new regulation is to make certain that the agencies’ performance will not be jeopardised by internal conflicts of interest and that the agencies will become much more transparent.

This policy change will have a deeper impact than the earlier described voluntary structures and the proposal of higher standards in banking regulation. The Commission chose for a new Regulation instead of a Directive, because regulations have direct effect and can therefore be used to avoid diverging legislation at the national level (COM (2008) 704 final). This measure is also not simply an adjustment of already existing legislation; this measure requires the setting-up of a new authority with a mandate to delegate supervision to a certain member state. Obviously, this will also have a significant impact on public policies at the national level. The member states will also lose certain policy-making powers as regulations have direct effect and does not leave the member states any room for manoeuvre. Although this mandate appears to be rather limited, it is not uncommon that institutions are delegated more tasks in the future. In this case, it could mean that this Committee will eventually also be asked to take up the responsibility of supervising all credit rating agencies operating in the EU instead of keeping this task at the member state level. But before this European Regulator can be set-up, member states will first have to delegate their powers to the European level. This measure will therefore add an extra executive layer in this policy-field and could have an enormous impact in the future. Also, this proposal does not only meddle in the composition of the boards and even the remuneration of the independent board members but also demands an annual report on the functioning, procedures, and transparency of these rating agencies. This is a drastic change compared to the current situation but deemed necessary by the Commission to protect the stability of the European financial system.

There has also been a discussion about the need to reform supervision of the European banking sector. From 1993 onwards, the EU's principle of Home Country Control applied to the European banking sector (Bos 2002, 7). This meant that EU banks could operate in another EU country but under the regulation of their home country. It was argued that this deregulation of the banking sector should increase competition and served the interests of consumers. The idea is that when a cross-border problem occurs in the financial sector, for instance a bank which is about to collapse, these national regulators should cooperate in finding a solution (*Het Financiële Dagblad*, 30 August 2008). The home-state is supposed to take the lead in these negotiations. The problem is, however, that the proper infrastructure to facilitate this cross-border cooperation is lacking. Additionally, it seems that some member states –for example, the United Kingdom, Germany and the Netherlands– host more cross-border banks and financial institutions than other member states. Obviously, this raises tensions between on the one hand, member states which are keen on maintaining the current situation since this would give them a certain economic and political power, and those member states which advocate reforms because they feel that their interests are neglected on the other. The actual reforming proposal was presented in October 2008 and will therefore be discussed below.

*T2 September 2008 – December 2008*

*Macroeconomic policies*

As we have seen, the second half of 2008 was characterised by many temporary macroeconomic responses of the member states to support their economies. Again, these actions have been accommodated by the EU although the Commission remained strict in her conditions. But the EU also joined the member states in taking measures to support the eurozone economy.

In the EU, with its 27 member states, it is difficult to reach agreement on how to fight the financial crisis. Conflicting interests, different economic situations, and diverging ideological viewpoints are difficult to overcome. However, early October 2008 the member states were able to reach agreement on macroeconomic principles to stabilise the banking sector (*Financial Times*, 8 October 2008). Although this is not a binding, universal European strategy, it suggests a united front to battle the global crisis. All countries agreed to increase the deposit guarantee scheme up to €50,000 for at least one year and some countries even raised this to €100,000. This resulted in permanent harmonising legislation with the aim to reduce distortion on competition between the different deposit guarantee schemes among member states. This will also be discussed below. All member states are free to implement measures and rescue packages as they think seem fit. The total of seven principles include that state-aid should be ***temporary***, that European state-aid rules must be respected and that the taxpayers' interests must be protected at all times. This agreement means that there will not be a 'joint rescue action' because the member states prefer to focus on the reconstruction of their own, domestic banking sector (*Financial Times*, 6 October 2008a).

A further effort was made, although rather modest, to stimulate lending to SMEs by providing the EIB with extra funds (*Financial Times*, 3 December 2008). The EIB's funds were raised by €67 billion to €232 billion 'to help fund "green technology" projects in the European car industry, make loans to SMEs, and accelerate the distribution of EU regional aid to Central and Eastern European Countries'. The capital to SMEs is distributed through commercial banks; this should therefore be an incentive for banks to start lending to small businesses again. This is part of the EIB's package of measures in response to the financial crisis for 2009-2010 (EIB, last accessed at 7 July 2009). Other measures include an increase in convergence lending to SMEs in Central and Eastern Europe and even candidate countries because the crisis has had a disproportionate impact on this area. Phillipe Maystadt, EIB President, stressed that these measures are only temporary –only for 2009 and 2010– and ‘will allow quick disbursements and contribute to the real economy, notably by protecting good projects and helping viable companies in these difficult times’.

Although the rescue packages for the banking sector and the economy are generally welcomed, they are also a cause for concern. Governments finance the capital injections and lending guarantees by issuing extra bonds (*Financial Times*, 29 October 2008). It is expected that in 2009 the market will have to absorb €2600 billion in bonds to finance the rescue packages. This will produce a number of tensions on the money market. First of all, since the supply of bonds will increase, it is expected that the interest rate will increase to attract as many investors as possible. Governments will be confronted with increasing costs to finance their rescue packages. Second, commercial issuers, which already have problems raising capital, might be priced out of the market. Finally, it is possible that member states shut each other out of the market. For example, Germany is well-known for its reliable and most liquid bonds, this could cause problems for other member states which will have to offer a higher coupon rate to attract sufficient investors and end up with higher costs.

As mentioned in $T_1$, the main problem of the ECB was the dilemma of increasing inflation on the one hand, and mounting pressure to cut its interest rates as some of the eurozone countries’ economy took the slump and could use a lower interest rate to stimulate investments. By the end of October 2008, the German inflation rates finally came down opening the door to a cut in the eurozone’s inflation rates (*Financial Times*, 28 October 2008). The ECB warned though, that it will not cut its rates in an aggressive way as the BoE and the FED did. But the ECB will lower its interest rates more gradually so that it will not immediately lose all of its tools. The ECB also assured the banking sector that all demands for liquidity will be met in an attempt to calm the European financial markets (*Financial Times*, 16 October 2008). In addition, the ECB announced that there will be more possibilities for banks to borrow from the ECB, ‘to put up a broader range of collateral, including assets with a lower credit rating than previously accepted and denominated in currencies other than the euro'. This shows that the ECB is also taking incremental steps to accommodate the European financial sector to ensure a quicker recovery from the crisis.

*Regulations*

September and early October 2008 were characterised by many bank nationalisations, capital injections and lending guarantees by European governments. These bank bail-outs are, as all other measures of state-aid, subject to the antitrust legislation of the EU. Only in exceptional circumstances will temporary state-aid be approved of and only under strict conditions. One of those conditions is that the bank receiving the state-aid should provide the European Commission a plan in which it outlines reforms to restore its viability (*Financial Times*, 30 September 2008b). The Commission's conditions are generally very strict rules to ensure a level playing field on the national and European level. This is demonstrated by the case of WestLB (*Financial Times*, 9 September 2008). Neelie Kroes, the Commissioner for competition, threatened to reject the bank's reforming plan because the bank was not able to present a 'sustainable business model' in which it planned to gain access to retail customers as the major tool to recovery.

Another more interesting case is the French bail-out plan for banks. France planned to (re)capitalise six of its biggest banks at the same time. The aim of this preventive programme was to avoid situations of a frozen inter-bank lending market as in the UK and Germany (*Financial Times*, 29 November 2008). Ms. Kroes initially blocked this plan because 'support should be sufficient to offset the negative impact of the current financial crisis and no more'. Interestingly, just ten days later it was announced that the Commission would relax the terms for state-aid to banks (*Financial Times*, 9 December 2008). The Commission will discriminate state-aid to banks between 'fundamentally sound' banks and 'ailing institutions'. As a result, the Commission approved the French scheme to ensure that banks would maintain lending to businesses. In my opinion, this proves that the EU is willing to accommodate the member states in their efforts to save their banking sectors. Clearly, no new legislation is needed to accommodate the member states. This is only a minor and temporary adjustment of existing legislation while the conditions to provide state-aid remain strict: 'The pricing mechanism needs to carry a sufficient incentive to keep the duration of state involvement to a minimum, for example through a remuneration rate that increases over time' (Commission, IP/08/1901).

The EU and its member states did not only respond to the problems in the financial sector with bail-outs and lending guarantees. As mentioned above, the EU is also taking regulatory measures and tries to reform its banking regulations to avoid future problems. For example, the Commission announced that capital requirements for banks will be increased and that the supervisory regime for cross-border banks will be improved (*Financial Times*, 2 October 2008). EU policymakers saw chance to include the new banking practices in the reform proposal of the Capital Requirements Directive which should improve risk management, increase transparency, and improve supervision. This is the main element of the reform and is accomplished by setting-up 'colleges' of supervisors for financial institutions engaging in cross-border operations. These colleges should include representatives of all member states involved, and should decide by consensus. The main problem remains, however, that the home-state of the bank can act unilaterally in two important matters. First, it would be able to impose its own reporting requirements. Second, it would be able to determine the extra capital requirements. Evidently, this does not solve the problem discussed before of the smaller member states, which do not have as many financial institutions as some other member states and will therefore always 'play second fiddler'. In my opinion, this situation can lead to a race to the bottom between member states to attract as many financial institutions as possible, losing sight of the public's best interests.

The 2008 financial crisis has also led to amendments of the Directive on deposit guarantee schemes.[3] In the new Directive, the minimum coverage level of €20.000 is increased to €50.000 in 2009 and will be increased to €100.000 by 31 December 2010 (Directive 2009/14/EC) and the payout delay will be reduced from three months to 20 working days. The objective of these reforms is to harmonise coverage levels and payout delays. This was deemed necessary as the variety of rules of the member states were believed to distort competition between the member states. These harmonising reforms have removed the ***minimum*** coverage level and replaced this with a ***common*** coverage level of €100.000 by the end of 2010. This means that these reforms constrain the

[3] Directive 94/19/EC on deposit-guarantee schemes as regards the coverage level and the payout delay

member states' options for interpretation or additional coverage levels. This can hardly be called a radical change in policy but rather yet another incremental change which ultimately results in the delegation of power to the European level. However, national public policies will be affected by these adjustments because the increases in minimum coverage levels will have a considerable impact on a member state's financial resources should an emergency situation occur. Also, after 2010 the member states can no longer increase the minimum coverage levels.

The Commission installed in October 2008 a Workgroup to advice the Commission on the future of the European financial market, including regulation and supervision (De Larosière report 2009). The result –the so-called De Larosière report– was presented in February 2009 and concluded that repair is necessary in three levels of the financial markets: at the regulatory level, the supervisory level, and at the global level. I will only discuss the most important repair proposals of the regulatory and supervisory levels. The global level is outside the scope of this study.

In general, the Group's strategy is to propose the least radical changes, but the most incremental changes to avoid deadlock. Although most member states such as the Netherlands and Germany, and to a lesser extent the UK, agree that the financial crisis has been exacerbated by the inefficiency and lack of European financial regulation and supervision, they differ in their ideas on how to repair these problems. The disagreements mainly consider the questions of what should be regulated, and who should be doing that. The managed capitalist countries favour harmonisation of rules, improved European financial regulation, and increased supervision at the European level whereas the UK is less enthusiastic about these ideas. The Group's strategy is to build new rules and committees upon already existing structures which makes it more likely that member states would be willing to cooperate as these new structures would not conflict with current existing norms. In the future, these new structures could be delegated more powers from time to time as part of a sequence of small changes which, over time, have a cumulative effect.

The Group agrees with the Commission and the member states that the current rules regulating the European (and global) financial markets are too thin (De Larosière report 2009). The European financial system is very fragmented. The financial markets regulations (and directives) and responsibilities are not only spread between and across various political levels but also between sectors –i.e. the banking, securitisation, and insurance sector. Each sector has its own set of rules and responsibilities that lie across the political levels. The Group therefore argues that these rules and responsibilities of the different sectors should be more concentrated into harmonised sets of rules at the European level, preferably in the form of regulations (which have direct effect). Below I will only discuss the proposed repairs in relation to the banking and securitisation sectors. The Group also made some suggestions to repair the insurance sector, however, these are outside the scope of this study and will therefore not be discussed.

With respect to the policy and regulatory repairs, the most important repairs the Group proposes include, among many other things, reforms of the Basel II framework, reforms of the credit rating agencies regulations, and 'closing the gap in regulation' (De Larosière report 2009). One of the issues related to the Basel II framework criticised by the Group is the dependence of investors on external ratings even though the bases of these ratings and risk models were not entirely clear to, or understood by these investors or board members. This should be solved by educating the board members and investors and by simplifying the internal risk models. The Group further proposes, among other things, an increase of the minimum levels of capital banks should hold to cover their risks, and to limit the 'pro-cyclical impact' of the current Basel II rules by, for instance, introducing the Bank of Spain's 'dynamic provisioning' principles: building up capital in times of economic growth and allowing these buffers to decrease in economic downturn.

The De Larosière Group commented on the Commission's deposit guarantee schemes (DGS) proposal (De Larosière report 2009), which will be discussed below. The Group underlines the importance of one DGS in which depositors of all member states are guaranteed the same amount and protection, instead of the current system of minimum coverage levels. The Group takes this one step further and argues that the DGSs should be pre-funded by the financial sector at the *national level*. The idea is that these pre-funded schemes reduce the pro-cyclical effects on the financial sector in times of distress. The Group does not support such pre-funded DGS at the ***European level*** because the management of this system would be too complicated and ‘would raise numerous political and practical problems’.

The Group also responds to the Commission proposal for a Regulation on credit rating agencies (De Larosière report 2009). The report argues that this proposal is ‘too cumbersome’ and that the division of work (licensing and oversight) between the home and host state will not be effective or efficient. Instead, the Group proposes to mandate the Committee of European Securities Regulators (CESR) to license the credit rating agencies and supervise their functioning.

A third major problem addressed by the report is the lack of a consistent set of rules (De Larosière report 2009). This would improve the functioning of the single financial market and reduce distortions in competition stemming from regulatory diversity at the national level. The main cause for this can be found in the political choice to leave the member states several options in the implementation and enforcement of directives. This has lead to a situation of wide diversity of interpretations; a phenomenon that is directly related to pre-existing legislation at the national level. In order to improve the consistency of financial market core rules between member states, existing national differences should be removed by the Commission or level 3 committees. To avoid such situations in the future, new legislation should be based on regulations, which have direct effect (and leaves the member states no interpretation options).

Apart from the regulatory repairs, the Group also makes recommendations with respect to the supervisory aspects of the financial markets. The Group has subdivided the supervision repairs in micro-prudential and macro-prudential supervision (De Larosière report 2009). In general, the Group argues that the current supervisory framework focuses mainly on the micro-prudential supervision (supervision of individual firms in distress). Macro-prudential supervision (supervision of the financial system) is considered by the Group to be at least as important as micro-prudential supervision, and should include supervision of all financial sectors (and not just the banking sector). The report identifies many other problems in this area which need to be addressed by the EU, such as the inconsistent supervisory powers of authorities between member states, and ineffective warning systems.

In relation to the macro-prudential supervision, the Report recommends that an institution at the European level –the ECB/European system of central banks (ESCB) – is made responsible to oversee the macro-prudential supervision at the European level (De Larosière report 2009). For this, a new group –the European Systemic Risk Council (ESRC) (which would replace the Banking Supervision Committee (BSC) – should be set-up and be entrusted with several tasks such as issuing risk warnings, advise on macro-prudential policies, and form judgements. If this recommendation is implemented, this would be a permanent policy change because a new organisation is created for which new legislation needs to be created.

With respect to micro-prudential supervision, the Report concludes that the current system of committees cannot guarantee financial stability (De Larosière report 2009). Instead, a new supervisory structure should be set-up: the European System of Financial Supervision (ESFS). The ESFS should fully respect 'the proportionality and subsidiarity principles of the Treaty'. The daily supervision would remain with the national supervisors. Three European Authorities would have to be created which would replace the Committee of European Banking Supervisors (CEBS), the Committee of European Insurance and Occupational Pensions Supervisors (CEIOPS), and the Committee of European Securities Regulators (CESR). The Authorities (covering the three financial sectors: banking, securities, and insurance) would ensure cooperation and communication between the national supervisors, and oversee the application of the European supervisory standards.

If these recommendations are indeed implemented by the Commission, than the set-up of these new structures to supervise the micro-prudential and macro-prudential policy areas and the transformation of the three level 3 committees into three Authorities, proves that the EU is ready for permanent changes in its financial policies. New legislation would have to be –and is already– adopted to make these changes possible and it would also affect public policies at the national level. Of course, these new structures would respect principles of proportionality and subsidiarity to avoid deadlock. The Group seeks to find the least radical (but rather incremental, see for instance the reference to the subsidiarity principle) but nevertheless most effective possibility to reform. The proposed new committees are built upon existing structures (layering) which makes it more likely that member states will accept these proposals. Although these changes are not extremely radical in the way that all supervisory and regulatory powers are concentrated at the European level, these changes could have great potential in the future if these committees are delegated more and more tasks over time. This can be seen as part of a sequence of small steps which, over time, causes changes of norms at the European and the national level as they influence each other.

In sum, many initiatives have been taken at the European level to battle the current crisis, but also to avoid comparable situations in the future. Especially the credit rating agencies are confronted with a serious reform of their policies as the Commission plans to set-up a new European Regulator to supervise. The banking sector also faces a policy change in the form of ‘colleges’ to supervise cross-border operations. Arguably, adding these new executive layers can be considered as significant changes of current European financial policies, but are hardly revolutionary. These proposals will not initiate a fundamental policy shift at the European level; there are simply too many conflicting interests between member states as is illustrated by Schmidt’s model of varieties of capitalism. The policy changes at the European level will take a long time as actors need time to explore each other’s differing opinions and convince them of their own ideas so that an agreement can be reached. This is usually accomplished in very small steps and supports both Schmidt’s ideas on fragmented systems and incremental changes, and the first hypothesis proposed in the introduction.

The actions taken by both the European and the national level illustrate that these two levels can influence each other’s policies. For example, the EU is accommodating the member states in their rescue packages which shows that member states can influence European policy-making. Although the Commission continues to be strict in their investigations of member states’ rescue plans, the accommodating measures strengthen the member states in their confidence to intervene in their financial sectors and economy using short-term measures as a kind of ‘boost instrument’. On the other hand, the proposed policy changes and the increased use of regulations instead of directives will have an impact on public policies at the national level as well. The EU’s choice to use regulations will harmonise rules across member states, but this means that the member states will lose their room for manoeuvre. The Commission prefers increasing European control over the financial sector by means of layering to increase the chance of success. This means, however, that the prior existing policies of the member states also influence policy-making at the European level as the new European structures have to be built on top of them. As a result, the managed capitalist countries' wishes for more radical changes cannot be included; the Commission's strategy forces policy-makers to follow a path of small changes spread over a long period of time.

## 4. Discussion

### *4.1 Summary*

The global financial crisis landed in the European states at very different times. It is rather remarkable that the UK was hit much earlier by the financial turmoil than the Netherlands and Germany. Although the Netherlands and Germany already showed some early signs of the financial crisis coming up later in 2008, both countries were still able to profit from high demands for their export products while the UK's economy was already slowing down. The impact, however, was not that different. All three countries were confronted with similar problems: collapsing banks, and frozen inter-bank lending markets which finally resulted in spill-over effects to the economy. A pattern appeared in the responses of the states: ad hoc macroeconomic policies, actions of state-aid and nationalisations at the national level while at the same time pressing for improved regulation at the European level. As we will see later, this pattern particularly applied to the managed capitalist countries which relied mostly on traditional patterns of public policy.

At the national level, the crisis induced responses of all three governments were quite similar. At the national level, all three member states opted for comparable **macroeconomic** policy and state-aid mixes in an attempt to restore systemic stability: a combination of nationalisations where necessary, bail-out schemes and capital injections to provide liquidity, and special lending guarantees in an attempt to defrost the inter-bank lending market. The main motivations of the governments to intervene were to secure systemic stability, to restore public trust in the banking sector, to protect depositors, and to support the inter-bank lending market. Because the EU has a large number of cross-border financial institutions, a collapse of a bank could have had serious repercussions not only for the national financial system, but also for the European financial market. The fact that the collapse of one bank could have initiated a domino effect through the European financial system shows that existing legislation is no longer sufficient. The crisis gave member states a chance to challenge existing regulation and demand improvement. This, however, is a difficult process as the EU's political system is fragmented with many vetoes which make radical changes impossible.

An interesting detail is that despite the increasing cross-border operations of member states' financial institutions –which resulted in an increasing likelihood of spill-over effects to their financial systems– and the fact that because of the current crisis all actors realise that the complexity of the European financial markets has increased and that there is a need for **regulation**, member states are still very reluctant to set-up a single agency at the European level to regulate and manage financial institutions engaged in cross-border operations. Fortunately, the De Larosière Report advised the Commission to set-up, for instance, the ESFS which would operate according to the principles of subsidiarity and proportionality. This increased the chance of success and cooperation of the member states. Also, the member states agreed on voluntary structures for meetings between finance ministers and setting-up European supervisory authorities with a limited mandate to approve and delegate new applications of credit rating agencies combined with an endless list of weak agreements –for instance, with principles to stabilise the banking sector– and accommodating measures of the Commission –for example by relaxing the state-aid rules for banks. This is an illustration of how difficult change is at the European level. Change at the European level is not a process of punctuated equilibrium but a gradual one; a sequence of small steps starting with the set-up of voluntary structures and committees with only limited mandates.

Overall, this study shows that the governments of the three case studies relied on traditional public policy patterns in response to the financial and economic crises which raised tensions with European competition policies. This was especially the case in the managed capitalist countries with regard to the macroeconomic responses. The Netherlands and Germany intervened without hesitation in the banking sector in the form of nationalisations and bail-outs. The public policies of the EU member states are increasingly influenced by EU legislation, as illustrated above. This caused the member states to demand adjustments in banking regulation at the European level, instead of adjusting regulations at the national level which they traditionally would have done. The fact that member states knock on the European door for improved regulations for this sector proves that expectations at the national level are converging. The member states expect the EU to respond with a common European banking regulation so that the European financial markets will be better protected in the future. So, what we can see is that the EU legislations not only influence policy-making at the national level (for example, the EU's competition policies), but that the policies and actors at the national level also influence policy-making at the European level (adjustment of European banking regulation and the accommodative actions). However, the EU's political system is complicated, fragmented, and with many vetoes. This will make it difficult to radically change regulations in a short time span. Rather, this is a process of incremental changes over time.

### *4.2 Research question*

The research question of this study was:

> 'What are the effects of the crisis induced responses on the policy-styles of European national governments in relation to the liquidity problems in the banking sector as a consequence of the financial crisis?'.

The 'effects' on policy-styles was determined in terms of either ad hoc responses or permanent responses. Permanent responses require new legislation as they aim at building up new structures. Permanent responses can initiate fundamental shifts in a country's policy-making and policy-style, whereas ad hoc responses will only be in place on a temporary basis and only need –if any– minor adjustments of already existing policies. A second important element is the intention of the government when intervening in the private sector. For example, conditions which stimulate a swift return to the private sector to raise their capital are clearly only meant to stabilise the financial sector. In these situations, the government is not looking for long-term participation.

As stated above, at the national level the member states implemented macroeconomic policies to support their financial sectors. In the area of macroeconomic responses, the managed capitalist countries relied on traditional public policy patterns. This contrasts sharply with the reforms of the 1990s following the economic crises of that time. The implementation of packages to stabilise the banking sector in the Netherlands or Germany hardly demanded any new legislation as the managed capitalist countries had already sufficient regulation in place to facilitate government intervention in the private sector because they have a history of a strong intervening state. Although only temporary responses, these actions obviously raised tensions with the EU's competition policies which shows that member states have converging expectations and that they are willing to challenge European legislation in times of crisis.

This was slightly different for the UK. The nationalisation of Northern Rock surfaced a gap in regulation to enable the government to intervene. A temporary act had to be implemented which will be replaced in 2009 by permanent legislation to allow the government to interfere when deemed necessary. This illustrates how a desire to take temporary **macroeconomic** actions can result in new legislation and possibly a shift in policy. Although only a small and incremental step, this can be considered quite spectacular for the UK. This also proves Schmidt's point that majority governances are better equipped to implement radical changes. Especially considering the short time frame of these decisions, this is also consistent with the punctuated equilibrium discussion. The UK government had very limited tools to intervene in the financial sector in times of crisis. Their political system enabled them, however, to take swift actions and adopt the necessary regulations to intervene in the banking sector. Following the criteria set out in the introduction, this should be classified as a permanent response and therefore a shift in policy style. This does not mean that the UK government plans to intervene more often but it has given itself the tools to do so if necessary.

Member states generally turn to the Commission for a regulatory response. At the European level, the Commission is confronted with more interventionist national policies in the financial sector as well as in the economy. These policies have been accommodated by both the Commission and the ECB, respectively in competition policy and monetary policy. But the EU did not only accommodate the member states, it also made serious attempts to reform financial policies to prevent similar crises in the future but, so far, with few results. Reforms in policy areas are difficult to accomplish on any political level, especially at the European level. Building up new agencies and structures imply that member states have to delegate powers to the European level which is a delicate procedure because it is often interpreted on the national level as losing sovereignty. The Commission's strategy is to build these new European structures upon already existing (national) structures so that the member states would not be confronted with too radical changes. However, this is a time-consuming process and considering that this study has been written in the midst of the financial turmoil it is hardly surprising that the EU has produced only few results so far. However, many ideas were ventilated and many proposals were made in this period which demonstrates that politicians on every level realise that change is inevitable.

As pointed out in the introduction, the member states turn to the European level for regulatory responses because their national policies are restricted by European ones. It was argued that member states influence European policy-making and vice versa. It is hardly surprising that especially the managed capitalist countries turn to the EU and try to adjust regulations of the banking sector. A strong state has always been part of their traditional policy-styles. The EU is now part of their structure and through which the member states can challenge existing European norms and transfer their own national norms to the European level. Unfortunately for them, the wishes of the managed capitalist countries are not included in the reform packages. As discussed above, the Commission opted for the strategy of layering. Again, this will be a process of gradual incremental changes over time and not one of punctuated equilibrium. The EU's political system is too fragmented and with many vetoes which makes radical change very difficult. What we are witnessing here is the very beginning of the sequence of incremental changes which will gradually reform the EU's banking and securities regulation, but which will be built upon prior-existing policies. However, these already existing legislations will also influence the new European policies as the new ones have to be layered over the already existing policies. This and the member states' wishes, will severely limit the policy-makers' options.

In short, it can be concluded that the member states have focused their energy and resources on emergency rescue packages –macroeconomic responses– to stabilise their financial sectors on the national level while at the same time actively deliberating with their European counterparts for reforms in regulation as a permanent solution on the European level. Member states realise that a reform of the current bank regulation is necessary but has produced little result so far. Since ad hoc responses on the national level have dominated in this time frame no fundamental changes in policy-making or policy-styles in the Netherlands, Germany or at the European level can be observed yet. The only exception is probably the UK which, as stated earlier, had to implement an emergency act to enable the government to intervene. However, it is unlikely that this will have a significant impact on the policy-style of the UK considering that the government has been –and will be– averse to interfering in the private sector, with or without this permanent piece of legislation.

*4.3 Responses to the financial turmoil*

*Macroeconomic responses*

As has been discussed in paragraph 4.1, the three countries of this study implemented a similar policy mix to stabilise the financial sector: nationalisations, capital injections, lending guarantees, and rescue funds were the main tools used by governments. These macroeconomic government responses show that there is convergence of government behaviour of the market and managed capitalist countries in times of crisis considering that the both market and managed capitalist countries used these tools. These actions of the governments imply an enormous increase in government spending, usually financed by raising capital on the bond market. Two of the three countries of this study have stated explicitly, although Germany hesitated more than the UK (which is remarkable) that borrowing the country out of the recession is the best solution to overcome the crisis. However, the UK's chancellor, Mr. Darling, toned down this statement of Prime Minister Brown arguing that in the short-term government borrowing would increase to support the financial sector and the economy but that in the medium or long-term the country should 'live within its means'. In addition, Ms. Merkel was also quite reluctant to borrow her way out of the economy arguing that it is unlikely that consumer demand would increase after tax cuts or increased social benefits as Germany has a rather high savings ratio. A large part of the extra resources available to the public would probably end up at a savings account. Eventually, Ms. Merkel caved and Germany presented its own economic rescue plan soon after. The German plan is clearly of a temporary character and, considering Ms. Merkel's hesitation, it is unlikely that this will mark a turning point in German's policy-style. Finally, the Netherlands has for the last decade respected the limitations of the Stability and Growth Pact and has restricted its budget deficits to a minimum. The Dutch government has no intentions deviating from this standpoint. Therefore, it is unlikely that the UK, Germany and the Netherlands will make a *permanent* shift back towards Keynesianist policy-making.

*Regulation*

So, instead of a permanent turn towards Keynesianism, the general response –especially that of the Commission– is improving or extending financial (European) regulation. Some EU member states have demanded improved bank regulation which has lead so far to many discussions but only small policy changes. For example, a new piece of regulation is the proposal to increase supervision of credit rating agencies. As predicted, one of the aims of this proposal is to increase transparency and supervision in this sector.

As already mentioned before, many plans have been discussed and proposed in the time frame of this study. The results, however, have been minimal so far. The EU is moving at a glacial pace when it comes to policy-making. Too many conflicting interests of the member states have transformed this into a 'mission almost impossible' and a common position has become even less likely now that the national economies are in recession. This has put the relationships under pressure, not only between member states, but also between member states and the Commission. The positive reactions of governments with respect to the cleverly De Larosière Report are clear signs that member states are willing to cooperate. However, changes at the European level are gradual as a result of fragmented political systems. This is where we see the process of layering of new norms on top of those of the member states. These new European norms should not conflict the national ones as this will produce a veto. Revolutionary European policy shifts should not be expected, rather, a process of incremental policy changes spread out over a long period of time seems to be a fruitful approach in Europe.

### *4.4 Varieties of capitalism*

How does Schmidt's model help us understand what has gone on? Schmidt argues that economic shocks caused by globalisation and Europeanisation led to major changes in economic policy-making and policy-styles of EU member states, which was discussed in 1.3.5. Considering the incredible amount of capital European governments plan to invest in their financial sectors to ensure systemic stability, and in their economies to weather the recession, changes in their policy-making and policy-styles could have been expected.

If this is compared to the crisis induced responses of the UK government to stabilise the financial sector, it can be concluded that the UK did not respond as was expected according to Schmidt's model. An interesting development was that businesses and banks both lost their easy access to fresh capitals because the inter-bank lending market had frozen. This easy access to capital was traditionally seen as an important element of the motor behind economic growth and innovation. If the government had decided not to use its ability to be the 'lender of last resort', the consequences for the national and European financial sector would have been even more dramatic than it is today. Through (part) nationalisations, providing capital injections and lending guarantees, the UK government and the BoE managed through macroeconomic policies to avoid systemic failure, although at high financial costs. Although the government considered it vital to intervene in the financial markets, it is nevertheless highly unusual for the UK government to do this, let alone on such scale. This is to be considered a major change in UK's policies although these state-aid actions are not likely to be permanent.

However, the adoption of the emergency legislation to enable the government to nationalise Northern Rock combined with the intentions of adopting permanent legislation to intervene in the banking sector in the future, is a permanent change of policy style. The quick response and adoption of this piece of legislation can be ascribed to the majoritarian governance system of the UK. This not only makes radical changes less difficult but also enables the government to create new tools in a very short time span which supports the punctuated equilibrium discussion.

Another new strategy worthy of note is the government's effort to get the (inter-bank) lending market started again. For example, by organising special meetings with bank representatives to attempt to bring down the inter-bank interest rates, it seems that the government stepped away from historic the hands-off approach. Even more astonishing was the statement of Gordon Brown that he considered borrowing his way out of the crisis was the best way to weather the economic recession. At first sight, this Keynesian promise should be considered a radical break with the country's monetary past. This statement was later somewhat nuanced by Chancellor Darling, saying that in the short-term borrowing to support the financial sector and the economy was inevitable but that in the medium and long-term the country should 'live within its means'. Again, an unusual shift in policies for the UK government but not likely to be everlasting.

Although the UK government considered it necessary to intervene and secure systemic stability, it tried to handle the regulatory aspects of this difficult situation in a manner typical for the ideal-type of market capitalism. For example, the new public agency, UKFIL, set-up to oversee the (part) nationalised banks operates at arm's length from the government, is mainly concerned with turning the (part) nationalisation of banks into a profit for the government but does not interfere in the bank's strategy. This is exactly what Schmidt predicts: a semi-independent regulatory agency which administrates the rules set by the government. Also, the UK rejected European plans to curb boardroom remunerations because it feels that governance interference in boardrooms is inappropriate. This response was not only predicted by Schmidt but was also expected by Hall in the discussion of macroeconomic and regulatory policies in paragraph 1.3.4. So, although there was convergence on the macroeconomic aspects of the government responses, there is hardly any on the regulatory responses. The UK too relied on traditional public policy patterns with the exception of the (part) nationalisations of the banks.

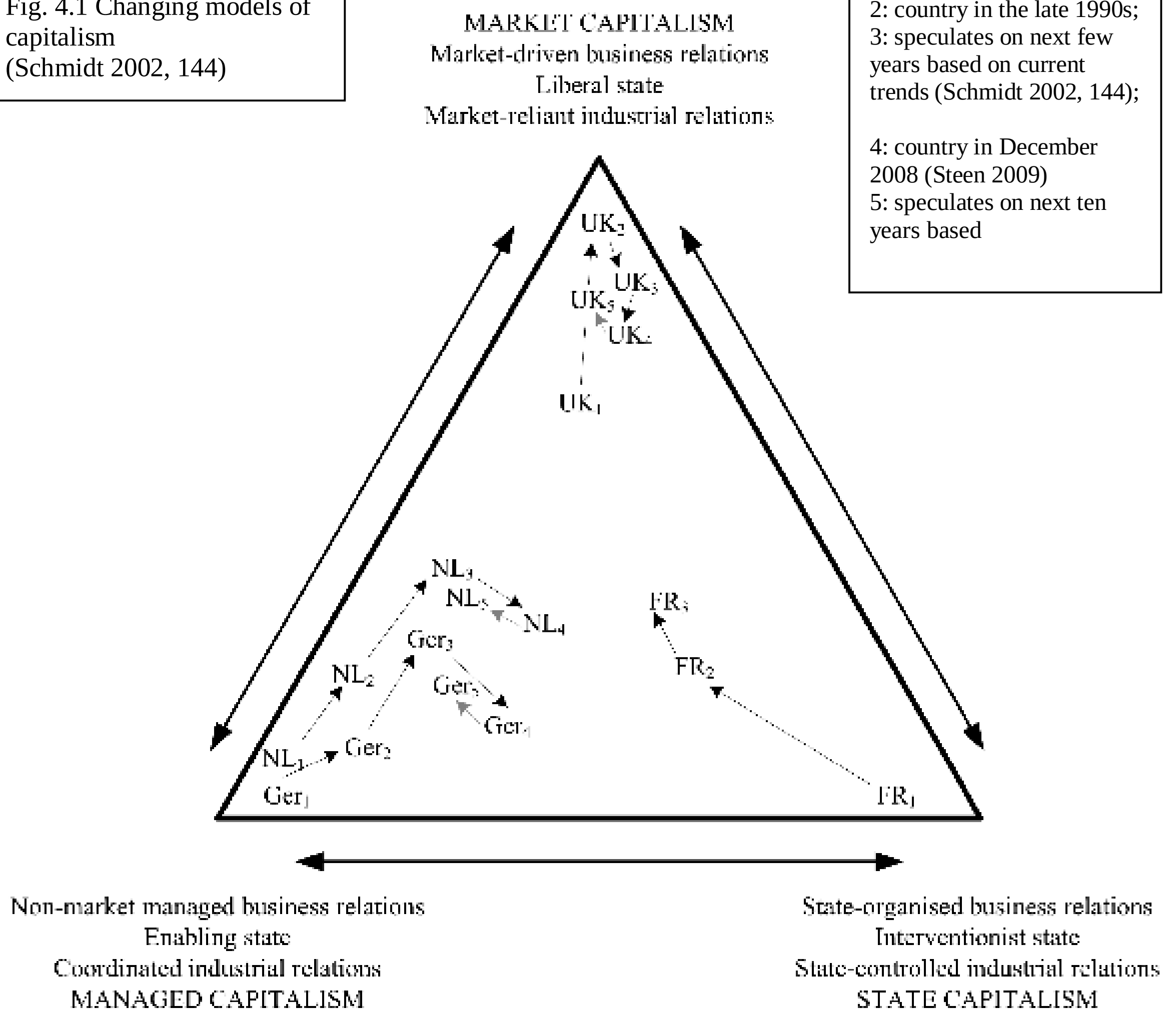
### *4.4.1 Proposed changes in models of capitalism*

Schmidt presents a figure which illustrates how the policy-styles of three countries –the UK, Germany and France– have changed over time (2002, fig. 3.1, 144). The current and expected future changes caused by the current financial turmoil will be added to this figure to demonstrate the impact of the financial crisis on the policy-styles of the three case studies in this research. Based on the conclusions below and the illustration in figure 4.1, the hypothesis in chapter 1.3.5 should be falsified:

> Hypothesis 2: Since previous economic crises caused permanent shifts in policies of managed capitalism countries towards market capitalism, it can be expected that the German and Dutch policy-styles will again make a permanent shift towards market capitalism as a consequence of the global and enormous scale of this crisis.

On the one hand, the UK showed revolutionary policy shifts and interfered in the financial sector, but on the other hand, the approach and the execution of state actions do not suggest any permanent changes to their policy-styles. The temporary state-aid actions that the UK government took resemble the actions taken by the Dutch and German government, which, of course, belong to the ideal-type model of managed capitalism. In addition, as stated earlier, the UK government intends to adopt permanent legislation to deal with future crises in the banking sector. Could this mean a shift in policy away from market capitalism and towards managed capitalism? If we just look within the time frame of this study, the UK did announce a permanent reform in financial regulation which could, for instance, enable the government to nationalise or interfere otherwise in the financial sector to secure stability of the system. But this permanent reform has not been adopted yet. Nevertheless, I am confident that this legislation will be adopted in the future; therefore I expect a small shift towards managed capitalism.

Fig. 4.1 Changing models of capitalism
(Schmidt 2002, 144)




1: country circa 1970;
2: country in the late 1990s;
3: speculates on next few years based on current trends (Schmidt 2002, 144);

4: country in December 2008 (Steen 2009)
5: speculates on next ten years based

To illustrate the current and expected future positions in Schmidt's figure the UK's current position ($UK_4$) has shifted away from $UK_3$ to a lower position but remains on the right side of the triangle (Schmidt 2002, fig. 3.1, 144), as is shown in figure 4.1. The UK's future position ($UK_5$) is less easy to predict. Considering the short time frame of this study, it is not unthinkable that the UK will adopt additional permanent legislation to enable the state to intervene faster to avoid future crises situations in the financial sector. However, based on what we do know it should be concluded that the position of $UK_5$ should be somewhere between $UK_3$ and $UK_4$ since the government announced in the pre-budget report an increase in, for instance, income tax of £50,000. Also, if the EU answers to the demands of some member states for bank regulation, the final position will definitely move away from market capitalism but this will be discussed in more detail below. On the other hand though, the state's intentions to privatise the (part) nationalised financial institutions again, and the set-up of institutions to organise and supervise the nationalised banks proves that the government of the UK is committed to its arm's length approach. This still fits the ideal-typical model of market capitalism.

As for the managed capitalist countries, the responses of Germany and the Netherlands were less revolutionary but had nevertheless a deep impact on society. Germany's large public banking sector was hit quite hard by the financial crisis and several banks had to be nationalised or needed capital injections. The conditions for the nationalisations or capital injections were most strict. As in the UK and the Netherlands, dividend payments were banned and the banks had to accept boardroom members from the governments, and in Germany the banks had to provide the government details of their business model to ensure that they were no longer engaging in high risk lending. One remarkable element was Merkel's hesitation to borrow her way out of the crisis. Eventually, she agreed to a rescue plan of a significant size to stimulate the German economy.

So, if Germany's current position ($Ger_4$) is to be placed in figure 4.1, it will show that it has shifted to the right but away from market capitalism as, compared to the UK, the government is playing a much more intervening role to weather the crisis. Again, the expected future position ($Ger_5$) is more difficult to predict. Germany is in favour of curbing boardroom remuneration and seems to be determined to transform the banks which received state-aid into 'fundamentally sound' banks. It is unlikely that Germany will eventually shift back to $Ger_3$ considering its interests positions at the European level. It is more likely that Germany ($Ger_5$) will shift away from state capitalism and to a move upwards again and end up somewhere between $Ger_2$ and $Ger_3$. This will certainly be the case if Germany supports and the EU succeeds in producing new regulation for the financial sector.

The Dutch changes in policies were not depicted in the original figure of Schmidt. The first Dutch position ($NL_1$) is placed left and above $Ger_1$. Globalisation and Europeanisation pressures pushed $NL_2$ upwards to a more market capitalist ideal-type after which it moved even further up ($NL_3$), parallel to the German shifts. The global financial turmoil forced the Dutch government to intervene and nationalise Fortis and inject fresh capital in several other banks. This caused a shift back down and away from managed capitalism ($NL_4$). In this case the future is also difficult to predict. No new national regulation has been announced in the time frame. However, the Netherlands is considering supporting a reform of the banking regulations at the European level which, for instance, could lead to a European supervisory authority. Therefore, $NL_5$ is likely to move away again from state capitalism and back up, but not back to $NL_3$.

In short, the UK, a market capitalist country, and the Netherlands and Germany, both managed capitalism countries, implemented a comparable policy mix of nationalisations, liquidity and capital injections, and providing lending guarantees to banks. This was necessary as the financial sector lost its access to capital and funding. This means that in terms of ad hoc **macroeconomic** responses the market capitalist and managed capitalist countries are quite the same –government intervention– and are moving in the same direction. This is different for their ideas and **regulatory** demands on the European level. When it comes to permanent regulatory responses, the UK is less interested in more European regulations as this will further constrain the domestic policy-options and entire industries. The UK continues to prefer to keep government relations at arm's length. The Netherlands and Germany, on the other hand, support further integration as they realise that ongoing Europeanisation has increased the number of cross-border operations of financial institutions and will only increase in the future.

### *4.5 Norms, agencies, and change*

This brings us to the final point of this thesis: the concluding discussion of norms and agencies. In paragraph 1.2.1 it was discussed that norms are expressed in laws, policies, institutional structures and rules. The discussion on what changes norms suggests that change is either caused by crises external to the system (the breaking points), or is the product of gradual small changes over time. It was argued that Schmidt seems to support the former causes of the normative changes: the breaking points in history. As we have seen in paragraphs 4.2 and 4.3, all three countries investigated in this study implemented ad hoc macroeconomic responses to support the financial sector and the economy at large. Most of these policy choices were, however, only temporary. But this does not automatically mean that they did not cause any normative change.

The UK did not have any pre-existing norms in place to legitimise macroeconomic actions such as the nationalisations of banks. This had to be improvised by designing temporary regulations, which will be replaced later by permanent legislation. This proves the **breaking point** issue which was mentioned earlier in the discussion on the causes of normative change. An external crisis spilled-over to the British national system. This caused economic vulnerability and sufficient institutional capacity was found to make it possible to (part) nationalise companies for the first time in more than two decades. But this is at the same time the furthest the UK will go. The UK seems not very interested in regulatory policies at the European level as this will constrain their industries and their own policy-options too much.

The Netherlands and Germany, however, had already pre-existing norms in place which legitimised these macroeconomic actions. Instead, the managed capitalist countries decided to press at the European level for permanent regulatory responses to limit future risks in the financial sector. This is a symptom of their reliance on traditional patterns of public policy-making. The difference is that instead of expanding regulations on the national level, the managed capitalist countries turned to the European level to improve legislation. These member states will use their influence in the layering process of European norms, to transfer their own national norms to the European level and therefore to other member states. However, the Commission did not include the wishes of the managed capitalist countries as they preferred much more radical changes to the European banking policies.

This process in itself is a change of norms at the national level. Traditionally, the member states would have evaluated and adjusted their national policies. However, they have accepted and believe that a common European banking regulation is the solution. The European financial markets have gotten more and more dependent on each other as a result of continuing European integration. The member states realise that the legislation for this policy area is no longer sufficient to fulfil their needs and should therefore be adjusted. They argue that the EU is best equipped to harmonise rules and to provide the needed legislation.

The main reason member states' responses were dominated by ad hoc responses is that their macroeconomic and regulatory response options to the financial and economic crises were severely limited by European regulations. Therefore, the macroeconomic responses of the market capitalism countries were similar to those of the managed capitalism country. As already outlined in the introduction, the agency-structure debate argues that member states' interests are determined by already existing institutions, rules, and norms of both the national level and the European level. Ongoing European integration has an increasing influence on domestic policies which makes it more complicated for member states to make fundamental changes to these policy-areas. This is usually a time-consuming process of small, gradual policy changes. Ad hoc responses, as stated earlier, can be implemented on a fairly short notice because they require minimal adjustments of already existing legislation.

So, how can we explain the positions of $NL_5$, $Ger_{5,}$ and $UK_5$? What then, does drive national policies? If governments' policy choices and political preferences are constrained and shaped by existing EU institutions, rules and norms, and actors realise that particular policy-areas need to be reformed, it means that member states will have to press for policy changes at the European level. Only this way can permanent shifts in policy-making be achieved, which will then have to work through the domestic policies of the member states. But it is a lengthy and time-consuming process which runs through many layers to reach agreements at the European level. As a result, no fundamental shifts in policy-making or policy-styles at the European level can be observed in this time frame. The European level permanent policy changes are likely to be realised in the future which is a road with high hurdles to success. More European regulation means an increase of government interference in financial policy-areas, therefore the final positions of the Netherlands, Germany and the UK will move away from market capitalism and towards managed capitalism. This conclusion supports the first hypothesis:

> Hypothesis 1: European financial markets and banking regulation has become dominant in domestic policy-making which constrains the member states' policy-options. This will lead to ad hoc macroeconomic responses at the national level but, at the same time, will initiate fundamental regulatory changes in policies at the European level.

This hypothesis also makes clear why the second hypothesis proved incorrect. The increased demand for a common bank regulation as a consequence to this financial crisis is incompatible with a shift towards market capitalism as market capitalism is generally characterised by minimal state interference. The increasing layering of European public policies on domestic policies causes member states 'to go European' if changes are necessary in a specific policy-area. If the member state's policy-makers eventually succeed in convincing the Commission and other member states of the necessity to reform, it will lead to further integration. This financial crisis (the breaking point) has shown the economic vulnerability of the European member states. This has opened a window of opportunity for policy-makers to gather sufficient willingness of member states to change policies in the banking sector. The changes to the structure will then again have its influence on the domestic policies and will constrain the policy-options available to the member states.

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