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Estimating the size of the European stimulus packages for 2009 - An Update[1]

Briefing Paper for the Annual Meeting of the Committee on Economic and Monetary Affairs with the National Parliaments on 11-12 February 2009 at the European Parliament in Brussels

David Saha and Jakob von Weizsäcker[2]

Bruegel

1. Introduction

In December 2008, the European Council agreed on an EU-wide economic stimulus of "around € 200 billion". However, this agreement is not very specific in two important respects. First, it is unclear which country is to contribute how much to the roughly €170 billion part of the fiscal stimulus that is to be effected by member states, with the remaining €30 billion to be contributed at the EU level. Second, there is no clear timeline detailing which part of the stimulus is to be delivered by when. However, both the geography and the timing of the European stimulus are important dimensions when trying to assess the likely economic impact of the pact and the progress towards it implementation.

In order to contribute to the debate on the geography and timing of the stimulus, we presented a first estimate of the size of fiscal stimuli that had recently been proposed by member states (and had, in some cases, already been adopted) just in time for the European Council. The present update of that earlier paper simply presents the latest breakdown of the fiscal stimuli in member states using the same methodology as before. In addition, an heroic attempt is made to compare the total European package for 2009 to the stimulus packages set to be implemented in the US and China.

To keep the complexity of the EU side of the exercise manageable, we only take into account the 13 largest economies in the EU that make up more than 90 percent of the EU's GDP, plus the planned boost at the Community level. Despite this simplification, the task of estimating the size of the different programmes remains challenging, not least because of the great variety of different instruments used and the rapid evolution of national debates.

In the following section of this note, we present our main findings. The third section then explains the methodology underlying our results. Finally, the annex lists the country specific tables on which our assessment is based.

[1] An earlier version of these estimates was released just before the European Council in December 2008. The current estimates capture, to the best of our knowledge, the situation as of 28th January 2009.

[2] The excellent research assistance of Maite de Sola, Marco Cornia and Martin Kessler is gratefully acknowledged.

Main Findings

The estimates regarding the effective size of the active fiscal stimulus (beyond automatic stabilisers) are summarised in Table 1.

Table 1: Estimating the size of the stimulus package for 2009

	Tax cuts and fiscal expenditures		Extra credit & similar measures	
	€bn	**% of GDP**	**€bn**	**% of GDP**
Belgium	1.2	0.3%	2.1	0.6%
Denmark	0.0	0.0%	0.0	0.0%
Germany	35.8	1.4%	70.3	2.7%
Ireland	0.0	0.0%	0.0	0.0%
Greece	0.0	0.0%	23.0	0.9%
Spain	12.3	1.1%	54.3	4.9%
France	14.3	0.7%	41.5	2.1%
Italy	-0.3	0.0%	0.0	0.0%
Netherlands	3.2	0.5%	0.0	0.0%
Austria	3.9	1.3%	2.5	0.9%
Poland	1.5	0.5%	4.9	1.6%
Sweden	1.1	0.4%	9.0	3.0%
United Kingdom	16.5	1.0%	22.1	1.4%
13 Largest EU countries	**89.7**	**0.78%**	**229.7**	**2.0%**
Imputed EU-27 total	**103.0**	**0.78%**	**263.8**	**2.0%**
European Commission	**9.3**	**0.07%**	**15.5**	**0.1%**
Imputed Grand Total	**112.3**	**0.85%**	**279.3**	**2.1%**

In our evaluations, fiscal stimuli delivered in the form of tax cuts or expenditure increases are treated separately from the government-sponsored provision of extra credit to producers and consumers, or economically similar measures.

The most important reason for this is that one euro of subsidised credit is typically substantially less than the fiscal equivalent of one euro. In normal times, it only amounts to the amount of credit provided multiplied by the difference between the subsidised and the relevant market interest rates. Clearly, this approach is not readily applicable in times of liquidity restrictions and we recognise that government-sponsored credit can contribute to supporting private spending. However, the two categories of stimuli are essentially not - or at least not directly - commensurate, and it is problematic that the public discussion nevertheless often treats them as such.

Clearly, the contributions to the European stimulus vary substantially by country. According to our estimates, the classic fiscal stimulus is greatest as a percentage of GDP in Germany, which is due to the sizeable second stimulus package that the German government tabled in January 2009. At the other extreme, Italy appears to be engaging in marginal fiscal consolidation in response to the crisis, thereby reducing the effect of the automatic stabilisers. Spain is most active when it comes to the provision of additional credit and similar measures, which is to some extent related to its real-estate bubble bursting just before the global financial crisis hit. Overall, the size of the plans in the two categories, fiscal spending and credit provision, is not closely correlated. Greece, for example, is only active in the latter category.

The weighted average of the classic fiscal stimulus over the 13 countries reaches 0.78 percent of GDP. Assuming that the 14 small member states not covered in this note deliver a stimulus of the same proportion of GDP as the 13 larger member states, this can be taken to be the size of the national stimuli as a proportion of the EU's total GDP. Adding the 0.07 percent contribution of the European Community, the total fiscal boost is estimated to reach 0.85 percent of the EU's GDP. This would still appear to be substantially below the target of the Commission proposal that member states should strive to reach 1.2 percent of GDP.

However, compared to the December version of our estimates for the EU, there has been a marked increase in the size of the EU stimulus mostly due to the introduction of the second stimulus package in Germany with total volume just shy of €50 billion, almost half of which is to be delivered in 2009. As a result, the estimated size of the European stimulus packages has increased by about 0.2 percentage points of the EU's GDP. Similarly, there has been a marked increase in the total credit guarantees and similar measures granted as a result of the second German package.

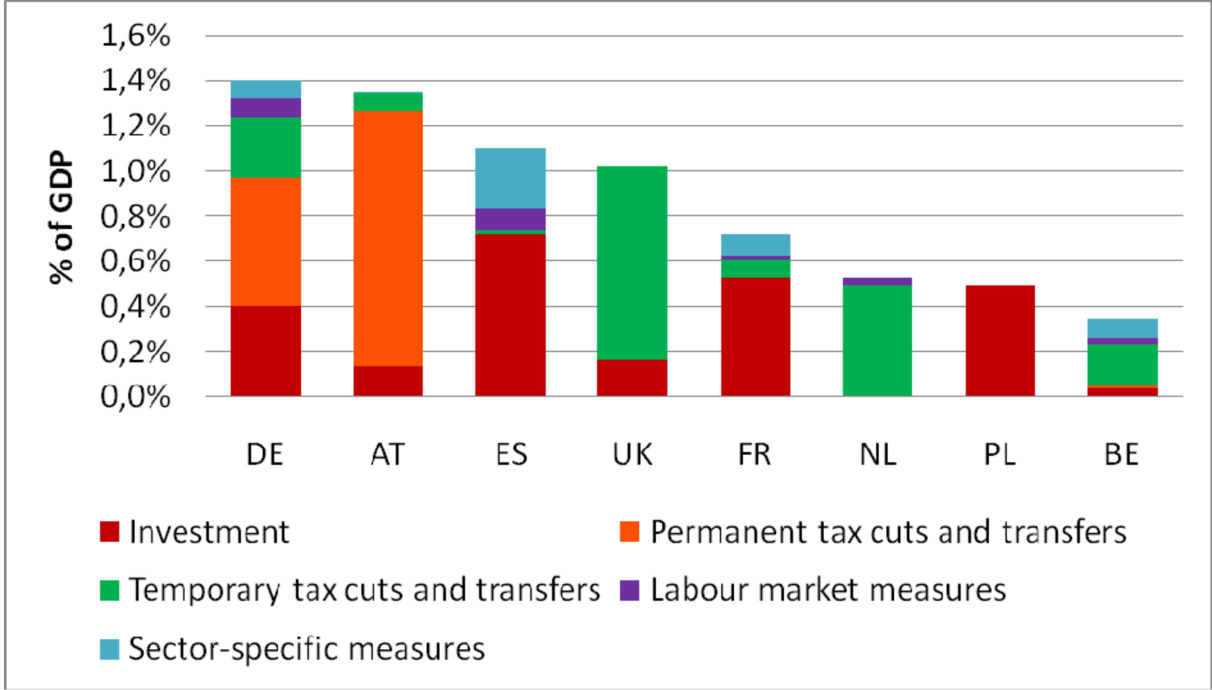
When comparing our estimates to the target set by the European Council, two things should be noted. First, the European Council's target allows countries to count towards the total size of the stimulus measures that would only become effective well after our cut-off point of end 2009. Second, by counting government-sponsored credit provision and economically similar measures towards the overall size of the package, the 1.2 percent of GDP target agreed by the European Council would be within easy reach even by the end of 2009. Similarly, it is clear that the target of 0.3 percent of GDP for Community level activity is nominally within reach based on the current proposals.

However, declaring victory on the European stimulus package by simply adding extra credit provision to the direct fiscal stimulus would be questionable on economic grounds. Our findings suggest that it is essential to look beyond that headline figures. It should be recognised that the likely real impact on aggregate demand in the near future may well be more limited than suggested by the headline figures.

Composition of Stimulus Packages

The stimulus packages across the EU not only vary substantially in size but also in composition. Figure 1 summarises these differences in composition for the eight largest stimulus packages.

Figure 1: Break-down of select EU stimulus packages by spending category



There is no clearly discernible pattern. At the one extreme, countries like Poland, the Netherlands and the UK only use one or two spending categories to deliver their stimulus. By contrast, Germany, with its large stimulus package, has decided to rely on all spending categories. One likely explanation for this great variance in composition are different starting conditions. For example, there may be countries where public infrastructure is acutely lacking so that investment projects enjoy widespread political support, whereas in others there are issues in the tax system that are waiting to be dealt with as part of a stimulus package.

An international comparison

Another interesting question is how the aggregate stimulus package in the EU compares to other large packages, not least in view of the impact on global aggregate demand. While truly global coverage is beyond the scope of this exercise, we have attempted to compile estimates of the stimulus packages in the US and China for 2009. Table 2 provides a comparison of these packages with the European stimulus.

Table 2: Comparison of EU, US and China stimulus packages for 2009[3]

	€bn	% of GDP
EU	112.5	0.9%
USA	199.6	1.8%
China	233.1	7.1%

While some questions regarding the Chinese data remain, it is nevertheless striking how China's stimulus package stands out as by far the largest as a percentage of GDP. There are at least two important reasons for this. First, investment makes up almost half of Chinese GDP, and since investment usually follows the economic cycle, the Chinese government is concerned that the current slowdown could lead to severe disruptions both economically and socially. Second, China has a large capacity for deficit spending given its low stock of government debt. The planned US package, as approved by the House of Representatives, is twice as large as the European package, occupying a middle ground between the EU and Chinese packages. However, in the US context where increases in government spending in particular were always difficult to enact, it would be a major victory of the incoming Obama administration if this package, which contains plans for substantial spending increases, makes it through the Senate in particular.

2. Methodology

The estimates we produce are based on publicly available information at the time of writing. Government announcements regarding planned fiscal measures are counted towards the estimates only to the extent that they have provided a break-down of the total amount announced into concrete individual measures.

Qualifying criteria

Legislative or administrative measures are included in our estimates if:

- they were adopted after 1st September 2008 or
- they had not yet been adopted but their adoption is highly probable.

Furthermore, the effects of such measures are only included to the extent that they were expected to occur between September 2008 and end 2009. All such effects are grouped under one of the following headings:

[3] Table 2 only includes tax cuts and extra spending. Due to methodological issues, credit provision and related measures were excluded from the comparison. It is also worth noting that the US and China plan major expenditures for 2010 and beyond which are not included as they are set to become effective after the end of 2009 .

- *additional spending disbursed*
- *foregone tax revenue* and
- *extra credit and economically similar measures*

Measures intended to (fully or partly) refinance the stimulus are counted negatively to the extent that they become active before the end of 2009. Expenditures brought forward to that period that were planned for 2010 or beyond are also counted, whereas changes in cash-flow within the period under consideration (between September 2008 and end 2009) are regarded as neutral. Early payments of individually defined government liabilities or subsidies are the economic equivalent of government sponsored provision of credit and are only counted as such.

Additional spending (on and off budget) and foregone tax revenues are treated as commensurate. One of the difficulties with planned off-budget increases in investment (such as in state-owned enterprises) is that it is difficult to ascertain whether these investments are in fact additional or were already planned anyway. However, to the extent we lack information here we give the announced plans the benefit of the doubt.

Additional credit volume and economically similar measures such as changes in the timing of payments are listed separately.

For the sake of simplicity, we also exclude mere reallocations within budget positions, even if they are likely to have marginal effects on consumption or investment.

Calculation of effects

For the quantification of tax cuts, only the mechanical effect of the tax cuts are considered, excluding changes in tax revenues resulting from changes in the behaviour of individuals and firms. We thereby avoid having to make contentious assumptions about agents' behaviour during crises.

For the calculation of additional credit volume, measures at the core of the financial sector rescue packages including the recapitalisation of banks, the buying-up of problematic assets from banks and the guarantee of credits between banks are excluded. Also excluded are measures proposed by government where government does not have proper legislative control over the actors that are to carry out the measures, eg the proposals by some member states involving EIB actions.

Amounts are entered as billions of euros or billions of national currency units.

Annex: Member state and community-level breakdown

Belgium

The Belgian stimulus was announced on 11th of December.

	€bn	% of GDP
Additional fiscal spending:	1.24	0.35%
Additional credit + similar measures	2.13	0.60%

Category	Measure	Net amount (€bn)
Tax cuts	Measures for construction sector[4]	0.30
	No tax on credit insurance	0.02
Extra spending	Higher unemployment pay[5]	0.10
	Energy subsidy to households[6]	0.14
	Higher social security allocations[7]	0.51
	Investments into green technology	0.02
	Larger fund for energy cost reduction[8]	0.01
	Accelerated public investments	0.12
	Lower cost of using food safety agency[9]	0.03
Extra credit + similar measures[10]	Participation funds (for SME credit)[11]	0.30
	Measures for companies facing liquidity problems[12]	0.44
	Lower tax retention[13]	0.23
	Amount of tax retention to be kept at company	0.04
	Indexation of taxes taken into account in tax retention	1.12

Denmark

No package according to our criteria (but budgetary expansion of 0.4% of GDP already decided in 2007 comprised of higher EITC and higher threshold for the middle income tax bracket). Stimulus-related measures may be announced in February according to current information.

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[4] Largely VAT cuts for construction work.
[5] Temporary measure for 2009 only.
[6] Each Belgian household shall receive an energy voucher over €30.
[7] Contains the "welfare envelope" and additional welfare measures taken in the 2009 budget.
[8] This figure represents the budgeted costs for enlarging the fund.
[9] Lower fees to be charged to industry clients.
[10] More access to financing instruments for export, import and investment risks is also planned through the "Ducroire", but no additional budget or credit impact is quantified since existing resources are to be better utilised.
[11] New product "INITIO" largely designed to offer credit to SMEs.
[12] Consists of measures to allow later payment of bills and of debts to the government.
[13] These last three measures apply to tax retention only, not to the final amount of taxes paid by firms and are thus the economic equivalent of an interest-free loan.

Germany

	€bn	% of GDP
Additional fiscal spending:	35.83	1.40%
Additional credit + similar measures	70.30	2.74%

Category	Measure	Net amount (€bn)
Tax cuts[14]	Degressive depreciation deduction	1.94
	Higher tax-free allowances for companies	0.24
	Suspension of car tax on new vehicles[15]	0.44
	Tax deductibility of professional commute [16]	5.00
	Package for tax burden reduction, stabilisation of social security contributions and investment in families[17]	6.00
	Income tax cut[18]	2.90
	Reduction in health insurance contributions[19]	3.00
	State payment of 50% social insurance for short-time workers	1.25
	Reform of car tax[20]	0.17
Extra spending	Investments into transport infrastructure[21]	1.00
	Longer eligibility for short-time compensation	022
	Improvement of regional economic structure[23]	0.20
	Infrastructure investment programme[24]	8.65
	Innovation support programme	0.45
	Retraining and stronger job service	0.95
	Increased child benefits[25]	2.15
	Premium for new car purchases[26]	1.50

[14] The deductibility of construction work from the personal income tax will only have fiscal effects in 2010 and thereafter.
[15] This includes an extended car tax holiday for cars fulfilling strict ecological criteria.
[16] "Pendlerpauschale" was reintroduced, valid retroactively from 2007, by a constitutional court ruling. Since the Federal Ministry has announced it will not re-finance these expenditures, these payments work as a stimulus. Only repayments for the years 2007 and 2008 are considered here since the 2009 deduction will only be paid out in 2010.
[17] Mainly higher childcare benefits, tax deductions based on the number of children and lower employee contributions to unemployment insurance. The total amount is in effect a mix of cuts in taxes and social security contributions and additional spending.
[18] Takes effect on July 1st, 2009. Consists principally of a higher standard deduction and lower bottom rate.
[19] Takes effect on July 1st, 2009. Benefits both employers and employees equally.
[20] Only administration costs are budgeted so far
[21] Acceleration ofplanned projects already in the pipeline.
[22] Costs of this measure remain unclear, not least due to interactions with other social insurance systems, but will only to a very limited extent fall into 2009.
[23] Of which €100 million are paid in cash and another €100 million in commitment authorisations.
[24] Total volume of €17.3 bn allotted for 2009-2010. The German government maintains that at least 50% of this sum will be spent in 2009.
[25] Consists of a one-off lump-sum payment to all families eligible for child benefits plus higher child care components of social security benefits
[26] The premium is paid conditional on buying an energy-efficient car and selling an old car for demolition.

Category	Measure	Net amount (€bn)
Extra credit + similar measures	CO2-friendly renovations of houses	2.80
	Additional credit for SMEs	15.00
	Credit for infrastructure investment by municipalities in structurally disadvantaged regions	1.50
	Corporate innovation and energy efficiency credit	1.00
	Additional guarantees and credit lines for larger enterprises[27]	50.00

Ireland

Ireland is planning a neutral cyclically adjusted budget: Automatic stabilisers will be allowed to work, but no further anti-cyclical fiscal policies will be enacted.

Greece

	€bn	% of GDP
Additional fiscal spending:	0.00	0.00%
Additional credit + similar measures	23.00	0.89%

Category	Measure	Net amount (€bn)
Additional credit + similar measures	Special government bond issue to supply SME credits and mortgage loans[28]	8.00
	Loan guarantees	15.00

Spain

	€bn	% of GDP
Additional fiscal spending:	12.31	1.10%
Additional credit + similar measures	54.28	4.86%

[27] We assume that a maximum 50% of the €100 bn total volume will be used in 2009

[28] Although this will show up in the budget as government deficit, its effect is to provide extra credit at low interest rates.

Category	Measure	Net amount (€bn)
Tax cuts	Longer tax-exemption of saving accounts for housing purchases even if no house is bought	0.03
	Extended eligibility for tax deductions when selling houses	0.10
	Reduction in employer social contributions for hiring previously unemployed workers	0.08
Extra spending	Employment Plan[29]	1.10
	Public Investment Fund[30]	8.00
	Sector specific support[31]	3.00
Extra credit + similar measures	Option to temporarily halve mortgage repayments[32]	2.50
	Credit for enterprises and families[33]	42.00
	Deductions for low-income families[34]	2.00
	Early payment of unemployment benefits[35]	0.08
	Up front tax deduction for housing[36]	1.70
	Earlier repayment of VAT reclaims	6.00

France

	€bn	% of GDP
Additional fiscal spending:	14.30	0.72%
Additional credit + similar measures	41.45	2.08%

[29] Yet undefined plan to be comprised of active labour market measures and temporary employment schemes.
[30] Allocated to municipalities for subcontracting public works.
[31] Although officially called sector-specific, this package contains both sector specific and cross-sector support. €800 million earmarked to support the car industry, remainder to be spent on environment (€600 million), research and innovation (€500 million), a new care component of the welfare state (€400 million), housing renovations and sustainable tourism
[32] This measure allows homeowners in economic hardship only to pay half of their mortgage instalments for two years, effectively an option to restructure mortgage debt to allow slower repayment.
[33] Provided by the government-owned ICO bank (Instituto de Crédito Oficial). 7 bn were already made available in 2008.
[34] Timing change: rather than being repaid at a later moment in time as previously practised, the deductions will now be applied before the initial tax payment.
[35] Economic equivalent of an interest free loan.
[36] Economic equivalent of an interest free loan.

Category	Measure	Net amount (€bn)
Tax cuts[37]	Reduced obligation to contribute to social insurance conditional on new hiring, for very small firms	0.70
Extra spending	Direct public investment (government and local government)[38]	6.50
	Sectoral subsidies: housing industry, subsidies to building, renovation, buyers and renters.	1.20
	Sectoral subsidies: car industry	0.60
	Increased payment to the endowment for the basic income provision[39]	0.80
	Employment policies	0.50
	State-owned enterprises investment	4.00
Extra credit + similar measures	Credit for PPP projects[40]	8.00
	Loans and guaranteed loans to SMEs	22.00
	Loans to social housing construction	4.50
	Faster implementation of research tax credit and profit tax reimbursement[41]	5.60
	Change of VAT reimbursement mechanism[42]	3.60
	Higher down-payments on public procurement projects[43]	1.00

In the absence of further information, the planned additional investments by state owned enterprises are assumed to be in addition to existing investment plans.

[37] A further measure of changing the accounting rules for capital depreciation will only lead to budgetary effects in later years.
[38] Most of these investments were originally planned for after 2010 and are now overwhelmingly to take place in 2009.
[39] 'Revenu de solidarité active'
[40] We expect 50% of the total volume of €16 bn for 2009-2010 to be implemented in 2009.
[41] Economic equivalent of an interest free loan.
[42] Economic equivalent of an interest free loan.
[43] Economic equivalent of an interest free loan.

Italy

	€bn	% of GDP
Additional fiscal spending:	-0.26	-0.02%
Additional credit + similar measures	0.00	0.00%

Category	Measure	Net amount (€bn)
Tax cuts	No increase of highway toll	0.09
	Tax cut for productivity bonuses[44]	0.46
	Deductibility of corporate tax from regional corporate tax	1.19
	Deferred VAT payments[45]	0.19
	Municipal infrastructure investment	0.00
	Voluntary revision of company book values[46]	-2.76
	More tax inspections	-1.88
	Tax inspections of private associations	-0.15
	Increased taxation of TV services	-0.47
Extra spending	Spending on low income families	2.40
	Aid to house mortgages	0.35
	Unemployment benefits	0.10
	Financing of strategic infrastructure	0.06
	Increased tax revenue costs	0.05
	Renewal of school cleaning contracts	0.11

[44] Less income tax paid on bonuses based on productivity criteria.
[45] Loss of revenue from later payment of VAT by companies will lead to a marginal tax revenue losses as some firms will have gone bankrupt before paying up their tax liabilities.
[46] Presumably in response to intensified enforcement efforts.

Netherlands

	€bn	% of GDP
Additional fiscal spending:	3.20	0.53%
Additional credit + similar measures	0.00	0.00%

The total size of the Dutch package has been quantified as €6 bn, 1% of GDP. Since other proposed measures such as the accelerated payment of public sector bills and active labour market policies have not been allocated money yet, we cannot take these into account.

Category	Measure	Net amount (€bn)
Tax cuts	Accelerated depreciation of investments	1.10
	Tax cuts for SMEs	2.00
Extra spending	Unemployment benefits (working hours reduction)	0.20

Austria[47]

	€bn	% of GDP
Additional fiscal spending:	3.93	1.35%
Additional credit + similar measures	2.50	0.86%

[47] We include measures agreed on by the new government but not yet formally adopted by parliament.

Category	Measure	Net amount (€bn)
Tax cuts	Early implementation of income tax reform	2.20
	Degressive depreciation deduction	0.23
	Reduced VAT rate on medication	0.28
	Tax exemptions	0.14
	Burden reduction for families with children[48]	0.50
Additional Spending	Regional employment initiatives[49]	0.08
	Spending package, September 2008[50]	0.40
	Additional research expenditure[51]	0.05
	Mandatory kindergarten year for all	0.07
	Energy saving cheques[52]	0.10
	Investment in public facilities[53]	0.02
	Advancing of railroad investments	0.01
	Subsidies to house saving scheme	0.02
	Investments into broad-band internet infrastructure	0.01
	"Mittelstandsfonds" - venture capital fund for SMEs	0.08
Extra credit + similar measures	additional erp credits	0.20
	credit guarantees for SMEs	0.40

[48] Contains different forms of tax deductions for families with children.
[49] Supporting corporate investments with employment effect and continuing education measures.
[50] Consists of abolition of university tuition fees, increase of care benefits and pensions and extension of business internationalisation support
[51] To be spent directly on programmes and projects.
[52] Incentive programme for households to engage in energy-saving investments.
[53] investments into buildings and other real estate owned by the BIG, the state-owned real estate group.

Poland

	PLN bn	% of GDP
Additional fiscal spending[54]:	6.80	0.49%
Additional credit + similar measures	21.50	1.56%

Category	Measure	Net amount (PLN bn)
Extra spending	Increased co-financing of EU structural funds projects	6.80
Extra credit + similar measures	New SME credit line	20.00
	Investment in renewable energy from national fund for environmental protection	1.50

Sweden

	SEK bn	% of GDP
Additional fiscal spending:	12.13	0.38%
Additional credit + similar measures	95.46	3.01%

Category	Measure	Net amount (SEK bn)
Tax cuts	Tax deduction for house renovations, conversions, maintenance	3.60
Extra spending	Increased employment service (active labour market policy)	4.70
	More vocational education	0.50
	R&D in automotive sector	3.00
	Additional infrastructure investment	0.33
Extra credit + similar measures	Higher export credit guarantees[55]	75.00
	Deferment of tax payments by companies	0.46
	Credit guarantees for car sector	20.00

[54] Other components of the Polish stimulus plan as published by the Polish government are not included here since they were already part of the budget, ie decided before our cut-off date 1st September 2008 (income tax and VAT reforms). PLN 40 billion in guarantees of bank liabilities are part of a financial sector bailout and thus also not considered here.
[55] An increase in the ceiling for export guarantees by SEK 150 bn was approved. We assume only 50% of that additional volume will be used in 2009.

United Kingdom

	GBP bn	% of GDP
Additional fiscal spending[56]:	14.90	1.01%
Additional + similar measures	0.00	0.00%

Category	Measure	Net amount (GBP bn)
Tax cuts/increases	VAT cut[57]	12.50
Extra spending	Accelerated capital expenditure[58]	2.40
	Mortgage rescue and support for Mortgage Interest Schemes for eligible homeowners in difficulty[59]	0.00
Extra credit + similar measures	Credit guarantee programme[60]	20.00

Community level

	€bn	% of GDP
Additional fiscal spending:	9.30	0.07%
Additional credit + similar measures	15.500	0.12%

[56] A new top rate of 45% of the personal income tax much discussed recently will only be introduced in 2011.
[57] Cut from the previous standard rate of 17.5% to the European minimum standard rate of 15% until end 2009.
[58] GBP 3 bn shall be brought forward for spending during the 2008-2009 and 2009-2010 fiscal years. Our figure assumes a start of spending in January 2009 and uniform distribution of spending until March 2010, thus yielding GBP 2.4 bn of spending during the 2009 calendar year.
[59] Has not been quantified yet.
[60] Only the GBP 20 bn of additional credit guarantees approved on 14th of January 2009 qualify as additional credit, whereas the numerous measures taken on 19th of January we classified as bank bailouts and thus did not include.

Category	Measure	Net amount (€bn)
Extra spending	ESF spending forwarding	1.80
	Plan to spend budget reserves on energy and internet infrastructure[61]	2.50
	Forward structural funds spending	4.50
	Accelerated call for trans-european transport projects (TEN-T)	0.50
Additional credit + similar measures	Additional EIB loans to SMEs and Mid-caps	3.50
	EIB convergence lending	2.50
	EIB flexibility reserve	3.00
	Climate change financing by EIB	6.00
	EBRD additional credit for green and infrastructure investment	0.50

[61] €5bn in 2009-2010. We assume 50% of the spending to occur in 2009.

US

	$ bn	% of GDP
Additional fiscal spending:	258.56[62]	1.80%

The US stimulus package, as passed by the House of Representatives in the American Recovery and Reinvestment Act has a total volume of $825 bn. Consistent with our general methodology, we only take into account the effect of spending and tax cuts in 2009. For this purpose, we make use of the expenditure profile of the stimulus calculated by the Congressional Budget Office[63], which estimates about $ 260 bn to be spent in 2009, the package's effect to be concentrated on the period of 2009-2011 and having significant fiscal effect until as late as 2015.

Below, we also present a breakdown of the $550 bn expenditure part of the total package (the other $ 275 bn coming in the form of tax cuts). Due to lack of information on the spending profile of the single expenditure items, we are unable to present this breakdown disaggregated by years and thus only present total expenditure by main topic.

Category	Measure	Net amount ($ bn)
Tax cuts	Tax cuts	109.33
Extra spending	Spending package	149.25

[62] Due to the difference between US fiscal years and the calendar years, we adjusted the figure accordingly.
[63] *Cost estimate of H.R.1 American Recovery and Reinvestment Act*, Congressional Budget Office, 2009

Main components of spending package, all years

Category	Item	$ bn
Education	Relief to states to prevent cutbacks to services	79.0
	Relief to school districts	41.0
	Pell grants	15.6
	Higher education modernisation	6.0
	Sub-total	**141.6**
Infrastructure	Highway construction	30.0
	Infrastructure modernisation	31.0
	Clean water, flood control, and environmental restoration Investments	19.0
	Transit and rail systems	10.0
	Sub-total	**90.0**
Healthcare	Temporary increase in Medicaid matching rate	87.0
	Health information technology	20.0
	Preventive care	4.1
	Sub-total	**111.1**
Welfare/unemployment	Unemployment benefits and job training	43.0
	Health insurance and medicaid	39.0
	Food stamps	20.0
	Sub-total	**102.0**
Energy	Smart grid	32.0
	Renewable energy tax cuts	20.0
	Weatherproofing of modest-income homes	6.0
	Sub-total	**58.0**
Federal motor fleet	Buying energy-efficient cars.	0.6
	Sub-total	**0.6**
Other measures	**Sub-total**	**46.7**

Grand total	**550.0**

People's Republic of China

	RMB BN	% of GDP
Additional fiscal spending[64]:	2,065.00	7.09%
Additional credit + similar measures	0.00	0.00%

Due to the very limited availability of authoritative data on the Chinese economic stimulus, these numbers must be seen as a reasonable scenario, not as a definitive assessment of the Chinese stimulus. In particular the spending profile of the main RMB 4 tr stimulus is unclear. There are also questions regarding the relation between the 'main stimulus', sectoral support plans and the VAT cut that we were unable to answer definitively. We interpret the latter as being additional to the main stimulus, which is the likeliest interpretation given present information.

Category	Measure	RMB bn
Tax cuts	VAT cut[65]	60.00
Extra spending[66]	Car sector support[67]	5.00
	Main stimulus package[68]	2000.00

Components of the main stimulus package, 2009-2010

Type	amount, RMB bn
Affordable housing	280
Rural infrastructure and housing	370
Healthcare, education and culture	40
Bio conservation and environmental protection	350
Post-disaster reconstruction	1000
Transport infrastructure (rail, road, airports)	1800
Technical innovation, industrial restructuring	160

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[65] The fiscal effect of the VAT cut has been quantified as RMB 120 bn over 2009 and 2010, we assume 50% of it accrues in 2009.

[66] More sectoral support plans are likely to be announced during the year. The effect of an already adopted plan for the real-estate sector has not yet been quantified.

[67] RMB 15 bn in subsidies for technological research and modernisation of agricultural machinery over 3 years. The effect of halving the sales tax on small cars has not been quantified to date.

[68] We assume that the stimulus spending will be uniformly distributed over 2009 and 2010, the official timeline given for this stimulus.

Banking Rescue and Economic Recovery Plans in the EU

Briefing Paper for the Annual Meeting of the Committee on Economic and Monetary Affairs with the National Parliaments on 11-12 February 2009 at the European Parliament in Brussels

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Introduction

The present financial crisis is becoming increasingly more serious than previously expected. It has triggered a credit squeeze and a credit crunch, larger financial and real estate wealth losses and further drops of confidence among investors, evolving into a major economic contraction of private demand not seen since the Great Depression. The IMF has just reduced the Euro Area growth forecast for 2009, from 0.5% in October 2008 to -2% in January and, for 2010, from 0.9% in October to 0.2% now. The IMF estimates for growth of world's GDP have fallen from 3.2% in October to 0.5% now.

Therefore, the economic policy response needs to be very broad in terms of institutions, policies, instruments and targets, must be coordinated globally and must involved central banks and national government fiscal authorities but also lower government layers such as regions and municipalities as well as civil society: industry associations, trade unions and NGOS.

The first economic policy reaction has been to try to avoid banks and other financial institutions going illiquid and, later on, to avoid becoming insolvent. Central banks have been dealing mainly with liquidity problems and Treasuries mainly with insolvency issues. Nevertheless, investors seem to be still thinking that many banking systems may effectively be insolvent, given that most banking shares continue to fall, so that the initial "credit squeeze" (increase in the cost of credit) is now also becoming a generalised "credit crunch" (reduction in the volume of credit) producing a further fall in private demand for consumption and investment.

The second economic policy reaction has aimed to soften this fast and deep slowdown in private demand by introducing fiscal stimuli packages. The main issue is that, paradoxically, these national fiscal packages have not been coordinated enough within the EU, in spite of the large spill-overs among member states which are to be produced in a highly integrated area with a single market as well as a single currency in many of its members. This lack of coordination is affecting their effectiveness and also creating a further loss of confidence among citizens and investors.

I am going to try to deal with the main general policy issues relating to both banking rescues and fiscal packages and then refer to the case of Spain as an example.

Bank Rescue Packages

Bank rescues should be only be related to nationalising or recapitalising banks to avoid or prevent them going bankrupt, that is, only to issues of solvency. Buying their distressed assets should be considered as helping both their liquidity and their solvency. Finally, government guaranties for banking debt issues could be more related to liquidity than to solvency issues.

Since the beginning of the financial crisis, banks have written down around $800 billion and have raised capital for a slightly higher figure, given that governments have contributed with around $380 billion to recapitalising or nationalising banks of which around $210 billion in the US alone. Citigroup has received $65 billion, Bank of America $45 billion, JP Morgan $25 billion, Wells Fargo $25 billion, US Bancorp $10 billion, Morgan Stanley and Goldman Sachs $10 billion each and other US banks $10 billion.

In Europe, the amounts have been smaller, around $170 billion. The UK has injected $49 billion, Germany $39 billion, Netherlands $36billion, Belgium $13 billion, Denmark, $7.2 billion, Ireland, $7 billion, Switzerland $6 billion, France $4 billion and Luxembourg $3.9 billion.

The main issue with banking rescues is how to implement them. First, they must be fair, in the sense that shareholders and top executives have to pay a price for driving or allowing the bank to get to such a situation. Second, they must be the same or very similar for all banks to lay down a level plain field and to avoid creating unfair competition in the market. Third they must be prudent given that they are made with tax payer's money.

For instance, the US rescue experience has not been a very good example of these principles, probably because they have been done at the last minute. The rescue of Bearn Stearns punished only common shareholders, the rescue of Fannie and Freddy punished both common and preference shareholders, in the bankruptcy of Lehman Brothers everybody lost their money, in the bail out of AIG only common shareholders suffered and only in the case of Washington Mutual both shareholders and senior debt holders were wipe out.

Nevertheless I have to recognise that US bailouts had to be done at great speed and that the Treasury and the FED have shown that they can act together in a record time and with a large degree of coordination. For instance, in the case of Bearn Stearns they were told by its CEO on a Friday evening that the next Monday the bank would default. In such a short period of time, both were able to find a buyer and to put $30 billion to buy its worst assets to make the sale possible. I mention this because this speed of reaction and degree of coordination would be almost impossible if any large European international bank would need a bail out, given that many member states and some central banks would have to act together and it would be very difficult to achieve such a level of coordination and speed.

In retrospect, to let Lehman go bankrupt has proved to be the biggest and most expensive mistake made by the US monetary and fiscal authorities. Being much larger than Bearn Stearns, after its default, all investors were made to believe that no bank would be "too big to fall" and decided to sell their shares or to "short them" in the rest of investment banks as well as in some large commercial banks, both in the US and in Europe, creating a panic in the equity and debt markets, a dislocation in the inter bank markets which spreads increased and in the exchange rate markets where the dollar shoot up by becoming the key world refuge currency.

The case of Northern Rock in the UK was another unfortunate case, where the FSA, the Bank of England and the UK Treasury could not get to act together at the right time, provoking a coordination failure which ended by depositor's cueing up at the branches of the bank to get back their deposits and by a straight nationalisation of the bank, when it have had earlier a couple of private buyers that were asking for just some financial help.

Bank rescue experiences have been very expensive, oscillating between 5 and 15 per cent of GDP, given the large and huge number of banking crises which have preceded the present one. Most of them included a piece meal approach, consisting in some of the following systems: buying distressed assets, recapitalising, separating the bad from the good bank, managing the bad bank or in some cases, straightforward nationalisation. In the present crisis the main novelty has been government guaranties to bank debt issuance.

In the US, the Tarp was designed to buy distressed assets from the banks themselves or from their off-balance sheet investment vehicles but, nevertheless, eventually it was used to recapitalise banks, to guaranty their debt issuance and finally, to absorb their bad assets. In the UK and in the Euro Area, the same two systems have been used, but there have also been straight nationalizations and more recently, the possibility to insure banks against future losses. All these rescue forms show some pros and cons.

The main problem with buying toxic assets, either by a government fund or a new bad bank, is how to value them. If the fund or bad bank pays above their implicit value it puts at risk the tax payers. If it pays their market value, it can make a profit maintaining the asset until maturity, but it does not help the bank much. Thus, a price between the two should be paid, which is not so easy to agree on. In principle, the fund or bad bank can pay more for the assets than a private buyer of distressed assets, because its cost of funds is much lower or even irrelevant, but it cannot do so entirely using tax payers money because it would become a bailing out the bank's private top executives and shareholders who made the mistakes or allow them to make them, in the first instance.

The issue with recapitalising banks is that, if their board members and executives are kept managing the banks, the government will find extremely difficult to know how much toxic assets the banks are holding in their balance sheets or off balance sheets and what is their relative level of quality. Therefore, as it has happened in the US, after recapitalising all banks with preferred shares and no representation in the board or the executive committee, some of these have shown much bigger losses and write-downs than the Treasury was told when injecting capital on to them, being forced eventually to put in additional capital. For instance, the US Treasury has finally been forced to absorb most of the expected losses of the $300 billion of distressed assets at Citigroup and of the $118 billion at Bank of America.

To create a bad bank, owned by the government, to manage all distressed assets from banks has proved to be more efficient. In the US Savings and Loan crisis, in the early 1990s, it was done through the Resolution Trust Corporation, and this institution was able to recover a high percentage after several years. In Spain, in the 1978-83 banking crisis, the Deposit Guaranty Fund (DGF), absorbed and managed bad bank assets for about 6 per cent of GDP, but its cost was shared by private banks which contributed to the DGF with 1 per cent of GDP. Every insolvent bank was put under the management of another clean and solvent surviving private bank, with some help from the DGF. Overall, a stronger banking system emerged as a result of having new owners, new boards, new managers and new regulation.

A similar system was used in the banking crisis in Sweden, were banks were split into two: the good and the bad bank. Shareholders lost everything because their shares were accounted to the bad bank. The good banks were nationalised with a new management appointed by the government and, after a few years, were sold and re-privatised.

The government kept managing the bad bank by restructuring and selling its assets and finally recovering a large part of the tax payers' money, after some years.

The US seems now to be ready to do the same through an "aggregator bank", which is going to buy the bad assets at a "fair price" (?) but, as without these government purchases, banks will become insolvent, it will have to pay a price for the assets which needs to be higher than that offered by private buyers which is again similar to bailing out private shareholders with tax-payers money.

Nationalisation, which seems to be the speedier and probably more efficient way to solve a generalised insolvency in the banking system, does pose several potential problems as well. One is that nationalization can be totally rejected by many politicians, as well as voters, who prefer other forms of bank rescue. The US could be a case in point given its long tradition of freedom to act but also to fail. Another is that of creating unfair competition for deposits between nationalised banks and private banks which did not need to be nationalised. A third one is that, for mere political reasons, the nationalised bank (with tax payer's money) can be used to lend to companies or sectors not solvent enough. A fourth one is that if not done correctly and efficiently it can become very expensive for tax payers. Finally, given the seriousness of this crisis, it could take more years than usual to get the banks back into solvency and sell them.

Finally, it is worth reminding here that the main reason why the Europe imported the crisis, in the first instance, from the US has been a lack of proper banking supervision by the European authorities. Banks have been allowed by some European supervisors to create huge off balance sheet conduits and SIV with almost no capital, to get rid of some balance sheet assets, in order to not only make room for more loans but mainly to invest in long term high yielding assets by financing them in the short term commercial paper market using the assets as collateral. A lot of the US toxic securitised assets were bought this way.

Not all European supervisors were so lax with their banks. Those which did not allow their banks to do so have been, almost all, central banks. By contrast, those which did allow them to do so were not central banks but government agencies (Germany, Belgium, Switzerland etc) or independent agencies (FSA). The only exception is The Netherlands, which being a central bank did allow its banks to do it.

After this important lesson, it would be convenient to change the European Supervisory System and switch to central banks all supervision, once it has been proven that central banks do a much better job in banking supervision than any other alternative. The reason why they do better is because they know banks better, because they deal with them everyday, they have superior information about them and their incentives are more aligned with supervision since they are their lender of last resort.

Fiscal Recovery Plans

Fiscal recovery plans at the EU have amounted until now to the following percentages of GDP: the EU wide fiscal package represents 1.5% of the EU GDP, that of Germany 2.4% of its GDP, that of France 1.5% of its GDP, that of the UK 1.1% of its GDP, Italy 0.7% of its GDP and Spain, 1.5% of its GDP. In terms of size, it is important to differentiate between announced plans and real plans, or what is the same between gross and net fiscal plans, since many of the announced are taking into consideration spending that was already accounted before in their approved budget.

Fiscal policy expansions are necessary when monetary policy becomes close to its zero bound and the drop in private demand is still so large than it can produce a deflationary environment which would be extremely dangerous. In the present banking crisis, fiscal policy becomes even more relevant because the effect of lower interest rates on demand is much reduced by the actual dislocation in credit markets. If fiscal policy is not used, some vicious cycles can develop as in past asset crises, where expectations become so negative that deflation and liquidity traps arise ending in Japanese or even Great Depression scenarios. Moreover, fiscal expansions upside is much larger than their downside because the latter only happens if the economic recovery becomes far too fast.

It is interesting to see, for the first time, the IMF preaching fiscal stimuli, when traditionally has been advising member countries to reduce budget deficits and public debt! The reason is that their well trained economists see a very serious probability of a depression-deflation future scenario if fiscal policy is not put to work as soon as possible and in large quantities. This is a situation in which the increasing lack of confidence by citizens and investors on banks, financial markets and economic policy needs to be reduced and its dangerous direction changed. Thus, there must be a firm commitment by governments to do whatever is necessary to avoid a depression and to dissipate any doubts about it in order to bring slowly private consumers and investors back into a normal level of confidence.

There is a great debate going on today about what should be the more efficient way of using fiscal policy in a situation like the present one. The first issue of this debate is about the credibility and sustainability of the fiscal stimulus or, what is the same, how the fiscal expansion is financed. In principle, the most appropriate way of financing present increases in government spending is with future government spending reductions or cuts, once private economic activity is back to normal and government revenues start increasing again so that net debt can be reduced down to its previous equilibrium level. The less adequate form of financing the present spending expansion would be by raising taxes later, unless the fiscal stimulus has taken the form of tax cuts.

On the one side, such a big fiscal effort needs to be done in such a way that it is not seen by markets as undermining medium and long term fiscal sustainability, otherwise their reaction will create more negative expectations and will result in a further deterioration of the present situation, that is, “a contractive fiscal expansion”. For that, it is necessary to design a fiscal stimulus plan that can be reversed at any time and to make sure that governments pre-commit themselves to unwind some of their policies when they believe it is necessary.

Therefore, a credible, consistent and robust medium term fiscal framework should be designed and made public to convince economic agents that it is sustainable and avoid a negative response. Such a fiscal framework should make a convincing case to show that it will not affect future pensions and health entitlements, otherwise the citizens response will keep being negative and consume and invest much less that expected. In order to achieve that some structural policies need to complement such a framework because they are going to boost productivity and potential growth, so that the recovery is faster and thus, the fiscal framework is more solid and sustainable.

On the other side, it is very important that such a fiscal package achieves a high return in terms of employment and of productivity improvements to show their citizens and the markets than that it can achieve real outcomes and that tax payers’ money is not wasted. For that it has also to be very flexible and diversified avoiding an excessive concentration on one or a few measures.

The second issue of debate is about the two different ways to help recovery, that is, by direct spending by the government or by tax cuts so that is the private sector which does the spending.

First, in favour of government spending versus tax cuts is that, given that the fall in private demand is going to be prolonged, the implementation lags of the fiscal stimulus are less important, so that it can contain large infrastructure investments and also short term investments in high labour content activities. Direct purchases of goods and services by the government can have a straight effect on demand and also some supply side effects. By contrast, raising public sector wages will be counterproductive given that it will be very difficult to reverse and it has very little effect on demand.

On the other side, households have suffered various kinds of wealth and income negative shocks so that they feel poorer. The fall in their houses prices in their financial assets as well as in their disposable income has been so large and the credit conditions have tighten so much both in cost and quantity that they are in a wait and see attitude and they try to save avoiding consumption. The world's wealth loss has been estimated at around $33 trillion, that is, 52% of the world's GDP. Under these conditions, a tax cut may not have much impact on consumer spending. Only consumers that are most credit constrained are likely to spend a tax cut but not these wait and see consumers and, of course, those consumers that they are so poor that do not pay taxes.

Therefore, temporary tax cuts should be only targeted to the most cash strapped consumers because they are the most in need and the most likely to spend them because some of them do not pay taxes. Therefore, those temporary and reversible fiscal policies that should work better would be: to extend unemployment benefits, to expand social safety nets, to support homeowners facing foreclosures in order to pay their mortgages and to give income tax credits for the most income constrained households.

The same can be said about firms. As the financial crisis has made credit markets dysfunctional, many small and medium firms have no access to reasonable priced credit. In this case a system of government credit guaranties could be developed provided these firms show that they are under a credible restructuring to increase their solvability. By contrast, generalized support to certain sectors should be avoided given the negative competitive spillovers that can produce for other countries competing in the same markets.

Another idea being discussed is to offer government insurance against extreme recessions or an insurance contract with a premium and payments contingent on GDP falling further than a determined threshold. That may condition bank loan approvals on firms having purchased such insurance as they do with mortgages in the case of flood and fire, but this idea can only be developed efficiently for the next recession.

The third issue of debate is the general multiplier effect of fiscal stimuli as well as the specific multiplier of tax cuts versus government spending. The effects of fiscal stimuli depend very much on a large series of factors both theoretical and empirical. The theoretical literature about the effectiveness of fiscal policy covers from the simple Keynesian model, close and open economy IS-LM models, demand side models incorporating rational expectations, Ricardian equivalence models and supply-side new classical models.

This existing theoretical literature suggests that fiscal expansion multipliers will tend to be positive and possibly large in the following situations:

When there is excess capacity. When the economy is closed or is open but the exchange rate is fixed. When households have short term horizons or are liquidity constrained. When there is not a crowding out of private spending or a substitution of private from public spending.

When increases labour or capital productivity or labour or investment supply. When government debt is low and does not face financing constrains. When there is an accompanying monetary expansion with limited inflationary effects.

By contrast their effects tend to be smaller or even negative in the following situations:

When it generates a crowding out of private investment or provisions or it filters to imports. When interest rates rise and the flexible exchange rate appreciates in response to the fiscal expansion. When households are forward looking or Ricardian and reduce consumption accordingly. When there is a problem of fiscal sustainability and risk premia on interest rates are high, in which case a credible fiscal contraction is better way to reduce interest rates. When fiscal expansion increases uncertainty which leads to more caution saving and investment decisions by households and firms.

The available empirical literature relates almost entirely to OCDE countries and has three different components. First, estimates of fiscal multipliers derived from macroeconomic model simulations and reduced-form equations. Second, studies looking at episodes of fiscal adjustment and identifying expansionary fiscal contractions across countries. Third, analyses focused on the existence of crowding out and Ricardian equivalence. Their main conclusions are the following:

Estimates of fiscal multipliers are overwhelmingly positive but rather small, averaging 0.5 for tax cuts and 1.0 for government spending (half a euro and one euro for every euro spent) but negative multipliers tend to be an exception because they are mostly found using some macro models with strong credibility effects.

There are nevertheless cases of non-Keynesian expansionary fiscal contractions, such as those of Denmark (1983-86) and Ireland (1987-89). These appear to be more likely when a fiscal contraction focuses on cuts in government unproductive spending, when high debt leads to high risk premia on interest rates and it is accompanied by a significant exchange rate depreciation and wage restraint.

There is very little evidence of direct crowding out or crowding out through interest rates and the exchange rate as well as very little evidence of full Ricardian equivalence or at least a significant partial Ricardian offset.

The main conclusion of the available empirical evidence is that the proper fiscal policy response to a downturn in the economy will depend on a large range of factors, so that only a country-by-country and episode-by-episode approach can really reveal which fiscal expansion is more effective and has a higher multiplier.

Nevertheless, the present situation is so unique and exceptional that the multiplying effect of these fiscal expansions tends to be larger than usual. First, we are now in a situation in which output is mostly constrained on the demand side, which is where fiscal expansions are more appropriate.

Second, households and firms are suffering a credit crunch and are more constrained than ever needing some government spending to stimulate credit and activity and some tax cuts or transfers directed only to the most in need which will be more prone to spend them.

Third, in this serious situation fiscal expansions will increase confidence among the citizens when they see that governments are responding to it in a comprehensive form. If such a fiscal expansion is coordinated among all the European Member State governments its effects would be even much larger and negative spill-overs would be avoided

Fifth, this fiscal expansion is being done with the complementary and synchronic support of a monetary expansion policy, which will tend to make the multiplier being higher. When nominal interest rates are getting closer to zero, the exchange rate tends to depreciate enough to offset the effects of induced imports so that net exports will remain unchanged. Therefore the fiscal multiplier can become as large as in a closed economy: that is, between 2.0 and 3.0.

Finally, in the European case, the most efficient way to make the fiscal expansion more coordinated and efficient should be by using the EU budget resources plus other resources of European public entities, such as the EIB. The European Social Fund, the European Regional Development Fund and others should be essential. For instance, agricultural related subsidies of the Common Agricultural Policy (CAP) take still 40% of the total EU budget outlays, which are financed through VAT revenue.

This CAP subsidy policy ends up being mainly a reverse income distribution policy, that is, from poor to rich. CAP revenue is mainly extracted, through VAT, from those European households with lower earnings, which are those which consume the highest proportion of their income, and the resulting subsidies, out of those VAT proceeds, are given mainly to European large land owners, which take almost 40% of the total. Of the close to 800.000 subsidy beneficiaries, the largest 31.000 get more than 40% of the total. It would be a good opportunity to profit from the present situation in order to reshape completely the CAP and use part of its proceeds to fund part of the EU fiscal stimulus package.

This example points out to a major difference between the way the US and the EU are trying to deal with their fiscal stimuli. In the US, the federal budget accounts for 19% of US GDP and that of its Member States accounts for 15% of its GDP. In the EU, by contrast, the EU budget is very small, being only 1% of the EU GDP, when average general government revenue of EU Member States is 45% of the total EU GDP. This is the reason why the US Treasury was able a few days ago to launch a second fiscal federal package of $825 billion after the $700 billion TARP, and a EU 27 wide Commission one of only 200 billion euros ($270 billion) having the EU a bigger total GDP and a 40% larger population than that of the US.

Going forward, the need for a much larger EU budget and for a single EU debt issuance agency, are going to be essential to have a European budget that can really soften the European cycles as well as asymmetric shocks within the EU Member States. For instance, if the EU had already a single EU debt issuing agency, a large proportion of the international capital flows that have been invested in US Treasury bonds and bills looking for a refuge could have been invested in EU bonds and bills, but this will never happen when the EU has 27 different issuers of different ratings.

Spanish Banking Support Programs

In the strict sense of the word, there has not been any banking rescue package in Spain. The solvency situation of the Spanish banking system is better than in most other EU Member States. There are two main reasons for having reached such a more comfortable situation:

The first one is that it is the only country in the world which was applying countercyclical provisions against non performing loans since many years back. The Bank of Spain obliged Spanish banks to build up to 35.000 billion euros extra generic provisions since 2000 on top of their specific provisions, knowing that there was a very high probability that bank credit in Spain would explode once in the Euro and that, consequently, non performing loans (NPL) would going to go up substantially. And that for two reasons:

On the one side, the ECB interest rate would always be too low for Spain because it was growing faster than the EU average and as the inflation rate chosen to make decisions about rates of the EU (HICP) was adjusted by the relative weight of each Member State in the total GDP of the Euro Area (EA). Between Germany, France and Italy they represented around 70% of the EA GDP, therefore, as they were growing at a slower pace than Spain or Ireland they were deciding the bias of the decision on their favour, but against those countries growing faster.

On the other, as Spain was going to have a higher inflation rate than the big three Member States and the EA average (it has turned out to be 1.05 per cent higher per year than the EA average in these first 10 years of the euro) then these low nominal interest rates set by the ECB would be almost zero or even negative in real terms for Spanish credit takers.

These called “dynamic generic provisions” need to be made, according to the adjusted risk of every loan, when most loans tend to be allocated, that is, during the credit boom, and should be used, together with the traditional specific provisions, during the inevitable credit bust and high NPL that eventually should follow. As a consequence, generic provisions of Spanish banks, in 2006, had an average percentage over total NPL of 300%, (excluding the specific ones).

The second reason for the Spanish banks relatively better level of solvency is that the Bank of Spain (as Bank of Italy and Bank of France) was extremely restrictive authorising Spanish banks creating any off-balance sheet investment vehicles or conduits with low or no capital. Thus, Spanish banks have not any SIV or conduit, which have been the vehicles for many risky investments by EU banks in US “toxic assets”. Therefore, there is almost no toxic asset in the balance sheet of Spanish banks and no off balance sheets instruments.

The third reason is that the large majority of Spanish banks are very traditional retail banks which did very little securitization, mostly issuing only covered bonds (cédulas hipotecarias). The reason for that is that the Bank of Spain never authorized any securitization without the bank taking the first default risk into its balance sheet.

Nevertheless, Spanish banks are now suffering an increasing level of NPL derived not only because of the present deeper recession than expected, but also because of the explosion of a large housing bubble, which is affecting very negatively real estate and construction companies. In spite of all that, at the end of December 2008, Spanish banks NPL were only 3.5% of total loans versus 4.5% of the EU average and their NPL provision coverage was of 80%, versus 42% of the EU bank average. The Bank of Spain estimates that Spanish banks, with their present level of provisions plus their non distributed profits will be able to cope with a NPL level of up to 9.0 per cent of total loans, in 2010.

These are the reasons why there has not been any need yet for any banking rescue in Spain. But today the main problem of Spanish banks is that they have financed in euros and long term (60% of the total over 5 years) 90% of the Spanish current account deficit. This means that they need to refinance around 80 billion euros per year on average in the foreign capital markets and that they are not able to refinance all of them at reasonable prices. Therefore, the Spanish Treasury has decided to help temporarily these banks through two new funds.

The first one, is the “Liquidity Fund” called “FAAF” of a size of up to 50 billion euros, which is buying only those triple A covered bonds (cédulas hipotecarias) and other triple A securitised bonds, from the Spanish banks which have not been able to place them at a reasonable price in the markets and therefore they keep them still in their balance sheets.

The second one, is the "Guaranty Fund" of a size of up to 100 billion euros, by which the Treasury guaranties new senior and other debt and securitised bond issues made by private banks in the markets.

In the liquidity fund, the Treasury pays a price for every triple A asset, such as that, by holding it to maturity, will report a profit. In the guaranty fund, the issuer pays a reasonably high guaranty premium to the Treasury which amounts to 86 basis points for the highest rated banks and 96 basis points for the lowest rated ones. Therefore the tax payer may not be at risk in both funds. Nevertheless, the guaranty fund is also authorised by the Treasury to buy bank shares if it would be needed, which it would involved a higher risk and become a true "bank rescue", but it has not been used yet for this second purpose.

Spanish Fiscal Stimulus Packages

The first fiscal reaction from the Government was a quick one, made at the beginning of January 2008, and consisting in a law-decree by which every tax payer would get back 400 hundred euros from his tax bill retentions. It affected 13 million tax payers and its cost was 5 billion euros, around 0.5% of GDP. It was done half in June 2008 and the rest along its second semester. Its impact is very difficult to compound but, given the fast fall in economic activity, the increase in the unemployment rate between June and December 2008 and the increase in the Euribor rate, it was probably very small.

The reason is that it was not focused on the low income earners which were the most credit constrained and who would have spent all, but it was given to all tax payers. Therefore its multiplier effect was very small, probably below 0.3. There were two additional tax cuts in 2008: the company tax rate was reduced from 32.5% to 30% and the wealth tax rate was reduced to zero.

The more recent Spanish Government "Plan E" is a very comprehensive stimulus program that has distinctive measures to support families, companies and employment. It also contains some structural measures to improve productivity and efficiency.

Fiscal stimuli to households for 2008 and 2009 amount to up to 14 billion euros, including the 5 billion previously mentioned. Among other measures it includes: helping 200,000 young to be able to rent a house (cost, 431 million euros); helping 1 million people to reduce income tax or social security contribution to families which have a new born or adopted child (cost, 1.2 billion euros); a new paternity leave when a child is born (cost, 240 million euros); a reduction of the income tax rate on savings of 6%, an increase in the minimum income tax exempted, a reduction of marginal rate to 40% and of other rates (cost, 2.8 billion euros).

It includes as well: helping 500,000 families to have a temporary moratorium to pay their mortgages in 2009 and 2010 (cost, 6 billion euros to be advanced by banks which gave the credit, but being reimbursable after 2011); an increase in the income tax deduction for permanent house for tax payers with an income of less than 33,000 euros (cost, 1.7 billion euros); an increase of minimum pensions of 6% and an increase of the minimum wage of 4% and finally an increase of grants given to students for secondary education and for Erasmus.

Fiscal stimuli to companies for 2008 and 2009 include the following measures: first, to increase the ICO (Government Financial Agency) credit lines up to 29 billion euros to small and medium size companies and self employed for liquidity, floating capital, internationalisation, creating new companies, expanding supply and developing low rent housing. These credit lines are executed by the banks, with their own balance sheet and at their own risk, but have an interest rate subsidy by ICO which makes it very attractive to small and medium size companies and even more to the self employed.

Second, a temporary moratorium of 5 billion euros to credit service payments due to ICO has been authorised by the Treasury.

Third, a new freedom of amortization for all new assets, provided the companies maintain their employment levels, in order to induce new investment. Fourth, VAT monthly devolutions instead of yearly ones, which will suppose an advance of 6 billion euros. Fifth, a fractioned payment of corporate taxes that will delay payments for 3 billion euros to reduce the impact of overvaluations due to the new accounting system.

Finally, there is another fiscal package to support employment creation given that most of the latest estimates for the unemployment rate point to 19% level in 2010. It includes: First, a fund of 8 billion euros to be invested by municipalities in small but high intensive employment projects that can be finished before the first quarter of 2010 which estimates a net creation of 225.000 jobs. Second, another fund of 3 billion euros to finance projects in some employment strategic sectors, such as house and public building rehabilitation, small transport infrastructures, environment, automobile, R+D+I, land acquisition to build low rent housing.

Third, a new plan of job training and labour insertion; a reduction in social security contributions of 1,500 euros per year for companies that contract permanently unemployed workers with family charges; an increase of up to 60% in unemployment subsidies capitalization to help unemployed workers to become self employed; an increase in active labour and employment policies to enhance employability of unemployed; a new employment plan for 100,000 unemployed to engage in social utility jobs; an increase of 20% in the budget for public works and a new plan to improve energy efficiency in housing, to increase housing for rent ; tourist infrastructures and housing renovation.

All these programs, added the work of the automatic stabilisers, are going to increase the budget deficit from a surplus of 2% of GDP, according to latest estimates, to a deficit of 7% of GDP in 2009 and another one of 8.5% in 2010.

Banking Rescue and Economic Recovery Plans in the Netherlands and Other EU Member States

Briefing Paper for the Annual Meeting of the Committee on Economic and Monetary Affairs with the National Parliaments on 11-12 February 2009 at the European Parliament in Brussels

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Executive Summary

In response to the economic crisis following the global financial crisis on November 26th, 2008 the European Commission presented a recovery plan aimed at spreading the financial burden between the Member States and the European Union (EU). The plan is based on "short-term measures to boost demand, save jobs and help restore confidence" while on the longer term it promotes "smart investment to yield higher growth and sustainable prosperity". Several large EU economies have announced or already taken measures to support their economy. These measures focus largely on restoring demand and safeguarding growth and jobs, and can be overall put into the various categories. In Section 2 the actions taken by the Netherlands are discussed, and the consequences for the fiscal deficit and the government debt are analyzed. In Section 3 we then review the measures taken by Germany, France, the United Kingdom, Belgium and Spain and assess their budgetary consequences. Finally, in Section 4 we evaluate the good and bad aspects of these measures, specifically the distinction between *general* and *specific* measures, and that between measures aimed at promoting *investment* versus those aimed at promoting *consumption*. We conclude that the Netherlands and Germany provide very little consumption-directed measures, but stimulate private and public investments. Other member states provide also tax cuts and consumption stimulus, which will most likely be saved instead of consumed in crisis times. However, even though the Netherlands (and Germany) stimulate investments, the measures will not be enough; the forecast for the recession has worsened lately, for the EU as a whole as well as for the Netherlands. The measures have also been criticized by the various social partners and opposition parties like the Conservative Liberal Party (VVD) and the Socialist Party (SP). Therefore, the Dutch government should take additional measures, and not wait until April 2009 to see how the crisis develops. One important point is the Dutch *housing market*, which is completely locked at the moment. It has to be revived by stimulating housing mobility. This can for instance be accomplished by lowering taxes on house sales. Those stand now at 6 % of the purchasing price, a significant cost, that means new owners cannot move house without incurring loss during couple of years (a couple of years is needed for them to see their house increase in price by enough to offset the taxes). Additionally, *public investments* in 'hard' and 'soft' infrastructure and *private investments* in Research & Development (R&D) have to be increased and front-loaded. The first can be accomplished by advancing already planned investments in roads, bridges and railroad, but one could also think of investments in research institutes and universities (human capital). The second can be stimulated by tax breaks for R&D: this will guarantee more long-term growth. This is especially useful in fending off a long and dragging recession, as is a typical characteristic for European business cycles.

1. Introduction[69]

In response to the economic crisis following the global financial crisis on November 26th, 2008 the European Commission[70] presented a recovery plan aimed at spreading the financial burden between the Member States and the European Union (EU). The plan is based on "short-term measures to boost demand, save jobs and help restore confidence" while on the longer term it promotes "smart investment to yield higher growth and sustainable prosperity". The amount of the plan is 200 billion Euro, 170 billion Euro of which within the national budgets and the remaining 30 billion Euro provided by EU funding. Several large EU economies have announced or already taken measures to support their economy. These measures focus largely on restoring demand and safeguarding growth and jobs, and can be overall put into the following categories[71]:

- Financial measures, for banks and Small and Medium-Sized Enterprises (SMEs) in the form of guarantees and soft loans
- Tax cuts either general, or specifically targeting home owners to stimulate consumption and the housing market
- Advancing planned public investments in infrastructure and the housing market
- Income support for vulnerable groups

In Section 2 the actions taken by the Netherlands are discussed, and the consequences for the fiscal deficit and the government debt are analyzed. In Section 3 we then review the measures taken by Germany, France, the United Kingdom, Belgium and Spain and assess their budgetary consequences. Finally, in Section 4 we evaluate the good and bad aspects of these measures, specifically the distinction between *general* and *specific* measures, and that between measures aimed at promoting *investment* versus those aimed at promoting *consumption*.

2. The rescue and recovery plans in the Netherlands

In November 2008, the Dutch government approved a recovery plan of 6 billion Euros[72]. The plan offers tax deductions for firms that make large investments and those who hire workers for short periods of time, while it will not offer tax refunds to the taxpayers like in some other Member States. Additionally, the government will increase labour market flexibility by providing the possibility to temporarily reduce working time and it will speed up public sector investments and payments to businesses. The plan aims at the economy as a whole without an industry specific focus, implying no distortion to the economic structure and competition within the firms.

On January 16th, 2009 the Dutch government announced a full-fledged economic support plan[73] that adds additional measures to the abovementioned recovery plan. Export insurance will be covered by the government for countries where commercial export credit insurance is no longer available, such as Russia, Kazakhstan and the Baltics.

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[69] The author gratefully acknowledges the very helpful comments of Mr. Edin Mujagic, MSc and the excellent research assistance of Mr. Rob Nijskens, MSc. This paper is updated to January 21st, 2009.

[70] *A European Economic Recovery Plan,* European Commission, November 26th, 2008

[71] Concise overview of measures taken or announced by Member States and key trading partners in response to the economic crisis, European Commission Staff Working paper, November 2008

[72] *Dutch move on $10 billion rescue program,* CNN, November 26th, 2008 http://edition.cnn.com/2008/WORLD/europe/11/21/dutch.economy/index.html

[73] *Dutch Government Announces Economic Support Measures*, Dow Jones, January 16th, 2009

Additionally, the government will guarantee 50% of company loans up to 50 billion Euro to spur investments. Finally, the government enlarged the guarantee fund for social housing and the contribution to the financing of hospitals to stimulate construction of homes and expansion of hospitals.

The recovery plan would impact on the public accounts of 2009, although only mildly since it mostly consists of guarantees. Only the 6 billion Euro announced earlier will have direct impact; the other measures only have an impact in exceptional conditions, when the guarantees indeed materialize. The benefits of boosting investment may produce positive effects on the medium run through additional tax receipts and higher growth and employment.

Additionally, the Dutch government has taken specific actions for the financial system. On October 9th, 2008, the government has made available a facility by 20 billion Euro for the recapitalization of the national banking sector[74]. Since the funds allocated are not enough to cover all the needs, the government continues to distribute funds on the same conditions. Up to now, the overall interventions of the Dutch government have topped 31.55 billion Euro. Table 1 presents the banks[75] involved in the rescue plan.

Bank/Institution	**Funds**	**Date**
Fortis Bank Nederland (Holding) NV and the Fortis share in ABN AMRO Holding NV	€ 16.8 billion (complete takeover)	3. Oct. 08
ING	€10 billion	19. Oct. 08
AEGON	€3 billion, possible further access to use TARP	28. Oct. 08
SNS REAAL	€ 750 million from standing facility, € 500 million from shareholder's foundation	13. Nov. 08
NIBC	€1 billion	28. Nov. 08
	€31.55 billion	

Table 1: Banks benefiting from the Dutch Rescue Plan

The structure of the rescue plan is as follows: In general the ailing bank issues new shares qualifying as core capital without the dilution of existing shareholder structure. These shares yield a fixed dividend to the government by 8.5% (eventually higher if the ordinary shares pay a higher dividend). Furthermore, the bonuses of the board members for 2008 are cancelled and all redundancy packages are limited to one years' salary. Finally, the existing shareholders have the faculty to redeem the state participation after 3 years at 150% of the nominal value. In the case of Fortis, the state nationalized the bank completely with the intention to privatize the bank in three years time again. In addition, the Dutch government provides a guarantee for loans between banks and financial institutions[76]. The guarantee amounts to 200 billion Euro.

[74] http://www.minfin.nl/english/News/Newsreleases/2008/10/Government_reinforces_ING_s_core_capital_by_EUR_10_billion

[75] On Fortis, ING, Aegon, SNS Reaal, NIBC, various press releases from the Ministry of Finance http://www.minfin.nl/english/News/Newsreleases/2008

[76] http://www.minfin.nl/english/News/Newsreleases/2008/10/Implementation_of_Dutch_Credit_Guarantee_Scheme

But up to now, it is barely used since banks fear for loss of reputation. The government has announced, also on January 16th, 2009 that it will increasingly stimulate the use of this guarantee to spur credit granting to businesses. Several banks have already shown interest in making use of these guarantees: if they use the guarantees together, none of them will suffer any reputational damage.

This plan has a short-term impact on the public accounts. In case the privatization or the sale of the state shares will not occur by the third year, the budgetary effects can last beyond 2011. However, since most money involved is borrowed on the international capital markets at quite low rates[77] and the government expects quite high interest rates and dividends (up to 2.7 billion Euro) on the capital provided, these measures *will not have very large impact on the fiscal deficit*. The public debt, however, will increase from *45.7% of GDP to 57,3 %* (source: Najaarsnota 2008) including all the outflows caused by the bank assistance programme. This figure remains however well below the limits of the Stability and Growth Pact (SGP) and may be sustainable over the medium term, when the acquired stakes are sold again.

3. The rescue and recovery plans in other EU Member States

In Table 2 we review the rescue and recovery plans in other EU Member States, like Germany, France, the United Kingdom (UK), Belgium and Spain.

Country and measures taken	**Budget consequences**
<u>Germany</u> *Spread over 2 years:* - Among others: tax cuts in depreciation, travel costs deductibility for commuters, special designations for families - Investments in infrastructure, housing, structural programs for specific regions - Credit to SMEs, CO_2-savings and energy-efficient innovation by companies *Financial Sector* - Loan guarantees, recapitalizations or equity support, and assumptions of risky assets - Equity support with conditions similar to those in the Netherlands - Several banks applied for loan guarantees, limited attention for capital support	- € 50 billion in total for the recovery plan - €470 billion for the financial sector, of which € 400 billion consists of guarantees; this is subject to uncertainty. - Coming from a strong fiscal position, Germany should face a *balanced budget* with the recovery plan. - The financial rescue plan's *short term fiscal impact can be large*, but with low interest rates, high dividends and capital gains from privatization the *government debt should not increase* over the medium term.

[77] The Netherlands enjoy an AAA rating

Country and measures taken	Budget consequences
<u>France</u> *Recovery Plan* - Fund investment projects in automobiles, housing, construction (i.e. infrastructure and public facilities) and public debt - SMEs will get tax breaks - Unemployed persons will be retrained - Rescuing the automobile industry *Financial Sector* - Recapitalization and buying up troubled banks' assets by a state-owned company - Credit guarantees for the medium term, to stimulate financing for businesses (especially SMEs)	- €26 billion for the recovery plan, and an additional € 6 billion for the automobile industry - €360 billion for the financial sector, of which €320 billion is guarantees. - The recovery plan will have an impact on the deficit, and increase it to 4%[78] of GDP, despite the economic benefits. - The government debt would rise to 67.5% of GDP, mainly due to the financial sector plan.
<u>UK</u> *Recovery Plan* - Reduction in VAT - Postponing corporate tax increase, and small firms can defer payments - Advancing investments in housing, energy, infrastructure and schools - Home owners' support package - Guarantee 50% of small and medium-sized firm lending up to £ 20 billion. *Financial Sector* - Nationalizations of Northern Rock and Bradford & Bingley - Large stakes in RBS and Lloyds Banking Group - Bank recapitalization for Tier One capital - Special liquidity scheme: short-term swap of illiquid assets for T-Bills - Additional debt guarantees - Buying up assets and guarantee some top-rated asset-backed securities.	- Initially £ 20 for the recovery plan; additional guarantees for firm lending (but these do not immediately materialize) - Additionally, £ 94.4 billion is used to bail out Northern Rock, £ 51 billion for Bradford & Bingley, £ 50 billion for recapitalization and £ 450 billion in guarantees. - The newly announced plan can costs up to an additional £ 50 billion in buying assets and even more in guarantees. - Total debt is expected to rise from 41.2% to 48.2% in 2009, increasing after that, and the fiscal deficit from 5.4% to 8.1%, but decreases after 2009[79].

[78] *Economic Forecast*, European Commission, Autumn 2008
[79] HM Treasury, Nov 2008, URL: http://www.hmtreasury.gov.uk/d/public_finances_databank.xls

Country and measures taken	**Budget consequences**
<u>Belgium</u> *Recovery Plan* - Tax cuts including lower VAT on construction, delaying VAT payments for companies and energy rebates for households - Higher unemployment benefit - Food and energy vouchers for workers - Credit guarantees for SMEs - Accelerating infrastructure projects *Financial Sector* - Nationalization of Fortis, which has been partly sold to BNP Paribas - Capital injections for Dexia and KBC Bank - Stabilizing the interbank market - Borrowing guarantee	- €2 billion for the recovery package - €19.9 billion for bank bail-outs and guarantees, and a further € 90 billion for guarantees in the interbank market and liabilities and assets guarantees - Total impact on the fiscal deficit will be negative 2.6% in 2008, and balanced in 2009. - Public debt will have increased from 84.9% to 88.3% by end of 2008, well above the SGP limit.
<u>Spain</u> *Recovery Plan* - Public infrastructure investments, environmental projects and investment in R&D - Stimulus for the auto industry - Credit provision to SMEs - Income tax deduction - Extension of housing construction support - Abolition of wealth tax *Financial Sector* - Buy up healthy assets to provide liquidity - Provide bank debt guarantees - Enlarge deposit insurance coverage	- €50 billion for the recovery plan. - €250 billion for the financial sector, of which € 200 billion consists of guarantees - The Spanish government intends to fund mainly by debt, making the impact on the deficit fairly small - Since many measures are contingent, the impact on debt is not big; coming from a low debt position, the 60% SGP limit will only be reached when everything materializes

Table 2. The rescue and recovery plans in other EU Member States

4. A comparison of the rescue and recovery plans

4.1. General versus specific measures

In stimulating the economy, governments can use measures to stimulate the economy overall, by giving consumers and companies the right incentives to consume and expand business. It can also direct its attention to specific parts of the economy, to stimulate these extra; this occurs when a specific industry may be of exceptional importance to a country. However, there is an important caveat associated with this approach: the government generally cannot determine which enterprises are worthy of saving (viable) and which deserve to disappear (non-viable)[80]. Therefore, it is better to stimulate the economy as a whole and let economic mechanisms do their job.

In Table 3 we will compare the measures taken by the Netherlands and the other EU member states mentioned above, on the basis of their overall nature being general or specific. This will focus mainly on the economic recovery packages; most financial sector rescue plans (except guarantees) are specific by definition.

General measures	Specific measures
The Netherlands Increasing labour market flexibility, stimulating export, guarantees for company loans, housing and health care	
Germany Infrastructure investments, credit guarantees, depreciation tax cuts for companies	Deductibility for commuters, special family designations, relief for specific regions and energy innovations.
France Promote construction (infrastructure and public facilities)	Aim at saving the automobile industry, social housing, very small companies, retraining unemployed in specific areas
UK Advancing public investments in housing, energy, infrastructure; lending guarantees for firms	VAT reduction, postponing corporate tax increase, home owners' support packages.
Belgium Accelerating infrastructure projects, credit guarantees for SMEs	Tax cuts: lower VAT on construction, delayed VAT payments & energy rebates. Higher unemployment benefits, vouchers.
Spain Investments in public infrastructure, environment and R&D; support for housing construction.	Auto industry stimulus, income tax deduction, credit provision to SMEs, abolition of wealth tax.

Table 3. General versus specific measures

[80] *Light Relief*, The Economist, January 13th, 2009

4.2. Investment versus consumption measures

We can also distinguish between stimuli directed at investment and those directed at consumption. The investment measures will have a medium- to long-term effect, while consumption-directed measures will have a more direct effect. However, in times of crisis, when people face large debts and uncertainty, extra money for consumers will largely be directed to pay off debts or to their savings accounts. Therefore, by analogy with the distinction between general and specific measures, investment measures are more preferred because they have a larger effect in the end. Additionally, governments have the possibility to advance planned public sector investments. This measure brings hardly any extra costs, since the investments were already planned, and has a large stimulating impact. In Table 4 we will again compare the different measures, by their different directions. Financial sector rescue packages are again excluded, since they stimulate investment by definition.

Investment-directed measures	**Consumption-directed measures**
The Netherlands Tax deductions for large investments, guarantee company loans, stimulate social housing and hospital expansions.	
Germany Infrastructure investments, credit guarantees for SMEs, depreciation tax cuts for companies, energy-efficient innovation stimulus.	Deductibility for commuters, special family designations.
France Promote construction (infrastructure and public facilities), automobile and housing investments.	Very small companies tax break, retraining unemployed in specific areas
UK Advancing public investments in housing, energy, infrastructure; lending guarantees for firms; home owners' support packages.	VAT reduction, postponing corporate tax increase.
Belgium Accelerating infrastructure projects, lower VAT on construction, credit guarantees for SMEs.	Tax cuts: delayed VAT payments & energy rebates. Higher unemployment benefits, vouchers for workers.
Spain Investments in public infrastructure, environment and R&D; support for housing construction; auto industry stimulus; credit provision to SMEs.	Income tax deduction, abolition of wealth tax.

Table 4. Investment versus consumption measures

4.3. Evaluation

We conclude that the Netherlands and Germany provide very little consumption-directed measures, but stimulate private and public investments. Other member states provide also tax cuts and consumption stimulus, which will most likely be saved instead of consumed in crisis times. However, even though the Netherlands (and Germany) stimulate investments, the measures will not be enough; the forecast for the recession has worsened lately, for the EU as a whole as well as for the Netherlands. The measures have also been criticized by the various social partners - such as the labor unions and the employer organizations - and opposition parties like the Conservative Liberal Party (VVD) and the Socialist Party (SP).

Therefore, the Dutch government should take additional measures, and not wait until April 2009 to see how the crisis develops. One important point is the Dutch *housing market*, which is completely locked at the moment. It has to be revived by stimulating housing mobility. This can for instance be accomplished by lowering taxes on house sales. Those stand now at 6 % of the purchasing price, a significant cost, that means new owners cannot move house without incurring loss during couple of years (a couple of years is needed for them to see their house increase in price by enough to offset the taxes). Additionally, *public investments* in 'hard' and 'soft' infrastructure and *private investments* in Research & Development (R&D) have to be increased and front-loaded. The first can be accomplished by advancing already planned investments in roads, bridges and railroad, but one could also think of investments in research institutes and universities (human capital). The second can be stimulated by tax breaks for R&D: this will guarantee more long-term growth. This is especially useful in fending off a long and dragging recession, as is a typical characteristic for European business cycles.

Fiscal Policy Facing the Crisis

Briefing Paper for the Annual Meeting of the Committee on Economic and Monetary Affairs with the National Parliaments on 11-12 February 2009 at the European Parliament in Brussels

Jean-Paul Fitoussi

Summary

The immediate causes of the crisis are evident and traceable to the collapse of financial markets and the ensuing debt deflation and credit crunch. Nevertheless, the current crisis is the mirror of a more fundamental structural imbalance, namely the trend of redistribution from low and middle incomes to high and very high. This has created a chronic demand insufficiency that in the US has been hidden by mounting private and public indebtedness. The high savings of other parts of the world made this possible, creating a fragile equilibrium. To put the global economy back on a path of sustainable growth, this structural trend will have to be reversed.

The fiscal stimulus packages should have three features. (a) they should primarily be addressed to (public) investment which is likely to increase potential growth, and especially to research on the new technology of environment and energy; (b) they should target the categories in distress, notably the working poor and those who have lost their home in order to minimize the social costs of the crisis, and sustain aggregate demand; (c) they should address the mounting unemployment (and unemployment duration) problem by extending benefits duration and eligibility.

The size of the stimulus will depend on how coordinated the measures are, knowing that the efficacy of a joint, coordinated fiscal stimulus is much larger than the one of an isolated one or an uncoordinated one.

The plans announced so far by western countries are mostly oriented towards public investment. Two issues seem relevant. The first is the actual size of these plans. For 2009 only a fraction of what is announced will be spent; the second issue is the lag in producing effects on the economy. Thus, our governments are taking a risk by letting the crisis unfold at least until the half of 2009.

OFCE estimations point to a significant but by no means exceptional impact of the announced measures on growth and GDP. Thus, a second wave of fiscal stimula is likely to be necessary.

That the present crisis shows itself as one of global demand deficiency is recognized by almost all economists and policy makers. The burst of the housing bubble and the correction of stock markets have caused, via a negative wealth effect, a sharp reduction in private consumption. But this would have been a "normal" crisis if the severe malfunctioning of financial markets – excessive risks taken by what were considered as serious institutions— would have not transformed it into a systemic crisis. In almost all countries, the interbank market came virtually to a halt, and as of today it is still far from having recovered a normal functionality. In this situation, credit conditions are considerably tightening both for firms and for households. And despite huge interventions by the central banks and by the fiscal authorities, a credit crunch is still probable.

Thus, the combination of a negative wealth effect and of increasingly tight credit constraints has caused the private expenditure to drop and is thus the immediate causes of aggregate demand deficiency that we are observing today and likely in the coming months.

Nevertheless, the deep roots of the current situation do not lie in the financial meltdown, or in the debt deflation. These are only the events that triggered the crisis. Three major macroeconomic sources of the crisis were (a) underlying global imbalances; (b) inequalities in the global economy; and (c) the increased global instability resulting from certain policy choices in recent decades. Point a and c are documented in the chair's summary of the macroeconomic group (UN Commission)

Here, I will concentrate on the second.

One of the main origin of the present crisis is the imbalance that has built up during the past three decades, related to a long term trend of redistribution from low and middle incomes to the high and very high. In most advanced countries the average wage stagnated, while inequalities surged in favour of the upper quintile of the distribution.

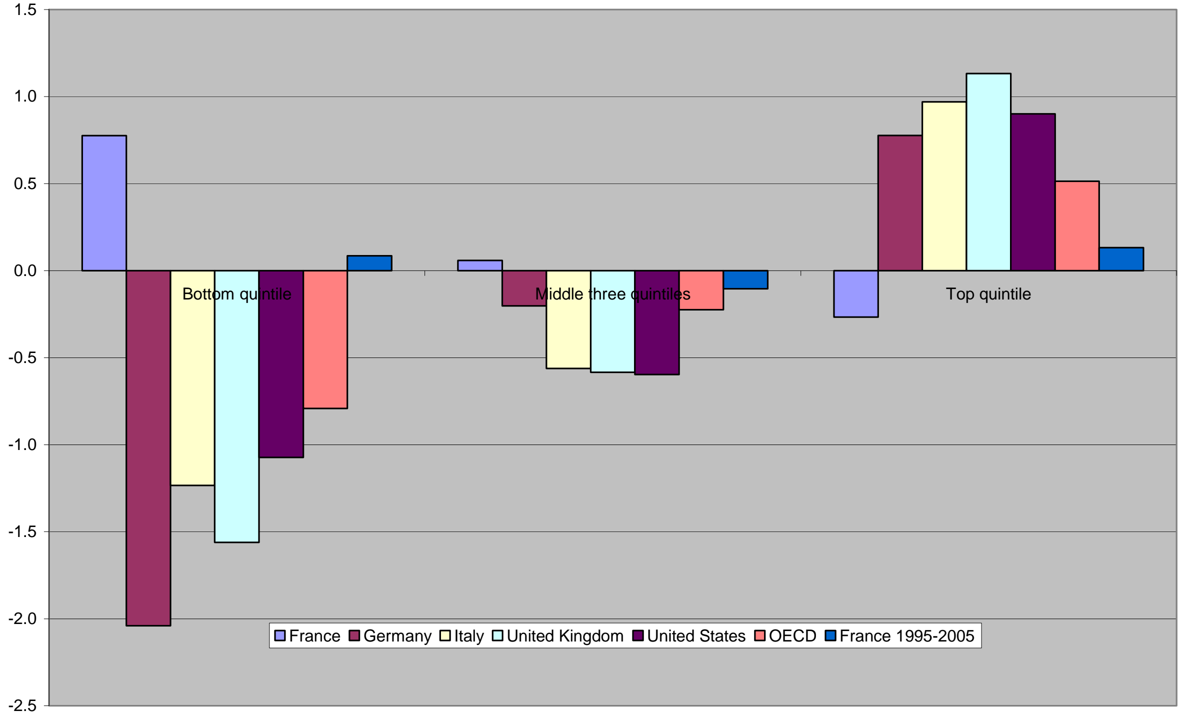

Figure 1 : Average yearly growth of income minus growth of average wage.
Source: OECD (2008).. My calculations

Figure 1, taken from OECD data (2008), shows the difference between the average growth of real income for each quintile (or group of quintiles) and the growth of average income, over the two decades mid-1980s to mid-2000s. The figure clearly depicts redistribution from the four bottom quintiles to the fifth, which is the only one that shows an increase over the period above average real income. While we only took the most representative countries, the OECD study shows this trend to be common to most countries in the group.

Over the twenty years we observe only one exception, France, where growth for the lower quintile was larger than for the average wage. Nevertheless, even for France this trend was reversed in the last decade.

The phenomenon of redistribution is even more marked than the figure shows. Dew-Becker and Gordon (2005) speak of "superstar economy", showing that in fact, those benefiting more from the redistribution are those at the very top of the income distribution (top 1%). This was more than confirmed by the work of Piketty and Saez ( )

This long term trend of income redistribution by itself would have had the macroeconomic effect of compressing aggregate demand: as the propensity to consume out of low incomes is generally larger, distributing income away from them tends to lower average propensity to consume.

Interestingly, this tendency originated different behaviours and different outcomes on the two sides of the ocean.

In the US, where the social protection system is less important, the compression of low incomes and of aggregate demand was compensated by the sharp reduction of household savings and by mounting indebtedness, that allowed to keep the spending (consumption) patterns virtually unchanged. At the same time, the limited safety nets forced the government to pursue active macroeconomic policies to keep unemployment low, thus increasing government debt as well. Thus, growth was maintained, and the structural loss of aggregate demand was "hidden" by increasing public and private indebtedness.

Most of European countries walked a different path. The redistribution to higher incomes resulted in an increase of national savings and in depressed growth. The safety nets embedded in the welfare systems exerted a pressure on public finances, but the institutional setting, notably the constraints to deficit embedded in the Stability and Growth Pact, resulted in fiscal policies that contributed to depress aggregate demand. In the meantime, high interest rates, and a financial sector less prone to innovation, limited consumer borrowing. As a result, the shift in distribution resulted in soft growth for most of the past two decades; even if national (public plus private) debt resulted substantially lower than in the US.

These two paths were mutually consistent, because the savings from the EU zone contributed to the financing of US borrowing, along with surpluses of other regions that for different reasons also experienced high saving rates (notably East Asia and Middle Eastern oil producing countries). Thus the combination of structural disequilibria that goes under the name of global imbalances (see also my Briefing Paper of June 2007) resulted in a fragile equilibrium that temporarily solved the aggregate demand problem on a global scale.

Today's crisis, which originated in the financial markets, broke this fragile equilibrium, and revealed the structural lack of aggregate demand that most countries face. It is important to stress once again that the financial crisis was only the factor that brought into surface the structural problem. (Quite a part from the fact that the level of remunerations in the financial sector contributed significantly to the rise of income inequality).

Thus I firmly believe that, once the necessary action to tackle the current crisis will be undertaken, a serious and in-depth debate on the structural causes of the current imbalances and on global measures to invert the global trend in income distribution will be necessary and urgent. These are the real structural reforms that OECD countries need, and not as it was broadly believed before the crisis, those structural reforms aimed at increasing wage flexibility and decreasing the generosity of the social protection system. It has to be emphasized, that the sheer existence of social protection systems at least in rich countries would be in the next months or years, one of the better instruments against further deepening of the crisis. It is why it is in the interest of OECD countries to help the building of social protection systems in developing countries.

While the diagnosis of the deep roots of the crisis that I outlined above may not be consensual, the profession is almost unanimous on the necessity to address the current crisis with an important and coordinated fiscal stimulus.

Today we experience a typical liquidity trap situation: Private savings massively went into government securities, in a "flight to safety". The objective must be to transform these savings in demand in order to curtail deflationary expectations, to restore the value of assets, and ultimately to escape a potentially deflationary process.

I will briefly analyze the plans already announced by the main economies below, but before I'd like to focus on the elements that a stimulus package should contains, on the global problems it poses, and also on what should be done to guarantee long term sustainability.

Three main principles and elements of an effective stimulus package should be highlighted:

A large part of it should take the form of public investment, to build and modernize infrastructures, to avoid rent seeking, pork in the barrel projects, and to lay the foundations for future growth. An important part of this investment should address the problems of environment degradation and climate change.

The current crisis is leaving on the ground many casualties, like home owners, blue collar workers, and entire sectors. An important part of the planned expenditure should be targeted at relieving their conditions and at sustaining their income and capacity to spend.

Unemployment is likely to increase significantly in most countries, both in the existing workforce and among those who will enter in the workforce in the next months. Everything should be done to avoid them to become discouraged, and to provide them with safety nets. In particular, I believe that a temporary extension of unemployment benefits, both in size and in duration, would relieve the pressure on laid-off workers; furthermore, loosening eligibility condition could allow supporting the young who are entering into the workforce.

As for the size of the stimulus needed to avoid free riding one should aim for a similar percentage of GDP in all OECD countries; If it were not the case differences between countries would reflect their degree of openness (and hence the value of the multiplier), that ultimately depends on their size. If such a common commitment is not taken, free riding would almost be inevitable, each national multiplier being lower when the reshuffling of the economy is isolated than when it is global. I would also emphasize that this risk should not lead to paralysis. I have to underline that it is the first time since long that we are observing such a generalized and simultaneous fiscal stimulus in big countries, so that the risk of free riding is minimized.

The actual numbers on the size of the stimulus depend furthermore on how coordinated the effort will be. What we know from textbook multiplier analysis is that in presence of a generalized fiscal expansion the multiplier is larger than it would be for each country in isolation. For example, the model imode.fr, used at OFCE for economic forecasting, gives an estimate of the fiscal multiplier that for European countries goes from 0.9 to almost 2 when the fiscal expansion happens simultaneously. Thus a joint (if not coordinated) effort would more than double the multiplier.

Estimates at the IMF point at a size of the needed stimulus of around 2% of GDP. Our own estimations at OFCE confirm that this is the order of magnitude that countries should aim to. But in actuality, we don't know. We are confronted to a radical uncertainty. Past episode of similar crisis which are not many (i.e. Japan) taught us that it is better to act quickly and to do too much that not enough.

There is in effect a real difficulty in measuring the amplitude of the crisis, and the effects of macroeconomic policies aimed at dampening it. This difficulty is reflected by the continued revisions of policies and forecasts by national governments, even before the plans are put in place. This makes it rather difficult to give a quantitative assessment of the needed stimulus. While of course it depends on the fact that the crisis is still unfolding, this uncertainty is at least in part an unavoidable consequence of the dismissal of tools that allowed in the past to evaluate policy in the global economy, notably multi country models. Today only a few institutions have multi country models and use them for policy analysis and forecasting. Their dismissal in the past, because Keynesian and hence "out of fashion", was a mistake that we are paying today. We have lost part of the technology for building a stimulus programme!

It is worth noting that some countries, notably developing ones, may not be in the position to afford a fiscal stimulus of several points of GDP. It is of foremost importance that the international community helps these countries to carry out the needed measures exactly as it needs to help them with the banking rescue packages (see my Briefing Paper of January 2009). OECD countries should resist the temptation to cut foreign aid spending; ideally, foreign aid should actually be increased.

Even if difficult to determine its optimal size, the size of the stimulus that most countries will implement in the next future will be certainly important. Thus, it is normal to respond to the concerns about the long term sustainability of current policies that emerge in the speeches of the heads of state and government around the world.

While the issue of sustainability is important, we should bear in mind that in this case we are talking about a countercyclical policy, and that no long term sustainability concern will appear, as long as policy will remain countercyclical. This means that as soon as the economy will enter in an expansion phase, fiscal policy should turn restrictive. It is very important that this does not happen too late, but it is at least as important that it does not happen to early. Turning to budgetary restrictions before the crisis is over could undermine all the previous effort to sustain growth. Also, the importance of the composition of public expenditures as regards sustainability should be underlined; public investment, if it succeeds in increasing the growth potential of the economy and hence future growth, may pose less sustainability problems. It may be so also for all expenditures aimed at increasing social cohesion.

The European Commission published on November 26, 2008 a rescue plan of around 200 billion euros, representing 1.5% of gross domestic product (GDP) of the EU27.

Each member state commits 1.2% of GDP, 0.3% being provided by European funding. Given the exceptional circumstances, the Commission has put on hold the Stability and Growth Pact.

However, the Commission requires the fiscal stimulus to be temporary, over a period of a maximum of two years (2009-2010), after which "the budgets of the Member States should undertake to correct the fiscal deterioration and return to the medium-term objective" of balancing public accounts. Table 1 shows a summary of the measure in the main European countries.

Table 1: Announced Fiscal Stimulus Plans										
	France		Spain		Germany		Italy		UK	
	€bln	% of GDP	€bln	% of GDP	€bln	% of GDP	€bln	% of GDP	€bln	% of GDP
Total public investment	8	0.4	8	0.7	7.2	0.3	1.4	0.1	2.3	0.15
Enterprise cash advances support	13.9	0.7	7.7	0.7	15	0.6	0.2	0		
Sectoral Aid	2	0.1	3	0.3	nc	nc	nc	nc	0.7	0.05
Employment policies and aid to households	2	0.1	5.9	0.5	23	0.9	3.3	0.2	4.4	0.29
Estate tax suppression			1.8	0.2						
TVA reduction	-	-	-	-	-	-	-	-	11.5	0.8
Other					4.8	0.2	1.5	0.1		
Total	26	1.3	24.7	2.2	50	2	6.5	0.4	18.8	1.3

Source: OFCE calculation from national sources

European governments, like the new US administration, chose to focus on investment. On average, nearly 40% of expenditure in 2009 will be in the form of public investment. At the extremes we find France, where it reaches 75%, and the UK, where it represents only 16% of GDP. In the UK, in fact, most of the engagement (60%) is towards the reduction of VAT. As I noted before, the choice of government investment is sensible: it boosts the activity and employment, and helps improve productivity and therefore growth potential. Nevertheless because of delays in the implementation of projects, the impact in the next six months, if any, would be week.

The VAT reduction impacts rapidly on economic activity. It is adapted to the current situation of the British economy, because by lowering consumer prices, it should help reduce inflation to a level closer to 2%. But it is unclear how much of the VAT reduction will be reflected in consumer prices, and how much will be used by firms to increase margins. For this reason, widespread reduction of VAT across European countries and making it the main item of the fiscal stimulus plans is not advisable, especially considering that inflation is rather weak in most countries of the Euro area and that it is on a decreasing path. What is emphatically considered as a stimulus of consumption (VAT reduction) may in actuality be an aid to enterprises.

With the notable exception of Italy, the major European countries have kept their commitment on the amounts involved in the various national plans. But this may be misleading: the cash advances for example are not new spending. Thus, in the French plan, almost 14 billion Euros are earmarked for supporting the cash flows of businesses. Of this amount, only 5%, i.e. about 700 million euro - the interest that would have been paid if the companies had borrowed (on normal conditions) the money - is likely to impact on economic activity.

According to OFCE calculations, nevertheless, this amount will have a high multiplier (estimated at 2.5) because it will allow some credit constrained small businesses to finance investment and other not to fail for liquidity constraints. It is not after all a bad idea for a state to ameliorate the cash flow of enterprises by playing on the delay of tax payments, when the banking system is deficient.

The announced funds allotted to investment programs will not be fully committed during 2009. Additional public expenditure should be in 2009 around 60% of pledges (40% for the French plan). In 2009, the effort would eventually be less than 1 percentage point of GDP on average, with significant differences between countries: less than 0.5 percent of GDP for Italy against 1.7 for Spain (Table 2).

Table 2 : Impact of Expenditure on GDP							
	France	Spain	Italy	Germany	UK	US1	Japan2
Announced Expenditure							
Bln National Currency	26	24.7	6.45	50	18.8	450	38 600
% of GDP	1.3	2.2	0.4	2	1.3	3.1	7.7
Effective Expenditures							
Bln National Currency	13.5	18.7	4.42	35	18.8	390	7 000
% of GDP	0.7	1.7	0.3	1.4	1.3	2.7	1.4
Effective Expenditures 2009							
Bln National Currency	9.5	18.7	4.42	16.5	18.8	390	5 000
% of GDP	0.5	1.7	0.3	0.7	1.3	2.7	1
Impact on GDP in 2009							
Yearly average	0.3	0.4	0	0.3	0.8	0.9	0.4
Year to year	0.5	0.6	-0.1	0.4	0.8	0.9	0.85
Impact on deficit in 2009							
ex ante	0.8	1.7	-0.1	0.6	1.3	3.1	0.8
ex post	0.6	1.5	0.1	0.4	0.95	2.7	0.6

The US plan was not voted by Congress as of today.

This column does not take into account the last plan, announced in December 2008, that would amount to 4.6% of GDP (2.6% of effective expenditure)

Source: National sources, OFCE estimation.

The average effort in the EU is also lower than the one of Japan (1.4% of GDP) and especially than what could implement the United States with the new administration (2.7% of GDP). According to estimations done at OFCE, the impact of the European plans will range from 0 in Italy to 0.8% of GDP in the UK, the latter being similar to the impact forecasted for Japan (0.85%) and the United States (1%).

The deficit of the Member States increase by 0.1 percentage points for Italy, by almost 1 point for the United Kingdom and by 1, 7 point in Spain.

According to our estimations, then, the currently announced plans will have no major impact, and a second wave of stimulus measures is to be expected. The American plan is not yet in force, the president having just taken office. The European plans announced until today are far from having sufficient impact in the short term.

By relying on public investment, the plans on both sides of the Atlantic are betting on the double benefit of a recovery in the short run and the building up of a capital stock for the future. But they are imposing a significant risk to the global economy. As no immediate and significant impact is to be expected, the recession will have time until the summer of 2009 to develop unchallenged, multiplying the situation of distress. The contagion of the crisis in the emerging countries adds a channel of transmission and increases the likelihood of an even worse situation.

To conclude, while the current plans pose the foundations for higher growth in the future, they may fall short of what is expected from fiscal stimulus in the very short run. Different measures, more targeted to the short run, should be quickly and boldly taken..

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Piketti & Saez

Asessment of the banking rescue packages and the economic recovery plans of the Member States - The examples of the UK and Germany

Briefing Paper for the Annual Meeting of the Committee on Economic and Monetary Affairs with the National Parliaments on 11-12 February 2009 at the European Parliament in Brussels

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Executive Summary

In the following banking rescue packages and economic stimulus programs of Germany and the UK are outlined and assessed. It turns out that the banking sector rescue packages may stabilized the banking sector in both countries to some extent. But up to now they did not succeed to get financial markets back on a functioning track. To achieve that more needs to be done. The assessment of the stimulus programs is also very skeptical. The British programs rely too much on tax cuts that are not very efficient in stabilizing the economy. The German package simply comes too late to prevent the downturn, but may help to stabilize the economy towards the end of 2009.

1. Introduction

The global economy is in a deep crisis. It started with the financial sector economic slump that has moved like mounting waves from banks to real economy enterprises with a devastating impact. Governments are faced with urgent needs to stabilise financial markets as well as goods and labour markets. The reason is both crises mutually reinforce each other. The financial market crisis worsened the goods market downturn in a dramatic way. If good markets are in recession, the probability of defaulting loans rises significantly and worsens in turn the crisis on financial market. Therefore a simultaneous approach to fight the crisis is necessary. Governments have to address both the banking as well as the real economy sector at the same time. For Britain problems of the financial market sector are of particularly high importance. It was this branch that has fuelled the astonishing growth performance of the British economy during the past decade. But now the very same sector is in a deep structural crisis and will not return to its former strength for the time being. Industry has lost most of its importance during the same period. It is rather doubtful whether it can absorb many of the newly unemployed. Therefore it seems likely, unemployment in Britain will be high by international standards for the years to come. For Germany the situation may be as difficult in the short run, but prospects for the medium run are brighter. In the short run Germany will also be severely hit by the crisis. The reason is its exports will decline dramatically, since the German economy growth performance during the past almost exclusively resulted from exports while domestic demand was slack. The crisis in the German real economy sector will be very severe by all standards. However, in the medium run as soon as the global economy picks up speed again, the German economy should be among the first to recover. Beyond doubt, the German banking sector is also in a deep structural crisis, but its aggregate importance for growth and employment is minor. This basically puts Germany in a better position than the UK. However, urgent economic policy response nevertheless seems necessary to overcome the crisis.

For all these reasons different kinds of rescue packages have been set up by governments all over the globe. At the forefront were the US government, but European governments, in particular the UK, followed swiftly. However different philosophies emerged in due course of all these efforts. While the US and the British government were fast to act, they put great emphasis on a governmental role in stabilising the economy. The German government on the contrary acted much more hesitantly at least with respect to a stimulus package for the aggregate economy. In Germany the government initially was more concerned about a rising debt level rather than about a dramatically declining economic activity.

In the following therefore these different approaches of the British and the German government will be analysed. One has to bear in mind that an assessment necessarily is of preliminary nature. Programmes still change or are amended. Furthermore their impact did not yet unfold completely. Thus a final judgement presently is not possible. What can be done is to compare the measures taken and asses their potential impact. As far as available, appropriate models should be used for that. In the following section the rescue packages for the banking sector will be compared. After that the economic stimulus packages will be outlined.

2. The banking sector packages

2.1 The British case

The break down of the ABS market created an urgent need to set up a safety net for the banking sector. Banks had to write-off significant amounts of their assets putting them into a critical position. In the UK even first signs of a bank run in the case of Northern Rock were seen. The government reacted with its immediate nationalisation. In Germany it turned out, banks among them some public banks, possessed significant amounts of ABS, too. Partly these were hidden outside official balances by placing them into Special Purpose Vehicles. After these shocking discoveries, economic policy set up rescue package in Germany, too.

The British rescue package for banks consists of basically two components. The first components are measures of the Bank of England (BoE). The BoE injects liquidity for banks at an amount of about 200 bn British Pounds (14 % of GDP). Recently the BoE set up an asset purchase facility funds of 50 bill British pounds. Banks could get this money in exchange for high quality private sector assets. The money should serve as an additional incentive for banks to increase their lending activities. Given the already low central bank interest rate, this is seen as a first steps towards a quantitative easing policy of the BoE. All these measures go into the right direction. Nevertheless it is doubtful whether they can change the risk avers behaviour of banks against the backdrop of the global crisis and the corresponding lack of trust.

Furthermore the BoE has lowered interest rates down to 1.5 %. That amounts to a significant easing of monetary conditions. In the same direction works the very strong devaluation of the British Pound in relation to the Euro. However, British exports have mainly consisted of financial services. But these will not recover in line with depreciation because of a necessary structural downward adjustment in this sector. Hence it is likely that the growth stimulating impact of the depreciation remains very limited under present circumstances. That applies basically to the whole monetary easing at least in the short run. Even under normal circumstances, monetary policy needs about a year to show a significant impact. In the present situation while the banking sector is in crisis, it will last even longer. Banks will transfer lower rates only very sluggishly to their customers. Firstly they need to increase their margins to cover accumulated debt. Secondly there is no trust in the banking system what makes banks very risk averse to lend money anyhow. The expansionary monetary policy now primarily serves to stabilise and consolidate financial markets. Only when this is achieved and trust returns, one should expect a significant positive impact of monetary policy on the real economy. Nevertheless all these monetary policy measures are a necessary condition to achieve a stabilisation.

The second component of the British rescue package are measures of the government: It has intervened into the banking sector on a very large scale. First of all, government has guaranteed private savings up to 50 000 British pounds, up from 35 000. This was basically a necessary reaction to the Irish measures, who gave an even unlimited guarantee to savings at Irish banks. They immediately bore the incentive to withdraw savings from British banks and to transfer them to Irish banks bringing British banks into severe difficulties. This highlights the necessity of a co-ordinated answer at least within the EU. But the measure was also taken to ensure trust into banks in order to avoid a detrimental bank run. There were very good reasons to fear that. In case of the Northern Bank first signs were visible. The government reacted to that by a complete nationalisation. The same applies more recently to the partial nationalisation of Bradford and Bingley. There, the government took over responsibility for more than 50 bn Pounds (63 bn Euro) of toxic assets.

Nationalisation is seen as the last mean to restore trust into the presently heavily distorted banking system. The problem is at what price this should happen. The government will not have enough money to pay banks for their assets in a way that they can recover. But if on the other hand it does not pay anything, the value of the toxic assets in the balance sheet has to be set to zero, causing many defaults on a global scale, too. That was the very reason why the US government forsake these kinds of measures. Up to now, most governments follow a case by case approach to nationalise banks only completely when they are in immediate danger to default.

Instead the British government was very fast to take pre-emptive general measures after the default of Lehman Brothers. All British banks were requested to increase their equity ratio to 10 % until the end of 2008 by issuing new shares. They could sell them to private investors or the state would step in taking the rest as preference shares. Furthermore banks were obliged to cut dividend payments and management salaries. In addition to that, the government gave guaranties for debts of the banking system up to 250 bn Pounds for at maximum three years.

As it turned out only a very minor part (0.5 %) of shares have been acquired by private investors. Large banks like the Royal Bank of Scotland (RBS) are now at 57 % in state ownership. Thus the state now has a significant stake at banks. These measures were widely seen as an example how to deal fast with the crisis. By the compulsory nature of the programme, no bank was able to play a wait and see strategy. That would have caused a further worsening of matters and in the end led to higher costs. The short term effect was as desired, banks got stabilised. Some sort of trust returned. Nevertheless recent developments show that the balance sheets of banks still deteriorate as the crisis goes on and on. British banks worked on a global scale hence they are also subject to the global loss of confidence in their assets. Their depreciation threatens successes up to now and the state may be obliged to inject more and more money until there is a complete nationalisation. But then again the question rises at what price.

In sum the banking rescue package in the UK has served to avoid widespread default in the British banking sector and achieved a temporary stabilisation. However the fundamental problem of toxic asset has not yet been solved. Still banks are in a precarious position desperately trying to adjust to changed circumstances.

Therefore the British government recently announced additional measures. The public share at big banks like RBS will be increased to 70% to give them fresh money. Secondly, all banks will be obliged to inform the government on toxic assets they still hold. Banks will then have the chance to insure 90 % of their toxic assets against loss. Details will be published by the end of February. The fundamental question is again at what price. In order to find a proper insurance premium one has to know the probability distribution of default. Any other premium will be biased either towards subsidising banks or burden them with undue costs. This former one cannot be justified towards the taxpayer and gives wrong incentives for banks to take too high risks. The latter one may cause their default.

2.2 The German case

The nature of the German financial rescue package was similar at the start and different later on. At the start the German government also had to react to the Lehman default and the Irish guarantees for savings at Irish banks. The German guarantees were at the same time more far reaching and less precise than the British one. The government announced that it would guarantee for all private savings at an unlimited amount. However this guarantee never found its way into a law it was just announced by the chancellor and the minister of Finance. Therefore it is unclear whether legal claims can be made.

The basic reason was as in Britain to establish trust into the banking system and to avoid a bank run, although in Germany there were no such dramatic signs of a bank run as in Britain. Nevertheless people seemed to have transferred a lot of money from private banks to public owned saving banks increasing liquidity pressure on the former.

After the Lehman default the German government was also forced to set up a rescue package. For this reason a financial market stabilisation law (Finanzmarktstabilisierungsgesetz) was decided upon by both chambers of parliament within weeks. By this an umbrella for the German financial sector was set up. The law established a Financial market stabilisation agency (SoFFin) that is in charge of executing the law. The agency has three instruments to help banks.

- Guarantee for newly issued debt securities and other liabilities of financial sector enterprises
- Recapitalisation of banks
- Assumptions of risk positions

The financial volumes for the respective positions are as follows:

Financial market stabilisation funds Germany

Recapitalisation / assumption of risk positions	€80bn
guarantee for newly issued debt securities and other liabilities of financial sector enterprises	€400bn
Total volume	€480bn

This amounts to about 20 % of German GDP. But it is unlikely that all the money for the guarantees will necessarily be spent. Only if all issued debt securities fail the sum would be due. But that is highly unlikely. The government assumes that 5 % will fail and therefore sets asides reserves of 20 bn.

The money is granted on several conditions only.

Conditions for usage based on the regulation appertaining to the Act (20. October 2008):

condition \ measure	Guarantee	Recapitalisation	assumption of risk positions
Solid business policy	X	X	X
Granting of loans to SMEs		X	
Provisions on remuneration incl. prohibition on severance payments		X	X
Prohibition of dividend payments		X	X

Financial support from state requires that future business of the banks is restricted by several aspects. They must not take any high risks and the board members will have to forsake a big stake of their salaries. Banks will not be allowed to buy their own shares back and they are also not allowed to pay dividends. Furthermore the agency requests fees in exchange for the provision of funds. It is also intended that the agency gets preferential shares or silent participation rights as compensation.

These measures serve the goal to keep cost as low as possible for the government. In particular by reducing salaries and preventing dividend payments any subsidisation of executives or share holders by state money should be prevented.

Up to now (January 2009) the following banks have made use of the program:
Debentures guaranteed by the government

Financial institute	volume (€bn)
Commerzbank	3
HSH Nordbank	5
BayernLB	5
IKB	2
Association of German Banks (intended)	6,7

What can be seen is that not all German banks have made use of the financial market stabilisation law. In particular the by far largest German bank, Deutsche Bank, is not yet part of it. The fundamental difference to the British programme is that German banks were not forced to participate by imposing e.g. conditions on equity ratios on them. To avoid conditions on salaries and dividend payments banks only very reluctantly used financial support by the state. That is the reason why in relation to the British case, it took so long until German banks moved into that direction. This has worsened their situation considerably and increased the necessary financial injection. But as in case of the British banks, problems have at best been stabilised, but not solved. It remains to be seen how much taxpayers will have to pay in the end.

3. The stimulus packages

3.1 The British case

The British government has set up a recovery plan consisting mainly of tax cuts.

Economic recovery plan I (November 2008)

	Nov 2008 – Dec 2009	2010
Financial impact in £bn (€bn) values in parts rounded		
economic recovery plan I (November 2008)		
Value added tax on 15%; period 1.12.2008-31.12.2009	12,5 (13,94)	
Other tax reductions (low income, house owner, SMEs)	7,5 (8,35)	
Sum	20 (22,3)[81] [82]	
in % of GDP (2008)	1,34	
Short term		
Government borrowing		
Lasting rise in duty on alcohol, tobacco and petrol		
Middle term		
Increase of top rate tax to 45% from 2011, (income > £150,000 a year), from April 2011 all rates of National Insurance (NI) contributions +0.5%		

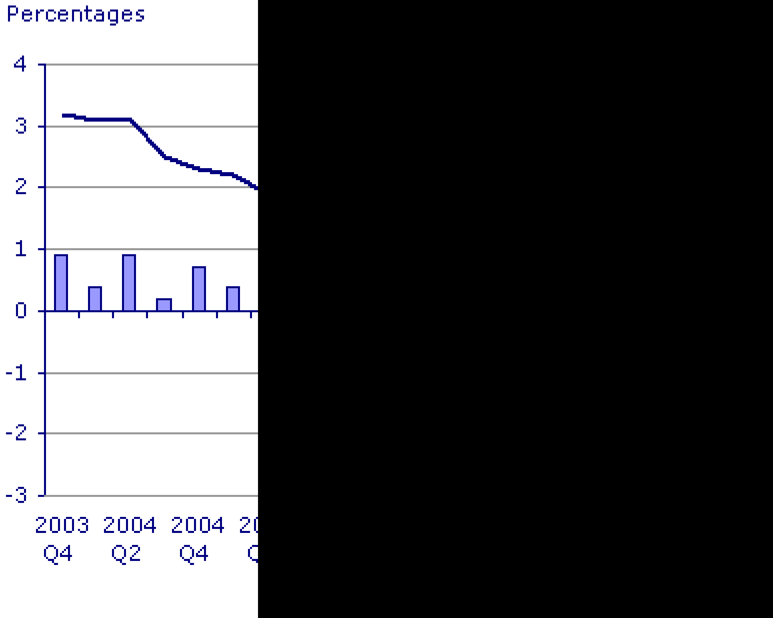
[81] Source: HM Treasury, Pre-budget report, November 2008 (www.hm-treasury.gov.uk/prebud_pbr08_index.htm)

[82] Estimation of additional fiscal spending by BRUEGEL: £14,9bn (€17,06bn; 1,01% GDP)
VAT cut: £12,5bn
Extra spending: £2,4bn

As in the case of the banking rescue plan Britain was fast to set an economic stimulus package as early as November 2008 (see table above). At the core of this package is a reduction of VAT by 2 percentage points down to 15 % until the end of 2009. The lowered VAT is supposed to lead to a decrease of consumer prices. That would increase purchasing power of consumers leading to an increased private consumption. Higher consumption should then compensate at least for some of the losses on exports and particularly investment. The government assumes costs of a bit less than 13bn pounds. In addition to that some further tax cuts were given to low income earners, house owners and small and medium sized firms. The total amount involved is 20 bn pounds according to the British government. That is about 1.3 % of UK GDP. The Breugel Institute assesses tax cuts a bit lower hence the volume is considered only at about 1 % of GDP.

There are two questions to answer. Firstly is the volume sufficient to fight the unfolding recession? Secondly, is the money efficiently used? The first question can only be answered against the backdrop forecast for the British economy. Official figures that the situation is very serious indeed.

GDP Growth
UK output decreased by 1.5% in Q4 2008



http://www.statistics.gov.uk/cci/nugget.asp?id=192

According to official government figures the British economy faced a severe downturn since mid 2008. Most recent forecast of the IMF indicate that the British economy will shrink next year by 2.8 %. This forecast already takes into account the stimulus package. It is reasonable to conclude that the volume is not sufficient by far. However, earlier forecast by the OECD were much more optimistic (-1.1 %), even without the stimulus package. Given these forecasts the programme would have been more or less sufficient. In the meantime the government has also come to the conclusion that more is necessary. In an economic recovery plan II additional guarantees for business enterprises of about 20 bn pounds will be given. Also the programme on debt equity swaps is extended by another 25 bn pounds.

It is doubtful whether the money is spent efficiently. First of all the VAT reduction can show indirect effects, only. Since firms have to pay, they charge in the end customers. It is likely

that they will only reluctantly reduce prices. Instead they may increase their profit margins. In that case tax reductions do not lead to a very much increased purchasing power at least not in the short run. Therefore consumption cannot be expected to show any short run positive impact. All other measures taken have more or less the same disadvantage. In general tax reduction as guarantees do only have indirect effects. They become effective only if firms use them and are no direct injections into the economy. Therefore they may have an effect at best only in the longer run, if any. Given all that and the particular dismal situation of the British economy that is burdened by an imploding financial sector the outlook looks very grim.

3.2. The German case

Initially the German government was very reluctant to acknowledge the necessity of a stimulus package. Therefore the first plan mainly consisted of more or less symbolic measures. Their aim was to calm the public rather than to stimulate the economy. With ever more pessimistic forecasts for the German economy and after a crisis summit with business leaders, trade unionists and economists the government decided to set up a second package. This time the government meant business and made a serious effort for stimulation. The financial volumes of both packages are outlined in the table below.

economic recovery plan I	2009	2010	2009+2010
Financial impact of the protection shield for employment ("Schutzschirms für Arbeitsplätze")			
on the collective governmental units (Gebietskörperschaften) 2009 to 2012			
in billion Euro[83]			
1. increase and grant of investments	1,32	1,40	2,7
investments in traffic infrastructure	1,00	1,00	2,0
Joint Agreement for the Improvement of Regional Economic Structures (Gemeinschaftsaufgabe Regionale Wirtschaftsförderung)	0,20	0,10	0,3
Program by Reconstruction Loan Corporation (KfW) “energy-efficient building”	0,04	0,22	0,3
further RLC-programs, e.g. local authority loan	0,07	0,08	0,1
2. tax reduction for private households	0,38	1,04	1,4
Motor vehicle tax exemption 2009/10	0,38	0,14	0,5
Intensified tax aid for handcraft services		0,90	0,9
3. tax reduction for companies	2,18	4,70	6,9
Degressive depreciation (25%)	1,94	4,33	6,3
Special depreciation SME	0,24	0,37	0,6
Sum	3,87	7,13	11,0
added for information[84]			
4. measures of Federal Employment Office (Bundesagentur für Arbeit)	0,30	0,50	0,8

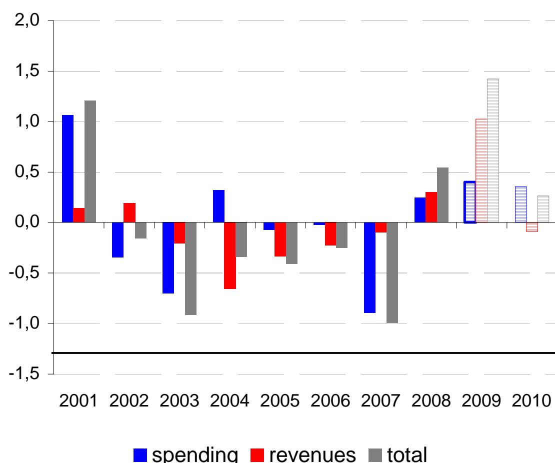
[83] without macroeconomic backlash
[84] IMK estimation

Sum:	4,2	7,6	11,8
sources: Federal Ministry of Finance; IMK estimation			
	2009	2010	2009+2010
commuter tax allowance	5,5	1,5	7,0
economic recovery plan II	2009	2010	2009+2010
1. investments by the public authorities	9,0	8,3	17,3
2. acceleration of investments by simplification of the public procurement law	?	?	?
3. credit / guarantee program	?	?	?
4. Extension of the stately secured export promotion	?	?	?
5. promotion of innovation by the federal authorities (ZIM)	0,5	0,5	0,9
6. broadband strategy of the federal government	?	?	?
7. stabilisation of demand for automobiles (scrapping premium?)	0,8	0,8	1,5
8. reforming motor vehicle tax	?	?	?
9. promotion research on mobility	0,3	0,3	0,5
10. job security			
a) social security fees short-time work	1,1	1,1	2,1
b) vitalisation + qualification	1,3	1,3	2,6
c) 5000 additional jobs Federal Employment Office	0,1	0,1	0,2
d) stabilisation unemployment insurance at 2,8 % 2nd half of the year 2010		1,0	1,0
11. cutting income tax	2,9	6,1	9,0
12. contribution to the compulsory health insurance	3,0	6,0	9,0
13. benefits for children & families			
a) bonus for children	1,8	1,8	3,6
b) standard rate for children	0,2	0,4	0,6
Sum	20,8	27,5	48,3
economic recovery plans I + II + commuter tax allowance			
Sum	30,5	36,6	67,1
in % of GDP	1,2	1,5	

As in the case of UK two questions have to be answered. Is the volume big enough and is the money used efficiently. In order to assess this, fiscal stimuli of all fiscal policy measures including those that decided upon in advance of the stimulus packages are presented in the figure below.

Discretiony Fiscal Stimulus[1] 2001 -2010

in % of GDP



[1] Computed as fiscal policy measures in relation to previous year. Without revenue from privatisation and without macroeconomic repercussions. Positive (negative) values signifie expansion (contraction).

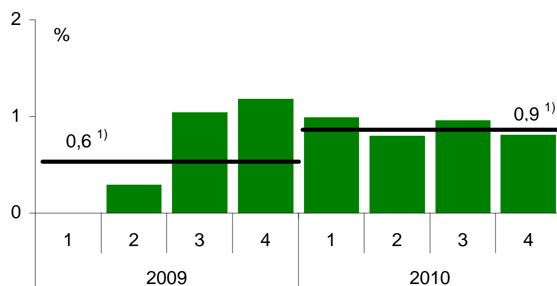
Sources: Federal Office of Statistics; Federal Government; calculations and forecasts of IMK.

The figure shows that there is indeed a major effort being made this year amounting 1.5 % of GDP. The main impulse is from additional spending on public investment. Tax cuts are of significantly lower importance (1 %). Next year the figures are much lower. These impulses were plugged into the IMK econometric model to assess their impact on the economy. One gets the results shown in the figure below.

Stimulus Package II

GDP [1] (real)

Deviations in % from baseline



[1] Average annual deviation.
Source: Simulations on IMK-Model.

The model shows that the second stimulus will raise growth in Germany this year by 0.6 % and next year by 0.9 % . Forecasts for Germany are not quite as grim as for Britain. The main reason is that the financial sector in Germany is much smaller than in the UK and has by far not the same importance for the aggregate economy.

Nevertheless the German economy is heavily depending on exports. Given that there is a global crisis with export markets declining Germany is expected to suffer a lot. The IMK forecast without the second stimulus package is a decline of 3 %. Including the package with its positive effect of 0.6 % one gets a decline of 2.4 % as forecast for 2009. This is almost equal of the most recent outlook by the IMF of -2.5 %. Given this figures Germany amidst its worst economic crisis World War II, despite the significant stimulus package. Therefore ass in the case of Britain one must conclude that the volume of the stimulus package is not high enough to prevent the very serious recession. What is achieved is that towards the end of 2009 some sort of stabilisation may be achieved. Simulations with IMK model show that the economy the may enter a stagnative path. The stimulus package does not help to prevent the downturn, but it seems to makes it of shorter duration.

The main reasons why the relatively high amount of money does not show a higher impact on the German economy are time structure and the composition of the programme. Many parts of the programme become not effective before mid 2009. But the downturn started already in the 4th quarter of last year and is expected to continue in the 1st quarter of 2009. Hence the programme comes too late. Furthermore as in the case of the British programme there is a major part in the programme that consists of cuts of taxes and social security contributions. These measures increase net income of private households. These may use it for consumption or savings. Especially high income earners will do the latter and this money does no help to stimulate the economy. The contrary is the case when spending for public investment is concerned. This money directly flows into the economy showing a much higher effect on output and employment. In the end one has to conclude that the German package is better designed than the British one, because public investment has a higher share. However, it comes too late to prevent the downturn.

Assessment on the banking rescue packages and the economic recovery plans of the Member States

Briefing Paper for the Annual Meeting of the Committee on Economic and Monetary Affairs with the National Parliaments on 11-12 February 2009 at the European Parliament in Brussels

Jean-Pierre Patat

Executive summary

Banking rescue actions and economic recovery plans success are linked. Great efforts have been done in most countries with regard to rescuing banks. If the disaster has been stopped, the result seems somewhat disappointing in the field of the banks' credit granting policies. Yet, the EU continental approach, with bank recapitalisation actions and guarantee mechanisms of interbank transactions is good, but markets have become excessively suspicious. They must stop to demand banks to increase their capital well above what is reasonable, as most of the major continental institutions have tier one capital close to 8%. Another core issue for the banking system to do again its job is to restore confidence on the interbank markets, as banks are faced in a classical crisis period situation with less demand from good risks and more demand from bad risks, but are paralysed by the fear not to ensure their liquidity.

Concerning economic recovery action, it is clear that the first priority in Europe is investment, as the continent is suffering from low growth potential. But investment expenses can have limited impact in the short term, and recovery plans cannot neglect actions in favour of consumption. Such actions must avoid wasting public money by sprinklings (such as general VAT rate decreases), while specific measures encouraging households to buy goods in which European countries have a productive capacity can be efficient. Actions for stimulating consumption can give the opportunity of a somewhat realistic coordinated European recovery plan which does not mean that all governments must do the same thing, as each country is faced with specific urgencies, but could implement actions which meet at the same time theirs own problems and some of their partners' problems. A good example of a non-concerted but possible cross-fertilisation can be found in French and German actions as Germany whose exports are dropping will implement more important measures in favour of consumption than France which is suffering from a competiveness problem.

It seems a race in billions of dollars / euros must be engaged. In comparison with 825 billion dollars of the US future plan (adding to already 150 billion dollars in favour of households) the total EU plans (250 billion euros) seem modest and the French plan (26 billions) is considered to be ridiculous by some economists and politicians. But one has to escape from a simple comparison of figures as one euro spent in consumption rescue can have poor effects while one euro in investment can have a higher effect because of the multiplier mechanism. Anyway, to restore confidence is crucial and it is not sure that economic agents won't be anxious about the future consequences on their own situation of these colossal public expenses. In addition, one cannot avoid to worry about the ability of governments to finance such huge deficits. We can already observe downgrading of some European governments signatures, and the widening of the spreads between "good" and other signatures. The situation will probably worsen when the private sector borrowings on the market become again attractive, which will reduce the appetite of investor for public debt.

A global and unified European borrowing, if possible, would probably worsen the cost of the debt for the best rated country. In addition, common existing European cohesion funds are not devoted to this mission but to reduce the disparity between the levels of development.

Governments must all the more be encouraged to limit their deficit, so in that in the euro area there is no possibility for a "monetisation" (that is to say direct purchases of public bills and bonds by the central bank) which is prohibited in the statute of the ECB.

However efficient the European plans may be, the US evolution will have a determinant role. The impact of the huge recovery plan that the new administration is designing is uncertain unless a "confidence shock" will change the behaviour of the economic agents.

1) Even if methods, transmission channels, psychological impact (and as a result, acceptance in the public opinion) are different, it is blatantly obvious to link banking rescue actions and economic recovery plans. As shown by the Japanese example, considerable amounts of money can be wasted in economic re-flation actions, with poor impact on demand and growth if the financial system remains paralyzed and inefficient.

For all that, managing the two actions simultaneously is a condition, but not a guarantee for success. In the banking area, past experiences and especially the Japanese trials and errors do not necessarily give the good responses to very complex, often new and not uniform problems. In the economic field, the most famous economic recovery policy in the past, the New Deal, and its relatively disappointing effect on growth which really started again with the war, shows that, in spite of the somewhat naïve belief in the virtue of a new Keynesian policy, billions of dollars alone are not sufficient for changing the behaviour of economic agents and restoring confidence. And yet, in the 30ies, the problems seemed retrospectively easier to solve than today, with globalization, trade opening, market expectations and judgements…

Coming again to the example of the crisis in the 30ies: one can estimate, in a first approach, that the risk that the present recession would turn into depression is weaker as millions of households did not lose there deposits and their money, which was the case in 1933, with the failure of dozens of banks.

But the characteristic of the present crisis is a constantly changing situation and new unexpected problems appearing which contributes to putting into the minds of economic agents the conviction that anything is possible, including, above all, the worst. An apparently limited dysfunction in a specific financial sector led to a surprising and general suspicion in the banking community. The vigorous central bank actions on the interbank markets seemed to gradually contribute to a normalisation. "The crisis is ended" said very audaciously a French economist in the spring of 2008. But it appeared that a lot of financial institutions, including secular and very notorious ones, were in great difficulties, the height being the explosive bankruptcy of Lehman brothers, the collapse of the stock markets with massive sales by speculative funds, while governments and central banks have been obliged to design and implement specific and sometimes totally unconventional actions, which have mitigated success and must be constantly revised, extended or even changed. In the economic field, a specific and expected lending in the real estate sector has degenerated in a general confidence crisis, with huge drops in household demand, investment expenses, and terrific problems in sectors, such as the car industry, which initially, and at least in some countries, don't seem to have to be affected.

In this context, governments are building banking rescue and economic recovery plans of which nobody can say if they are really accurate, sufficient and if it will not be necessary to increase their amount or even to change totally their stance.

In the following paragraphs, and in the light of the existing plans in Europe, but also in the United States, we will try, not to demonstrate what would be the best solutions, which would be very pretentious, but to analyse what actions could, if not guarantying spectacular results, be the less risky in terms of inefficiency, resource wasting, perverse effects, potential negative results for the future.

I shall successively examine the core problems in the financial sector, the demand and supply approaches in the economic recovery actions, the sustainability of public deficits and debts widening which is compatible with the necessary partial substitution of public expenses to private indebtedness. I will try to treat this question in line with the crucial constraint for European economies to preserve their competitiveness.

2) Great efforts have been made in most countries to rescue banks. In a first instance, and without any overall plan, national operations were managed in order to avoid specific banks to collapse: Northern Rock in UK, Hypo in Germany, Dexia in France, Fortis in Belgium… In a second stage, and considering the financial crisis worsening, the panic on the markets and the certitude of a recession, European governments designed and implemented more global and elaborated rescue plans with a double purpose: to consolidate banks financial situation and to encourage them to be less restrictive in their credit supply policy. Unlike the recent US groping experience , with the successive approaches of the so called Paulson Plan , the EU authorities rapidly converged to the core problems: to improve banks' capital ratios; to unjam the interbank markets on which transaction conditions have been affected since the summer of 2007 and heavily worsened after the failure of Lehman Brothers. So the EU countries' governments agreed to carry out, with local modalities, bank recapitalisation actions, and to implement guarantee mechanisms of the interbank loans, more or less inspired by the British experience.

More than two months after these measures had been effective, it is clear that the disaster has been avoided, but the results seem somewhat disappointing with regard to the market feeling about credit institutions and banks' credit policy.

While the UK government provided 40 billion euros to banks, their credit granting remains stingy, according to economic agents' complaints. And, as the worst, the situations of major institutions – RBS, Barclay – have seriously worsened with enormous losses and as a result, severe drops on the stock market. In Germany, it seems banks do not have enough provisioned for toxic assets and remain reluctant to increase their lending. In France, the government provided 10,5 billion euros to major banks to strengthen capital equities, and created a new entity , the “Société de financement de l’economie française” which grants credits to banks for making their medium-term refinancing easier. In addition, the President appointed a credit mediator in charge of dealing with the problems of economic agents which would be faced with a restrictive attitude of their bank. If this mediator has successfully treated a high number of files, on a global plan, a clear re-start of credit granting has still not been observed.

So, some European authorities are designing new bail-out measures. The UK government totally changed its strategy, with no new capital contribution, and a scheme in which it will insure banks against potential losses and risky loans. Coming back to the first inspiration of the Paulson plan which has initially been criticized (and finally changed in the sense of the European approach), British authorities will negotiate agreements with banks to cap potential losses on a portfolio of assets. French and German governments are clearly reluctant to engage in such a way, but the French finance minister announced a new rescue package of 10.5 billion euros which will be devoted, like the first package, to a strengthening of major banks' capitals.

All these new measures are designed to end uncertainty about future losses (or about future depreciation of capital ratios) and stimulate the flow of credits to consumers and companies. Moreover, banks are asked with firm commitments to increase lending. In France, an additional commitment asks them not to pay bonuses to the managers.

3) In considering such a mitigating situation amid fears about a public backlash against billions being committed to help the financial sector, one must ask if something has been wrong in the different approaches and what could be the ways for an effective improvement.

Is it necessary to go further and to nationalise banks or at least to enter in their capital in order to have a voice in the board of directors' decisions? In fact, governments already nationalised or became the main shareholder in banks that they saved from total failure: Northern Rock, Commerzbank, Dexia, and recently Hypo bank for which all rescue measures have been inefficient in avoiding a dramatic worsening of the bank's situation. But when authorities are adding funds to strengthen capital, like the French government does, the authorities prefer not to enter into the capital, as the devoted amounts are not important enough for giving a decisive weight in the boards.

Finally, is the purchase by the government or the central bank of bad ("toxic") assets the ultimate solution as some analysts are recommending, arguing that the endless Japanese banking system crisis was due to the fact that the authorities refused to do so? This issue which was clearly the basic principle of the first version of the Paulson Plan had been highly criticized in the first instance, as it was not efficient in treating solvability problems, unless overpricing the purchased assets. While in some cases, where a bank's situation is very serious (UK) such an issue can be envisaged, in countries (France, Spain, and even Germany) where, in most cases, banks have problems but are not in the risk of failure, such a solution would have more drawbacks than benefits.

In fact, my conviction is that the first European approach – strengthening of banks' capital and guarantying the interbank loans – is good but is suffering from some handicaps:

- After a period of excessive euphoria, markets are now excessively suspicious: as they are influenced by rating agencies (which try to restore their reputation), they demand that banks increase their capital well above what is reasonable, insofar as most European credit institutions have tier one capital close to 8%, while the required ratio is 4%. It is difficult to satisfy markets in such a crisis period. Governments give positive signals in providing capital rescues but cannot indefinitely add public funds in banks as stress tests show that most institutions are well capitalised. Some analysts suggest modifying the prudential regulation. Except for asking banks to set aside countercyclical provision in good years, as the Bank of Spain already did (but it is of course a measure for the future), changing the regulation in the view of softening the prudential ratio requirement would give a wrong signal. So communication must be perfected and pressures on the banking system maintained, which is a difficult attitude to manage because bank credit granting cannot be decreed or ordered by the summit.
- Is the approach for improving interbank relations the more relevant? At least in France, the government seems to have chosen a complicated system, with an administrative structure, the Société de Financement de l'Economie Française which, in fact, stands in for the interbank market participants, examines files, borrows funds on the financial market and lends these funds to banks. But the problem is in reality very crucial but very simple: banks remain reluctant to lend to other banks on the interbank market.

> If the government says it guarantees the interbank market operations, without creating a gas factory (as Swedish authorities successfully did in the 90ies), it can significantly release transactions, without needing to spend much money, as the blockings are, to a large extent, psychological.

We think that solving this problem is the core issue for the banking system to do its job again. On the interbank market, three months interest rates dropped recently, but this improvement of the situation is due to the massive and apparently durable central bank liquidity injections, and not really to interbank trust returning

In fact, banks are faced with a double situation: major wealthy industrial firms postpone their investment projects and don't ask for credit. But some large firms (in the car industry) and a lot of medium and small size businesses are affected by the crisis, with serious funding problems and need for credit: less good risk opportunities and more bad risks is a classical situation in a period of weak activity. But the fact that credits institutions fear they might not be able to assure their liquidity on the market contributes to a serious worsening of the problem and to the extreme cautiousness of the credit institutions.

And yet, it is obvious that banking funding could immediately improve the situation in some sectors without any new rescue measure: in the real estate sector, prices are decreasing; in some countries, Spain, France, the government already enhanced fiscal subsidies for borrowing interest payments. Conditions exist for a rapid bounce which only needs financing, all the more so in that the lending rates are at last decreasing after almost two years of continuous rise.

4) Concerning economic recovery actions of the EU governments, a major debate has surged in many countries on the respective priorities to give to investment or households consumption.

In fact, one has to consider that investment is the first priority in Europe as the continent is suffering of from low growth potential which must be significantly increased. Insofar as one element of the growth potential, the work force, cannot be rapidly and strongly improved (because of the demography and the social benefits which are at the same time a force and a weakness for Europe), the main efforts have to be done on the second element, which is productivity innovation and competiveness improvement. So, undoubtedly a massive investment involvement (of which the so called Lisbon Agenda already gave main orientations) must be done.

In line with the productive capacity problematic, the creation by the French government of an Equity Fund which would invest in advanced technology and products firms to avoid them to be taken over by foreign sovereign wealth funds can preserve jobs and maintain high potential activities in the European industrial site.

The problem is that investment is good for the future but can have a limited short term impact on the economic situation. And yet, all governments are hoping for a rapid recovery signal. If we consider the French rescue plan, a lot of measures will improve the short term financial situation of firms, and probably limit the job destruction, but it is not sure that firms use this relative affluence for launching investment expenses in view of the uncertainty of the final demand. One can do the same remark about the actions in favour of medium and small size businesses that most European governments have designed. On the other hand, public investment can have a rapid effect if the devoted credits finance government or local authorities' projects which have been already finalised but stopped by a financial constraint. That could be observed in the French public investment action plan and it is possible that some actions of the German plan could be also rapidly implemented.

Therefore, economic recovery plans cannot neglect actions in favour of household expenses which have more rapid effects on the growth.

However, they have to be well targeted and could have a maximum efficiency if they are taken in the framework of intra European cooperative measures.

Actions must avoid to waste public money by sprinklings which will, at least be ineffective, and at the worst, increase the external deficit of the country. In my sense, the general drop of VAT rates (cf the UK plan) is typically such a kind of measure. There is a great probability that distributors keep the margin, as they, inversely, reduced their margin when VAT was increased (cf the German example). Anyway, a price diminution of 2% would be too weak to launch a decisive restart of household demand. On the other hand, specific measures encouraging households to buy goods in which European countries have a productive capacity can be efficient, like the "scrapping allowance" for the old cars enhanced in France and more recently in Germany.

Actions in favour of consumption should give the opportunity of a somewhat realistic coordinated European rescue plan. Such a plan, the absence of which many analysts and politicians regret, does not consist of having all governments doing the same things. Each country is faced with main specific problems, real estate in Spain, huge household indebtedness in the UK, competiveness in France, weak, domestic demand in Germany…, and it is normal for each government to implement specific measures. But an initiation of cooperative action can exist if each government, not only does not take measures which can harm other countries (for example, unilateral drop in VAT, or the Spanish government urging to buy and to consume Spanish goods), but implements actions which meet at the same time its own problems and its partners' problems. A good example of this type of "cross-fertilisation" could be found in German and French actions. France has a serious problem of competitiveness, as shown by the export drop and the widening of its foreign account imbalance. So it is logical to encourage consumption less than efforts to improve competitiveness in order to make the most of the future worldwide recovery. Inversely, Germany has a good competitiveness but this asset is more and more useless as the worldwide demand, especially the emerging countries' demand is collapsing. So, Germany's present interest is to stimulate domestic demand, which has been until now very poor. In doing so, the German authorities limit the drop of their GDP and at the same time help also their partners. Probably, French and German authorities had no such a deliberate concerted action in mind but it is noticeable that efforts in favour of the consumption are greater in the German plan than in the French scheme (for example, the amount of the "scrapping allowance" is twice that of the French one).

5) A crucial question is that of the optimal size of the economic recovery plans. It seems a race in billions of dollars or euros must be engaged. The US government wants to implement a 825 billion dollars rescue plan, which has to be added to the 125 billions already engaged by the former administration (with, more particularly, the sending of cheques to millions of households). With a total amount of 200 billion euros, the EU global plan looks comparatively modest and the 26 billion euros of French action is considered to be ridiculous by a lot of economists and politicians. In a recent statement, the IMF general manager advised governments to devote 2% of their country's GDP to recovery plans. If this recommendation is obvious, global EU plans (to which we have to add the very recent new German plan of 50 billion euros) is well dimensioned, the French plan (1,3%) is below the recommended size (the French Socialist party has proposed an alternative plan of 50 billion euros), but one has to add the specific rescue measures in favour of some productive sectors like the car industry, and the US scheme is by far above the target (4,8% and more than 5% if one adds the already engaged expenses).

If one escapes from a simple comparison of figures, one can put two remarks or questions:

- One euro, or one dollar, has not the same impact on growth and employment depending on the financed expense. In industrialised countries, the effect of the sums devoted to increasing the consumption capacity of households is clearly smaller than the engaged amounts, as the household can save a part of the allocations, and as a large part of the manufactured products is imported. Sums devoted to public investments are of course sources of imports, but on the other hand, their impact on GDP can be higher than the initial expenses, because of the "multiplier mechanism" of which the potentiality is inversely proportional to the saving behaviour of households. This Keynesian concept is not questioned, even if its current effectiveness must be assessed in taking into account the fact that the imports share in industrialised countries' supply of products is higher than in the 30ies. So a correct evaluation of the recovery plans' efficiency is by far more complex that the simple comparison of the respective amounts of spent dollars or euros.
- To restore confidence is at least as important as to spend money. Is it sure that the announcements of these colossal amounts will not be partly counterproductive? Economic agents which were until now being convinced by their governments of the necessity of sound public finance policies can be somewhat confused by these U-turns. Of course, circumstances have changed and a bigger state involvement is needed and approved but, considering the enormity of the amounts at stake (all the more so in that a lot of analysts, economists and politicians are proclaiming that they are not sufficient!), economic agents don't need to read Ricardo to ask themselves what would be the future consequences of these actions on their own situation. This feeling of distrust could be strengthened if it appears that these plans have poor effects or, to say the least, disappointing effects considering the billions engaged.

May I add, as a personal remark, that the twentieth of the announced amounts could avoid famine of dozen of millions of poor countries' citizens and that to devote such sums to this action was never envisaged in the past! It appears that the current main problem is to save rich countries.

6) One cannot avoid to worry about the ability of governments to finance the huge deficit resulting or the implementation of the recovery plans.

Of course, a rapid and strong economic recovery could reduce the future burden of the temporary increase of the public debt if governments are virtuous. But it is not excluded that this recovery is limited and the industrialised countries' output grow sluggishly or poorly, insofar as in some countries – US, UK, Spain – economic agents have to reduce an unbearable indebtedness. Anyway, however successful the recovery plans could be, the question of the public debt financing will be posed during the next years. We can observe already some market reluctances, with the down grading of the Greek and Portuguese signatures, while the spread between long term interest rates on signatures which are still considered as good (Germany and to a certain extent France) and the others are widening. More surprising and more revealing of the worry of investors and markets is the warning on the Spanish debt, while the Spanish government has been until recently considered as a model of sound management, and its public debt is still at a reasonable level (well below the 65% ratio of France). But the prospect of a dramatic and rapid increase of this debt is seriously influencing the investors feeling.

The situation can and would probably worsen as the distrust for other financial assets presently gives a premium to the public borrowings which benefit from low interest rates.

When the private issuing becomes attractive again, the rates on government debt will increase and the spreads widen.

It has been put to the discussion that a global European recovery action, with a unified borrowing would have saved some countries from paying high interest rates. For not dealing with the question of the entity – one can create a special agency, which would be legally entrusted with borrowing on the markets, one can imagine the national government having agreed to a repartition of the collected funds and of the respective burden of the debt service. But it is not sure that such a financing would necessarily be advantageous. Behind the abstract and apparently transnational body issuing the loan, investors and markets would not neglect the existence of national entities which would be the real debtors. So, the interest rate paid would perhaps be relatively advantageous for the downgraded countries, but surely disadvantageous for the countries with good rating. Could the specific existing funds (European Regional Development Fund, Cohesion Fund) be entrusted with a mission of implementing a unified procedure of borrowing? But these funds are devoted to reduce the disparities between the levels of development of various regions, not for bailing out governments whose fiscal management is unsound. On a doctrinal point of view, one could argue that such a bailing out is by itself not acceptable insofar as countries have agreed to the Stability and Growth Pact which clearly plans, especially since its last reforms, the circumstances which authorize rules derogations – and the current conjuncture is of course a major circumstance – but also the way for coming back to reasonable limits when these circumstances are overcome. But in a concrete approach, one can ask if it is economically efficient to tax countries with sound policy for reducing the burden of countries with more lax policy.

Nobody can contest that the public expenses must temporarily take the place of the private sector one. But, concerning EU countries which have productive capacities and competitiveness problems, which don’t issue a reserve currency which could allow to endure a “deficit without tear”, it is important not to jeopardize the future: a sustainable public indebtedness should be the condition for efficient recovery plans that you not represent risks in the future.

Governments must all the more be encouraged to limit their deficits so that there is no possibility of a debt “monetisation “, that is to say direct purchases of public bills or bonds by the central bank. The Japanese central bank did this, with very poor success for economic recovery; the FED recently announced that it could do that. But such operations are prohibited in the ECB statute and there is no chance to have a European consensus for modifying this statute in that sense. Have we to regret this? “Monetisation” already exists when commercial banks buy public bills or bonds. In favouring these assets as collateral of its refinancing operations, (long term bonds could be accepted without problem), the central bank is encouraging banks to buy them. Direct purchases of public bonds is a “central bank money monetisation” which has economic consequences: first, monetary policy is made difficult with undesirable and not easily manageable liquidity injections on the interbank market; secondly, there is a risk for fiscal policy to have no more safeguards for avoiding excess. But the measure has also political consequences in weakening the independence of the central bank which becomes more and more a government agency; such a situation can be conceivable in exceptional circumstances, but could be difficult to reverse when the crisis is over.

However efficient the European recovery plans may be, the US economic evolution will have a determinant role and the efficiency of the US policy is as important as the EU governments’ action.

One can already give some comments: firstly, the important share of the US recovery plan devoted to public investment will take time to produce effects as there are no immediately ready projects which could be quickly implemented (it is said that the first concrete construction sites will start in 2010). Secondly, the real impact of the action for stimulating household demand is strongly dependant of the degree of confidence in the future of these economic agents. For the time being, one must admit that the "cheques" sent to households by the former administration did not avoid the collapse of the consumption. So, the economy needs a "confidence shock" which can arive with the new President, unless households worry about the enormous public debt and are anxious to reduce their own indebtedness.

Anyway, recovery could be seriously impeded if the protectionist arguments which can be noticed in the US and also in the EU are become concrete.

Banking Rescue Packages and the Economic Recovery Plans of Some (New) Member States: An Assessment

Briefing Paper for the Annual Meeting of the Committee on Economic and Monetary Affairs with the National Parliaments on 11-12 February 2009 at the European Parliament in Brussels

Leon Podkaminer

Summary

No new member state considered in this note (the four NMS which have already adopted the euro are not reviewed here) intends to implement an additional fiscal impulse consistent with the European Recovery Plan – or any fiscal impulse at all. To varying degrees, this attitude is understandable (perhaps less so in the Czech Republic or Poland, more so in Hungary and the Baltic Countries). A deliberate fiscal expansion in these countries may well contribute to an unwelcome increase in their *excessive* external imbalances, rising costs and availability of external borrowing, strong pressures on the national currencies – which in end effect would further enhance risks to the real economy and the financial stability.

An implication of the inability of the NMS to engage in additional deficit spending is that the *strong* EU countries would have to spend *more* than 1.5% of their own GDP.

The question is: which EU countries should be considered strong enough to take over the fiscal tasks of the weaker ones? My answer is that these are the countries which generate huge national *savings in excess of their own investment needs* – i.e. the countries which run massive current account surpluses. Specifically, these are: the Netherlands, Germany and some Scandinavian countries. It is worth observing that the two former countries alone have been running trade surpluses – monstrous in size - with the remaining EU countries (in total 228 billion euro in 2006, followed by 260 billion euro in 2007). These surpluses represent the outcomes of the *beggar-thy-neighbour* tactics vis-à-vis other countries (some NMS in particular). It is only *fair* to request that the strong EU nations spend the excessive savings they work out nationally on higher national consumption and investment. This would be not only in their own interest – but also in the interest of the whole Union.

Poland: standard measures supporting the financial sector's stability plus a *virtual* fiscal stimulus

Until now (mid-January 2009) the Polish financial system has not been *directly* effected by the global turmoil. No financial institution domiciled in Poland has gone bankrupt, no such institution has – as far as one knows – needed public assistance (or at least requested such assistance). As elsewhere in the New Member States, the local banks did not engage in the sub-prime, or other tricky investments. (They did not need to engage in such investments as their local business has been lucrative enough). This applies also to the local affiliates of the foreign banks which (like e.g. Fortis) have suffered heavy losses on their sub-prime exposures. However, some indirect effects have already materialised. Even if the balance sheets of the local banks (including the foreign owned ones) are as sound as claimed, their reputation has suffered[85]. (The balance sheets must have actually deteriorated somewhat – e.g. on account of a strong weakening of the Polish zloty (affecting the financial position of agents heavily indebted in foreign currencies), or due to the abrupt weakening of overall economic growth observed in the closing months of 2008). As elsewhere in the EU, banks' mutual confidence has been impaired - with obvious consequences for the inter-bank lending - and of course for lending to the real economy.

The measures taken (or about to be taken) to strengthen the financial system stability turn out to be pretty standard. First, following the EU finance ministers' agreement of 7th October, the authorities raised the bank deposit guarantee limit to the equivalent of 50 thousand euro. The new limit (in force until the end of 2009) can be further raised, should a need arise. Second, the National Bank of Poland worked out – and follows – a *Confidence Pact* which facilitates provision of liquidity (also foreign exchange). Among others, the Pact increases the frequency of open market operations, extends the maturity of the liquidity provisions, introduces foreign exchange swaps, decreases the haircut on Lombard credit, and expands the range assets accepted as collateral etc.

Deposits in the banking system have responded positively to the extended deposit guarantees. Also, there seems to be quite an adequate supply of liquidity (both the local currency and foreign exchange) supplied by the NBP. However, the ultimate effects of the measures taken to support the banking system continue to be disappointing. Banks rather hoard money (as deposits with the NBP, or in the form of treasury debt) rather than lend them out (to other banks, or to the real economy). To some extent this situation must have resulted from the absence of legislation covering issuance of official guarantees for unsecured inter-bank lending. (That legislation - covering also the methods and principles of eventual treasury support to banks and other financial institution - has passed the lower chamber of the Parliament on 9 January 2009. It still needs to be approved by the upper chamber – and then be signed by the state president).

It may be observed that the high interest rates administered by the NBP must have played a role as well. That role is hardly positive. Currently the basic NBP policy rate is 5% (the NBP deposit rate is 3.5%, the Lombard rate is 6%) – while inflation is fairly low and falling (actually a deflation was recorded in December 2008). (For comparison, in Sweden (where recent inflation dynamics is similar) the Riksbank's basic interest rate has been 2%).

[85] Arguably, the domestic affiliates of some foreign banks may have been stigmatized by the latter's misfortunes. Besides, there are still misgivings, felt not only by the general public, about the policies followed, *now*, by the foreign owners of the domestic banks. The question is: are they not sacrificing their local business to help the core business 'at home'? Doubts about the answer to that question do not strengthen the general level of confidence in the banking system.

The interest rates on loans demanded by the commercial banks are of course much higher (and their mark-ups have kept rising recently). Given the enhanced levels of uncertainty about the future (volumes of sales, prices), these conditions are not quite conducive to a rise in non-financial business sector's demand for loans. Thus, the low dynamics of credit extended to the economy may - to some extent at least - reflect the weakening of the demand for it rather than exclusively the banks' reluctance to lend[86].

The *Stability and Development Plan* announced by the Finance Ministry on 30 Nov. 2008 complements the NBP Confidence Pact. The Plan envisages many specific actions (including elimination or temporary suspension of various regulations restricting economic activities). Most of these actions are to support investments in fixed assets, including the infrastructural ones, co-financed from the EU funds. The Plan also enumerates two actions supporting private consumption (lower income and VAT tax rates) worth about 2 billion euro in total. However, the lower tax rates were on the agenda well before the advent of the crisis. Lowering of these taxes does NOT represent a response to the crisis.

The total nominal value of the '*pro-investment impulses*' paraded by the Plan is rather impressive (equivalent to about 20 billion euro). However, that value does not represent any fiscal stimulus at all. Instead, it represents the sum of additional amounts of *guarantees* that *could* be extended to the economy (including its financial sector) and the additional volume ('*of safe*') credits that the state-owned BGK bank could extend to small-and-medium enterprises. The value also includes the volume of investments co-financed by the EU, to be spent ahead of the initial schedules. The essential point about the Plan is that it claims to have left the public sector deficit unchanged (as compared with the original budget for 2009). In relative terms, the original budget plan assumed 5% GDP growth in 2009, with the public sector deficit at 2% of the GDP. Because the GDP growth rate was then scaled down to 3.7%, the same nominal deficit is now to account for 2.5% of the GDP. Anyway, compared to the year 2008, the fiscal policy for 2009 is planned to be MORE restrictive. (The public sector deficit in 2008 is estimated at 2.7% of the GDP).

The 'philosophy' behind Poland's fiscal response to the crisis is simple enough. Rising public sector deficit is considered a bad thing because it is maintained that this: (1) prevents the relaxation of the monetary policy; (2) impairs the country's credibility, thus making the public debt service more expensive; (3) possibly weakens the exchange rate and thus supports inflationary tendencies, (4) makes credit to the real economy more expensive. All in all, according to that philosophy (no doubt shared by the guardians of the provisions of the EU Growth and Stability Pact), the increased deficit spending is likely to make matters worse. The gist of that philosophy is that to support a flagging economy one needs a *more* restrictive fiscal policy.

Without engaging into a discussion of the validity, given the current conditions, of the philosophy in question, one may conclude that Poland is unlikely to contribute to the generation of a fiscal stimulus envisaged in the European Economic Recovery Plan[87].

[86] Too high interest rates should restrict the effective *supply* of credit, not only the demand for it. Such a tendency (first analysed by Professor Stiglitz quite some time ago) arises when banks realise that too high interest rates must discourage reliable borrowers (thus lowering the average quality of new loans extended).

[87] In 2009 Poland's GDP growth is now generally expected to be smaller than 3.7%. The recent EU Commission Interim Forecast envisages 2% growth, with the public sector deficit/GDP ratio rising to 3.6%. The implied 1.1 percentage point increase in the deficit ratio (1.1% = 3.6% - 2.5%) does not

The Czech Republic: measures supporting the financial sector stability yet to be worked out; a token fiscal stimulus

Exposure of the Czech banks to sub-prime securities appears to be negligible. Otherwise, the levels of risks facing the Czech banking system seemed, until recently, to have been much lower than elsewhere. Despite quite vigorous GDP growth, the domestic credit expansion in 2007-08 has been rather sluggish when compared with other NMS. (Growth has been export-led). Moreover, unlike in other NMS, credits denominated in foreign currencies were not popular at all (as was to be expected given the fact that the Czech interest rates have tended to be lower that the foreign ones). The presently observed devaluation of the NMS (floating) currencies creates problems, more or less acute, for debtors (and banks) everywhere – except in the Czech Republic.

The most recent statistics available (for November 2008) on interest rates and monetary aggregates do not show any obviously abnormal developments. Anyway, the Czech authorities have taken some precautionary measures. These include increased level of deposit insurance (50 thousand euro, as elsewhere) and the introduction of repurchase facilities to improve the distribution of liquidity (however the range of instruments acceptable as collateral has been quite narrow). Most importantly, in anticipation of harder times ahead, the Czech National Bank has been easing its policy. The CNB was the first central bank in Europe to start easing the policy in 2008 - in August. The most recent CNB decision (17th December 2008) lowered its basic interest rate to 2.25%.

The long lull is now coming to an end. The sudden (and unexpected?) deterioration on the 'real front' recorded in November[88] spells trouble also to the banking system. Further measures to preserve the financial sector stability will be in focus of the National Economic Council (called into life only on the 9th January 2009). Most probably also the budget plan for 2009 will also come for further revisions. The public sector deficit will certainly be much higher than that envisaged in the current plan (which stipulated e.g. the structural deficit of 1.5% of the GDP). The Czech authorities have not yet decided to make a genuine fiscal contribution to the European Economic Recovery Plan. The recent statement made by the Finance Ministry ('*Addendum to an updated Convergence Program (November 2008)*') creates an impression that the Republic will make a contribution with measures increasing households' disposable income by an equivalent of about 700 million euro. However, these measures had been integrated into the budget plan for 2009 much earlier. They do not represent an additional fiscal stimulus.

The second group of measures mentioned in the *Addendum* primarily relates to spending supporting investment (the bulk of that going into transportation infrastructure). These measures are worth about 600 million euro. The total fiscal cost of these investment-support measures is equivalent to about 0.4% of the GDP. Should these measures really represent *additional* spending (on top of the current budget for 2009), they would be welcome – though of course missing the 1.5% mark recommended by the European Council. But it not at all clear whether or not these measures have not been in current budget anyway. In that case the additional fiscal stimulus would be zero – just as in Poland. Of course, unlike in Poland, the public debt in the Czech Republic is quite low (<30% of the GDP). There seems to be some room for some fiscal expansion.

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represent any fiscal policy impulse. Instead it follows, pretty automatically, from lower budgetary tax revenues and higher non-discretionary expenditure as well as from smaller size of the GDP.

[88] In November value of exports fell 18% (year-on-year), value of imports by 13%, sales of industrial production by 18.5% and the value of new orders placed with industry by over 30%.

That this room is being ignored may reflect the Czech authorities preference for fiscal discipline as such. (In this respect they are not much different from the believers in the Stability and Growth Pact).

Hungary: no fiscal stimulus in sight

In October Hungary experienced an abrupt and steep depreciation of its currency - combined with outflows of foreign capital (e.g. invested in Hungarian securities). Given very high levels of foreign debt (both public and private) that was a serious crisis which required a fast and massive external assistance. Such an assistance came in the form of a 'rescue package' worth 25 billion USD[89]. The package was designed to restore external investors' confidence and alleviate the stress felt in the Hungarian financial markets. (Specifically, it includes measures to maintain adequate domestic and foreign currency liquidity, as well as capital levels in the banking system). As usual, there are string attached. These came in the form of a requirement to improve the fiscal balance. That commitment is respected in the budget plan for 2009 (approved on 15th December 2008). The public sector deficit is to contract to 3.4% of the GDP (from about 5% in 2008). The intension to continue[90] fastening the fiscal belts is stated in the updated 2008 convergence program. Referring to the European Recovery Plan, it is said that '*…in the present context there are no possibilities to provide a fiscal stimulus to the economy…*' This is reiterated, rather bluntly, in a more recent *Addendum* to the convergence program: '*There has been no measure implemented burdening the budget.*'

Measures supporting financial system stability include (1) increased deposit guarantee (to the equivalent of 50 thousand euro); (2) adoption of laws on state assistance to the financial sector institutions (covering provision of debt guarantees and capital support); (3) a number of measures aimed at enhancing liquidity (also in foreign exchange).

Additionally, the National Bank has, since the 25th November been easing its monetary policy. Currently the NBH base interest rate is 9.5% - against inflation of 3.5% in December. (On the 22nd October the rate was raised from 8.5% to 11.5%. That desperate effort was to stop the fall of the Forint. Currently the Forint has been weakening anew).

Bulgaria: maintenance of fiscal surpluses a priority

It is not quite obvious what measures have been taken (beyond the deposit insurance guarantees) to strengthen the stability of the Bulgarian financial system. There are statements to the effects that the authorities 'stand ready to guarantee liquidity and support the capital' in the financial system. Whether or not there have been actual preparatory actions behind such statements is hard to tell. What one has on record are the Bulgarian National Bank's ordinances lowering the required reserves ratios for the commercial banks: This move is clearly aimed at improving the liquidity situation. In the words of the BNB Governor: '*Implementing such a policy..., the BNB will expect from the commercial banks to keep their liquidity and capital adequacy at sufficient levels…actions planned by the BNB will add to the banks' flexibility thus enabling them to relatively more easily absorb potential losses from deterioration of their credit portfolios as a result of the lower rates of economic growth in 2009.*' (From the speech of the BNB Governor at the conference of the Association Of Banks in Bulgaria, Sofia, 4th December 2008).

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[89] The IMF is the major contributor to the loan at the core of the package. The loan will be quite costly – even if eventually unspent.

[90] Hungary's (past) lax fiscal policy culminated in 2006 when the public sector deficit reached over 9% of the GDP. Since then the fiscal belts have been tightened, pushing the economy into a virtual stagnation.

Given Bulgaria's monetary arrangements (currency board regime with the fixed exchange rate vs. the euro) and its very high reliance on foreign financing (current account balance approaching 25% of the GDP in 2008), the country cannot risk much of a fiscal relaxation. Indeed, the budget for 2009 targets the maintenance of a fiscal surplus of 3% of the GDP (roughly the level of 2008).

The Baltic Countries & Romania: fiscal tightening in the cards, not the fiscal stimuli

Growth in Estonia, Lithuania, Latvia and Romania has – for some time now - shared many features with growth in Bulgaria. All these countries have followed an import-fed growth trajectory resulting in huge current account deficits sustained over several years (and snowballing private foreign debt). For some time the external financing of the deficits will not be easily available. Currently one witnesses the tendency for capital outflows. The capital outflows, which of course depress the real economy, constitute by far the greatest danger to the financial stability. In the Baltic countries the currency-board arrangements which are the backbones of the overall stability are mow endangered (as demonstrated by the events leading to the dispatch of a heavy external rescue package to Latvia). In Romania the induced devaluation of the currency may hurt the domestic banks (and households which have heavily indebted themselves in foreign currencies). In any case, as the recent experience of Portugal, Greece and Spain indicates, *now* is not the right time for the countries of doubtful (or unproven) reputation to place ballooning amounts of the government debt on the market.

The required fiscal response – under the present situation of the countries considered - stipulates substantial fiscal tightening. This is what the governments of the Baltic Countries and Romania (as well as Bulgaria and Hungary) are currently up to. It may be added that in the Baltic countries the tightening assumes quite dramatic forms – e.g. huge cuts in nominal wages of the public sector employees.

Concluding remarks

No new member state considered in this note (the four NMS which have already adopted the euro are not reviewed here) intends to implement an additional fiscal impulse consistent with the European Recovery Plan – or any fiscal impulse at all. To varying degrees, this attitude is understandable (perhaps less so in the Czech Republic or Poland, more so in Hungary, Romania, Bulgaria and the Baltic Countries). A deliberate fiscal expansion in these countries may well contribute to an unwelcome increase in their *excessive* external imbalances, rising costs and availability of external borrowing, strong pressures on the national currencies - which in end effect would further enhance risks to the real economy and the financial stability. Anyway, the public sector deficits in all countries will be much higher than planned (and surpluses – e.g. in Bulgaria) much smaller – much against the will of the authorities. This will cause serious problems that are unlikely to surface in stronger and bigger countries that would go for increased deficit spending.

An implication of the inability of the NMS to engage in additional deficit spending is that the *strong* EU countries would have to spend *more* than 1.5% of their own GDP. Alternatively, the EU as a *whole* must engage in deficit spending – just as the US Treasury engages in deficit spending benefiting not only the US, but also its trading partners[91].

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[91] Perhaps also the EBRD and/or EIB could be instructed to provide generous lending to the member states. That lending could be financed by these institutions' (or '*European Union's*'?) debt, to be traded internationally.

The question may be asked as to which EU countries should be considered strong enough to take over the fiscal tasks of the weaker ones. My answer is that these are the countries which generate huge national *savings in excess of their own investment needs* – i.e. the countries which run massive current account surpluses. Specifically, these are: the Netherlands, Germany and some Scandinavian countries. It is worth observing that the two former countries alone have been running trade surpluses – monstrous in size - with the remaining EU countries (in total 228 billion euro in 2006, followed by 260 billion euro in 2007). These represent the outcomes of the *beggar-thy-neighbour* tactics vis-à-vis other countries (and vis-à-vis some NMS in particular). It is only *fair* to request that the strong EU nations spend the savings they work out nationally on higher national consumption and investment. This would be not only in their own interest – but also in the interest of the whole Union.

An Assessment of fiscal and bank support packages

Briefing Paper for the Annual Meeting of the Committee on Economic and Monetary Affairs with the National Parliaments on 11-12 February 2009 at the European Parliament in Brussels

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Executive Summary

- **Europe has entered the worst recession in a decade.** In such a situation it can make sense for national governments to stimulate demand, in order to stabilise expectations and to counter the risk of a vicious spiral into a depression.
- **Within a single market there is much to be said to support coordinated national action.** The European Economic Recovery Plan (EERP) follows this reasoning. It determines the framework for discretionary measures within national economic stimulus packages. Thus, in general, the EERP is to be welcomed.
- **The EERP rightly states that national packages should be timely, targeted and temporary.** The packages of major member states however do not fulfill these criteria. To boost private demand, a concerted VAT cut by all EU member states would be preferable. In turn, supply-side oriented measures take effect only with a considerable time lag.
- **Moreover, it is still unclear to what extent the compliance by member states can be controlled.** It also remains unclear whether all countries are equally obliged to fulfil the intended stimulus of 1.2% of GDP or whether there will be a differentiation according to the countries' initial situation. It is also unclear whether 1.2% is a benchmark for 2009 only or a combined two-year period (2009/10).
- **Besides these problems we see three more fundamental risks:** 1. A ballooning of public debt due to an unsustainable level of public deficits. 2. Lasting competitive distortions in Europe, if the EU Commission does not take effective countermeasures. 3. The lack of coordination on a global scale which could trigger competitive devaluations among the main trading blocks.
- **Conceptually, the government rescue packages for the banks are sound**.
- **As regards the adequacy of the rescue packages, it is difficult to come to a conclusive assessment at this stage.** However, judged against the pressing concerns as they presented themselves at the time when the packages were designed, a number of positive effects are undeniable.
- In addition to considerations whether the support packages may need to be revised in light of subsequent market developments, **changes are needed to specific design elements** and the actual implementation of the packages.
- While the competitive impact of emergency liquidity provisions by central banks is comparatively small, the **negative impact on competition is more critical in the case of state support.** Rigorous monitoring by the European Commission and enforcement of EU competition laws is necessary.
- While this may seem premature, thought should be given in time to the question of **how the recently implemented central bank and government support measures can**, once markets normalise, **be unwound** in an orderly way.

Need for a European Fiscal Stimulus Package

In the current economic crisis, Europe is suffering from the double impact of a global economic downturn and the repercussions of the financial crisis on the real economy. Great uncertainty in the markets is leading to reduced investment and consumption, and together with plunging exports to lower economic growth and unemployment. As a result, the EU is already in recession. Given the fact that negative expectations of market participants regarding income and returns are self-fulfilling, the downturn could become even worse.

In this situation, leaving the market to overcome the recession on its own would give rise to high adjustment costs. It would take a long time for the economy to get going again.

In such a situation it can make sense for national governments to stimulate demand, first and foremost if this helps to stabilise expectations. This implies that policymakers should take timely and targeted action before negative sentiment becomes too firmly rooted in the minds of consumers and companies. Moreover, policy actions should only be implemented temporarily for fiscal reasons and in order to prevent short-term support from turning into long-term subsidies.

Automatic Stabilisers: Necessary but not sufficient

Automatic stabilisers are policies which automatically cushion the oscillations of the economic cycle.

They are non-discretionary and do not require any government intervention.

Examples are lower tax payments due to lower incomes in times of economic downturn or the injection of money due to additional unemployment benefits paid. These measures stimulate demand, whereas constant transfers such as most public transfers and pension payments stabilise it.

The intensity of automatic stabilisers may differ among EU member states, as some countries have progressive income taxes and/or generous unemployment systems whereas others do not. The countries affected most severely by the economic crisis have only a low degree of automatic stabilisers. Considering the dimension of the actual economic downswing, it is not sufficient in Europe to rely on automatic stabilisers as the only means to stabilise the economic cycle. Their effects should be complemented by discretionary measures.

Relying on automatic stabilisers is not sufficient. Therefore, on the heels of the rescue packages for the banking system, the European Union has decided to launch an economic stimulus package, the European Economic Recovery Plan (EERP). This decision followed action taken by several member states individually. However, uncoordinated policies are often ineffective and may conflict with each other, and in open economies the effects of dispersed national programmes may fizzle out. Open markets and close economic linkages between member states as well as the necessity to take timely and targeted action require a coordinated approach. Coordination allows economies of scale and reduces the wastage of resources.

Demand-side orientation is recommendable

Monetary policy plays an important role in fighting the recession. Nevertheless, the potential for further rate cuts in Europe is rather low. With interest rates having been cut to 2%, other measures stimulating demand should complement the rate cuts. Short-term support for demand is needed in order to soften the decrease in consumption in an economic downturn and to prevent the risk of recession.

This being said, the adverse shocks differ among the EU-27: In some countries, primarily a shock to domestic demand has coincided with the crisis, whereas in other countries the collapse of export markets was the main handicap. Economic policymaking can only address domestic demand in the short run. Nevertheless, in a single market, concerted action to stimulate domestic demand may, in the end, also benefit exports.

Investment spending programmes such as increased public demand by bringing forward planned infrastructure projects or temporary VAT cuts could have an immediate effect on the demand side and hence the economic cycle. Corresponding initiatives can be swiftly approved and implemented by policymakers.

Cross-national disproportionate burden sharing: Inconvenient but recommendable

The fiscal leeway for deficit spending is narrow for some member states. From this point of view, it would be recommendable for countries with greater fiscal leeway to expand their fiscal stimulus packages. These countries would assume a larger burden of the whole package. If then all measures were conducted in a concerted manner too, they could work optimally in a single market.

> **Caveats in cross-national cooperation**
>
> ***Moral Hazard***
>
> Moral hazard may occur in a contractual relationship when one party does not bear the full consequences of its action - and therefore has an incentive to act less carefully or even in a hazardous manner. Consequentially, another party has to bear the costs. The party insulated from risk may behave differently if it is fully exposed to the risk. To prevent a moral hazard situation, incentives against precarious actions can be implemented.
>
> Example: If member states were expecting to be bailed out by the Community in case of an imminent sovereign default, they would have a low incentive to reduce fiscal profligacy beforehand. Fiscal resources would not be efficiently allocated. Therefore, Art. 103 II EC forecloses the possibility of bailing out member states.
>
> ***Free Rider Problem***
>
> Free riding in economic terms occurs when collectively provided goods are used by a party without paying or contributing its share in producing it. It becomes a problem when free riding has negative effects on the production of a public good.
>
> Example: A small country within the EU with highly open markets and a high export ratio could decide to not implement an economic recovery plan, but “free ride” on other countries’ stimulus packages. Larger countries could simply re-label fiscal measures, leading to no additional fiscal stimulus. If multiple “free riders” appeared in the EU, it would deter the incentives for all countries to implement recovery programmes. It would also increase the risk of purely national programmes being combined with protectionist measures.

Nevertheless, this should not induce smaller countries with a high degree of openness and export orientation to abstain from domestic demand-oriented measures: These countries could be tempted to leave the burden of fiscal stimulus to other countries while profiting from increased demand in the EU.

These *moral hazard* and *free rider* dynamics could be effectively mitigated if the Commission unconditionally adhered to its mandate to safeguard the internal market and if member states were urged to comply with the Commission’s specifications for national measures to be targeted and coordinated.

1. Assessment of the EERP

On November 26, the Commission adopted the European Economic Recovery Plan (EERP), and on December 12, the European Council approved it. The plan determines the framework for discretionary measures within national economic stimulus packages. From a menu of possible support actions member states may compile a mix in line with their national needs.

This tool box solution allows the countries to individually react to domestic economic challenges in the short run – while supporting structural reforms in the long run. This way, the EU has solved the trade-off between *rules and discretion* towards a compromise of *discretion within rules*.

The EERP will amount to EUR 200 bn, equalling 1.5% of Europe’s GDP, with 1.2% of GDP (EUR 170 bn) made up by budgetary expansion of member states and EUR 30 bn made available directly at the EU level.

In line with mainstream policy advice, the Commission stipulates that national measures be timely, targeted and temporary. These principles are indeed decisive for the fiscal efficiency and a marked economic impact of stimulus packages. They already point in the right direction and are a good approach to ensure reversibility of measures. This would have positive implications for fiscal policies and competition policy. Nevertheless, it is doubtful whether the EERP can induce the member states to act according to these measures. Furthermore, it is still unclear to what extent compliance by member states can be controlled.

EERP comprises both supply-side and demand-side measures

The EERP features various possibilities of short-term action in order to increase purchasing power and boost demand in the short run as well as structural reforms aimed at enhancing competitiveness in the long run.

Demand-side measures: Necessary in the short run

Tax reductions: The ERRP recommends tax reductions as a central measure to stimulate the economy. Ahead of all others, the UK, by making a VAT cut of 2.5 percentage points, hopes to increase consumption. However, a plan for a synchronised VAT reduction fell through in the EcoFin Council.

Germany is pursuing a more fragmented approach: cuts in taxes and levies, most of which will come into effect only in July are too little and too late in order to increase consumption considerably and in a timely fashion. This is all the more true as the cuts are only generated by a patchwork of small measures whose individual effects will hardly be noticeable to consumers. For example, as a result of Germany's economic stimulus plan, a family's net income (two children) with a yearly gross income of EUR 36,000 would increase by Euro 636 in 2009. This includes a EUR 100 one-off bonus for each child, a payroll tax reduction of EUR 27.24 a month, and a health insurance premium reduction of EUR 9.00 per month. Note that an income tax reduction only helps those who are employed.

Consumption incentives: Similar to tax reductions, *consumption vouchers,* which are essentially cash gifts, are supposed to avert a slump in consumption. Another more sector-focused approach is applied in Germany with the scrapping bonus for old cars (*Abwrackprämie*) which is intended specifically to enhance car sales.

Employment incentives are a central part of the German stimulus package. Germany has increased subsidies for short-time working and a reduction of non-wage labour costs in its stimulus packages. Those measures have a short term effect on employment and income, but in the case of the latter might have no effect at all if employees and employers consider them to be temporary.

The three Ts:

Timely – Temporary – Targeted

The Commission subscribes to the view of mainstream policy advice and determines three principles as the main measurement criteria:

Timely: Stimuli should lead to quick-wins in supporting economic activity and increase demand without delays.

Temporary: Recovery plans should not lead to permanent unsustainable fiscal deficits which would postpone burdens into the future.

Targeted: Policies should be targeted towards the source of the economic challenge in order to maximise their impact under restricted budgetary resources.

Supply-side measures: Adequate in the long run

Measures on the corporate side are special credits and credit guarantees to SMEs. These are meant to reassure the corporate sector by preventing a temporary lack of access to credit. However, if these guarantees were significantly increased, this could ignite a subsidy war between member states fought on easier access to corporate financing.

In addition, investment in education and infrastructure can enable structural investments which can also cushion negative shocks to the labour market in the short and medium run and increase productivity in the long run.Important questions remain unsolved

Policy focuses within the EU are different. However, not only does the focus differ among member states, but different measures may also unveil different fiscal effects – in the short run and in the long run.

Moreover, it remains unclear whether all countries are equally obliged to fulfil the 1.2% stimulus or whether there will be a differentiation according to the countries' initial situation. Another question is whether 1.2% is a benchmark for 2009 only or for a combined two-year period (2009/10).

Apart from that, the question remains whether already agreed plans, additional programmes and automatic stabilisers can be taken into account in the European package. No agreement has yet been reached about what happens if general national measures are attributed to crisis management (e.g. strategic industrial policies). Overall, net fiscal effects and the success of coordination are difficult to measure.

A concerted VAT cut would have been more effective.

Against this backdrop, a coordinated, temporary cut in VAT throughout the EU-27 would have been more adequate. A concerted VAT cut could boost consumers' real incomes and thereby promote consumption – especially as during a recession the cut would feed through to prices virtually in full. Due to the VAT relief being temporary, short-term consumption would be encouraged and preferred over saving. The coordination of VAT cuts in a single market is conducive to getting the fiscal stimulus to operate without causing distortions.

In particular, timely tax cuts could have ensured that many consumers only had a short wait before they saw more cash in their hands. The state would expand the financial leeway of the population and buttress consumption, but it would not intervene in individual decision-making. Demand would have been unconditionally promoted across Europe.

In turn, supply-side oriented measures only take effect with a considerable time lag. Indeed, in the long run, the support of structural reforms should be enhanced in order to increase the competitiveness of the member states. Nevertheless, while these structurally-oriented measures would have been useful within the Lisbon Strategy and should already have been implemented over the last few years, they come too late in the current serious situation.

2. Risks and Perspectives

With European guidelines in the EERP being rather general and not referring to any quantitative definitions, member states could take advantage by making use of the scope for interpretation. In the end, public deficits could further deteriorate due to measures not remaining temporary. Moreover, competition could be distorted by measures not being targeted. Apart from that, the focus on supply-side measures could mean that some national economic stimulus packages are "too little, too late".

Apart from these considerations, we see three risks arising from recent economic stimulus packages in Europe. The first risk is that public debt increases to an unsustainable level. The second risk is lasting competitive distortions in Europe, if the Commission does not take effective countermeasures. Last, lacking coordination on a global scale could trigger competitive devaluations among the main trading blocks. Well-intended fiscal stimulus packages could be used as a pretext by the EU's main trading partners for competitive devaluations as retaliation measures.

Time and Temporariness: The Fiscal Dimension

Whereas fiscal stimulus packages can indeed induce a short-term increase in demand, i.e. in consumption and investment, in the long term economic agents will realise that today's tax relief and subsidies will be the taxes of tomorrow. This is a particularly serious problem as most Western European societies are suffering from demographic change. A shrinking workforce will have to shoulder the burden.

Most member states will fail to comply with the 3% Maastricht criterion in 2009 and 2010. The recent downgrades of rating agencies on sovereign debt, and the widening of spreads on European 10Y bonds vis-à-vis German Bunds clearly show that international investors are taking these recent developments in nations' accumulated debt seriously. It remains to be seen whether increased risk charges on potential sovereign defaults will discipline the fiscal policies of those profligate EU member states and whether widening spreads are a clear market signal usefully complementing the rules of the Stability and Growth Pact. Sovereign debt will explode even faster, if debt service payments increase due to higher interest payments.

In the past, recovery and stimulus plans did not achieve sustainable growth but led to continuous indebtedness. This implies an urgent need for deficits to return to normal levels and reduce the increased debt burden once the economic situation improves. Against this background, the flexibility offered by the SGP revised in 2005 is more than sufficient and offers even more room for fiscal manoeuvre than necessary.

Among the European countries, only the UK has come up with a clear-cut redemption plan. In Germany's favour is its intention to simultaneously enact a "*Schuldenbremse*"[92] (debt brake) with the fiscal package II. However, it has not yet been decided when the package will be implemented. Therefore, the approval of national fiscal stimulus packages by the Commission should be made conditional on national implementation of suitable measures in order to reduce additional deficits in the next economic upturn.

Target: Aspects of Competition and Crowding-out Effects

Apart from the fiscal aspects explained above, competitive effects remain problematic: Since the European Commission's conceptual guidelines are not sufficiently clear and stringent, a lot of room for interpretation remains at the national level and regarding their recovery plans. This enables member states to wrap up benefits for their political clientele by re-labelling other economic policies.

The excessive deficit procedure: A toothless tiger?

The excessive deficit procedure is triggered once the public deficit of a member state exceeds the Maastricht reference value of 3%. Nevertheless, as far as the economic crisis is considered as an exceptional circumstance, it can be taken as a pretext to delay sanctions for non-compliance by more than three years.

The economic crisis is a largely symmetric shock to public finances in the EU. As far as political preferences in Europe shift towards fiscal profligacy, the majorities in the European Council could change towards discontinuation of the fiscal deficit procedure.

Another question addresses the outline of the exit option for increasing state interventions. Subsidy rules are construed extensively or less restrictedly. Moreover, governments acquire more and more shares in financial and industrial enterprises. Crowding-out effects arise from government guarantees and state intervention in the markets. They can distort competition within a state, within the EU and internationally. There are rarely any rules regarding time or content, or sunset clauses, which determine the exit from public intervention. Hence, a clear exit strategy is essential. National economic stimulus measures always tend to provoke the one-sided support of "*national champions*", which, in the end, could weaken European competitiveness as a whole. Therefore, the EU should work on binding exit rules in order to ensure that additional public expenditure does not become the rule but remains the exemption.

Global Scale

The last risks are protectionist tendencies on a global scale: Both the emerging markets and the industrial countries are suffering from the negative effects of the economic crisis. As most of the countries and currency blocs have failed to introduce structural reforms, governments could be tempted to indulge in competitive devaluations, if no international macroeconomic coordination takes place.

What applies to our considerations on protectionism in Europe, also applies on a global scale: Charity begins at home, and most countries or trading blocs will be interested in supporting their domestic economies rather than the community of states. This is where competitive devaluations may start, and where international macroeconomic imbalances may even intensify. Therefore, Europe is well advised to step up and lead the global macroeconomic dialogue in order to prevent protectionist tendencies from taking hold. So far, Europe has passed up its chance to become the leader in international coordination of economic policies.

Conclusion

Externalities in an open economy make a coordinated effort for Europe appear reasonable. However, the Commission's outlines should have been more stringent and binding. In principle, the EERP is to be welcomed.

[92] The debt brake is a constitutionally embedded mechanism which links the public expenditures with the public revenues. The rule sets an upper limit for expenditures – in boom and recession periods. This mechanism can allow deviations from the upper limit but combines it with strict regulations on how to reduce, for example, cyclical budget deficits.

Nevertheless, the proposed measures could have been more courageous. Some of the tools are weak and of limited use in stimulating private demand. Others will only take effect with a considerable time lag.

EU member states are being affected differently by the crisis; yet, the recession is reaching everyone. Therefore, economic stimuli cannot be restricted to a few countries only. The fiscal scope of most countries is tight, but the SGP should not be interpreted too loosely with its provisions for extraordinary circumstances, especially since the return to the path of consolidation is subject to discrete decisions.

Stimulus packages which are financed with deficits are only effective and acceptable if they include credible provisions for a reversal of these measures. Government interventions need to be combined with an explicit phasing-out timetable. Otherwise growth-inhibiting non-competitive structures might solidify. The lack of specific experience and knowledge of how to design such frameworks should not keep Europeans from trying to do their best. Europe already has a well integrated single market. Action against a severe economic recession should be coordinated to the same degree in order to prevent negative externalities undermining European economic integration.

An assessment of bank support packages

As piecemeal support for individual institutions failed to stem the rapid erosion of market confidence following the bankruptcy of Lehman brothers, governments started to build more comprehensive packages in late September / October 2008. The government support packages can be judged on the basis of two yardsticks:

— Are they suitable and adequate to address the symptoms and the underlying problems in the banking sector?

— Do they cause competitive distortions in the internal market?

In addition, while this may seem premature given that the crisis continues to ravage Europe's economies unabated, thought should be given in time to the question of how the recently instated central banks and government support measures can, once markets normalise, be unwound in an orderly way, which does cause neither market disruptions nor competitive distortions.

Suitability and adequacy

In principle, the bank support packages put in place by European governments encompass the right elements, viz.

— a guarantee of bank deposits

— capital injections

— government guarantees for bonds issued by banks

— the option to buy assets from the banks.

In addition to these government sponsored elements of support, central banks continue to provide liquidity support, of course. This support, which already started back in August 2007, was necessary to prevent the complete seizure of interbank transactions and payment systems and continues to be relevant.

Assessment of basic conceptual design

Conceptually, the government rescue packages for the banks are sound. Their comprehensive nature pays due regard to the fact that problems have originated on the asset as well as on the liability side of banks' balance sheets and that, hence, measures are needed to address all of these sources of problems. The relative weight given to individual support measures within the overall package will sensibly vary depending on the specific circumstances of any single bank and national banking system respectively.

Mandatory vs. voluntary participation

There has been an intensive discussion about whether participation in the bank support packages should be mandatory or voluntary for banks. The vast majority of EU countries have decided that mandatory participation was the right approach. The upside of mandatory schemes is essentially that it does not cause competitive distortions between participating and non-participating banks. Even this argument is not entirely convincing, though, because, relatively, the size of the benefit an institution draws from government support depends on the starting position: Assume that government support aims at bringing the core capital ratio of all banks to 10%; then, obviously, banks that were weaker ex ante benefit more – and somewhat unfairly so – than banks that ex ante aimed at a higher capital ratio on their own already. Mandatory schemes are also said to be more desirable because they make it more likely that the banking system will continue to provide credit to households and firms rather than trying to deleverage their balance sheets to the detriment of borrowers. Again, the argument is somewhat spurious, as it can well be questioned whether it is really desirable for banks to expand their lending volumes in the face of a severe recession.

Therefore, on balance, voluntary participation appears to be the option that causes fewer negative side effects: (1) banks differ substantially in their need for state support; (2) it keeps incentives intact for banks to find market-based solutions by seeking private capital; (3) it limits the real risk of negative implications on banks' governance by state ownership to fewer banks; (4) it limits the exit problem for the state of getting out of its participations; (5) it keeps the total bill for taxpayers lower.

Assessment of adequacy

As regards the adequacy of rescue packages, it is difficult to come to a conclusive assessment at this stage, given that the situation continues to evolve. However, judged against the pressing concerns as they presented themselves at the time when the packages were designed, a number of positive effects are undeniable.

- The emergency liquidity operations by the central banks were successful in restoring some sense of normalcy in the money markets. Spreads in the unsecured money market have since come down drastically, even though volumes are still subdued, especially in longer-dated market segments. However, the latter, it has to be said, is due to the absence of institutional investors such as pension funds and insurance companies.
- By means of the guarantees given by governments, depositor confidence was maintained[93], so that the danger of sudden, massive deposit outflows seems to have subsided.
- Overall, state-financed recapitalisations have (more than) closed the gap between write-downs and losses on the one hand and the capital raised by European banks from private sources on the other.[94] Thus, the ability of banks to lend has been maintained. In this context, a word is in order on lending volumes: some have pointed to the fact that many companies (and households) continue to complain about difficulties in receiving bank credit as evidence that the rescue packages are failing. We do not share this view. First, it needs pointing out that in many countries (incl. the Eurozone, lending volumes are still increasing markedly on a yoy basis. Second, lending volumes are determined by loan demand as much as loan supply; the former has dropped off dramatically, as evidenced, e.g., by the ECB's Bank Lending Survey. Third, a tightening of banks' lending standards is an appropriate reaction to the economic situation; certainly it would be inappropriate for authorities to expect that lending volumes increase under these circumstances.

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[93] A bank run did occur in the case of Northern Rock, of course, but this has remained a singular event so far, which, incidentally, occurred before governments gave blanket deposit guarantees.

[94] According to Bloomberg, European banks have registered write-downs of USD 295bn, but have received USD 340 bn in fresh capital.

CDS spreads on bank debt have receded[95], and banks have been able to place bonds and ABS in the market again. Some banks even managed to issue unguaranteed bonds at reasonable spreads. However, it remains an interesting fact that spreads even on guaranteed bonds continue to differ noticeably reflecting that investors seem to differentiate issues according to (i) the quality of the guarantors (i.e. the states' ability and willingness to honour their guarantees; (ii) assumed differences in operational procedures should the guarantees fall due (i.e. how long would it take for claims against the sovereign to be honoured), (iii) the issuer's stand-alone credit quality.

However, the stabilizing effect seems to have dissipated at least in some member states due to the disastrous performance of banks in Q4/08 and in light of a continued slide in valuations in many market segments, which are causing further mark-to-market losses. Huge losses recorded by some banks – UK banks stand out especially – raised the question of whether the October 2008 packages are sufficient both in terms of size and in terms of measures taken. As to size, there is recognition that the initial packages may not be enough and that second rounds may be necessary. This is illustrated by the continued up-scaling of loss estimates by the IMF for the global banking sector[96]; it is also illustrated by the renewed rounds of measures announced by the UK government (arguably, the UK has been hit hardest) and by the second round of recapitalisations to be done in France.

As regards the relative importance of instruments used, a shift in opinion is discernible: while the October packages were, so far, mainly used to give banks fresh capital and to guarantee their bond issues, discussion has now turned to whether governments will need to buy assets in order to avoid an unending cycle of continued valuation losses due to deteriorating markets in many asset classes and repeated capital injections which only restore the status quo ante.

While, as indicated at the outset, it cannot be denied that the sale of illiquid, non-performing and "toxic" assets is a useful component of any comprehensive bank rescue plan, scepticism is in order as regards the extent to which asset purchases by the state are a useful instrument to deal with the situation at hand. Setting up "bad banks" is not a silver bullet and it is wise to remember that the initial TARP programme never got off the ground on account of the difficulties with the model. The critical issues are the following:

— First, "bad bank" is not a properly defined concept, as there are at least three versions: (1) The Resolution Trust Corp model, refinanced by sovereign bonds (and hence with large upfront costs for taxpayers), which assumes and disposes assets of failed banks, whose remains were either merged or scaled back significantly; (2) the ring-fencing of assets on a case-by-case basis (as used for UBS), where the bank usually retains parts of the losses and does not get full capital relief; (3) asset insurance as suggested by the UK government whereby the government assumes the risk of further price deterioration, but does not have to pay for the assets fully upfront. For banks and their counterparties and investors, this increases transparency and it probably lowers the costs of refinancing these assets; however, banks would, at least under existing rules, get little capital relief and would continue to bear losses from these assets. Thus, clearly, the economic impact of the different models on the banks as well as on the general economy differs markedly.

— Second, the valuation of assets transferred is crucial. In Sweden, often held up as a role model these days, this was fairly easy as assets were largely homogeneous (real estate and corporate loans) and national. Today, assets are complex and globally dispersed. Apart from the general difficulty of pricing these illiquid, toxic assets, valuation determines relative winners and losers: Too high valuations hurt taxpayers and, on balance, those banks that have written down already, while low valuations impose losses on banks that have not marked-down their assets aggressively so far. And unless valuations are coordinated internationally, competitive distortions loom.

[95] It is noticeable though that while banks CDS spreads have stabilised, those on sovereigns bonds have risen. This probably reflects the markets expectation that banking systems will be largely nationalised with liabilities falling directly to the state.

[96] The IMF has just up-dated its loss estimate for US originated credit assets from USD 1.4tr to USD 2.2tr

— Third, not least against the background of the valuation issue, the setting up of a bad bank is inextricably linked with the question of bank restructuring and ownership. It is often forgotten that in Sweden there was a triaging of banks according to viability and that the banks for which "bad banks" were set up were nationalized first. By means of the latter, the valuation problem was circumvented and, in addition, the state automatically not only assumed the risk but also participated on the upside. In other words, simply passing on assets to the state without giving the state a major stake in the institution will most probably prove to be a political non-starter.

Amendments of design elements

In addition to considerations whether the support packages may need to be revised in light of subsequent market developments, thought must also be given to the need for changes to specific design elements and the actual implementation of the packages.

— First, in the vast majority of cases, state support has not been made conditional on a critical examination and, if found necessary, change of the business model. Put more generally, in contrast to the methods employed in the rescue operations conducted by the Nordic countries in the early 1990s, these days bank support did not go along with a triaging of the banks into those which (i) had a sound business model and were expected to return to profitability, once market conditions returned to normal; (ii) those banks that required minor changes to their business models with state support essentially covering the transition period, and (iii) those banks that did not have a viable business model and should be closed down. The failure to impose such a classification makes it all the more likely that state support will eventually turn out to distort competition, as weak banks that receive state support will (continue to) undermine the business of sound institutions, as state support allows weak banks to maintain their deficient lending practices.[97]

Secondly, as indicated above, it is highly questionably to ask banks to maintain or even expand lending volumes as a quid pro quo for state support. While it is well understood that the rationale of state support is to maintain the intermediation function of the financial system, asking banks to expand lending volumes in the face of a severe recession is likely to be counterproductive and is not in the interest of taxpayers, on behalf of which many governments have assumed ownership stakes in banks.[98] It should be recalled that, economically, recapitalisations of banks are addressing their *ability* to lend; there should not be a presumption that raising a bank's capital will automatically translate into an increased lending volume. Instead, the actual lending volume is – and should be – determined (apart from loan demand) by a bank's assessment of the riskiness of lending and the corresponding return on any given exposure. Consequently, what should be called for is prudent lending where returns cover the risks assumed; if need be (i.e. if the government considers the risk-adequate interest rates as being too high for a desired level of economic activity), government guarantees for lending would be the appropriate policy instrument (e.g. via state-funded promotional banks).

— Third, in most rescues packages, time limits have been stipulated for government guarantees; similarly, in some case (such as in Germany), there was an initial understanding that the purchase of assets was only possible in the form of a repo arrangement, whereby banks would have been compelled to buy back the assets after some time, which would have meant that capital and economic relief for banks would have been small. Moreover, time-limits for guarantees mean that there is a bunching of guaranteed debt maturing at a similar time (see also below the section on the exit problem).

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[97] A particular egregious example of state support without a sufficient intervention on unsustainable business models is the support given by the German Lander to some of the Landesbanken. Here, support and guarantees were given without a fundamental review, let alone change to the business strategies that brought these banks into their troubles in the first place. It is no coincidence that the support given by the Lander is taking place outside of the federal rescue plan, as only by doing so, the Lander retained their autonomy as regards the strategic choices for their respective Landesbanks.

[98] As an aside: such lending expansion would be tantamount to making the same mistake twice, as the present crisis was caused by excessive lending.

As most banks that use government guarantees will not be able to issue unsecured longer-term funding, the current limitation on maturities in some countries' guarantee schemes will be changed, at least in those countries restricting guarantees to a maximum of three years.

- Fourth, there have been questionable conditions imposed by supervisors on minimum capitalisations. It is one thing for investors in banks to ask for higher capital ratios – it is another thing for supervisors and governments to ask banks to ask for capital ratios of 10% or more and to effectively force banks into accepting recapitalisation if these targets are not met. It needs recalling that a 10% tier 1 capital exceeds the Basel requirements by a factor of 2.5. One lesson of the crisis has been the insight that the financial system needs to become less procyclical; capital requirements are instrumental to this. If however, regulators force banks to increase their capital ratios in times of crisis rather than let capital ratios breathe (subject to banks meeting the minimum capital requirements) then this has a procyclical, not an anticyclical effect.[99]
- Fifth, the rescue packages are all national packages. While European leaders, on the occasion of their summit in Paris in October 2008 agreed on the broad outline of the packages they did not manage to design rescue packages for cross-border groups. This made (and still makes) rescuing cross-border groups more difficult than necessary. In fact, the lack of European solutions has meant that existing cross-border groups needed to be broken up in order to be rescued - the case of Fortis is the most pertinent example here.

Impact on competition in the internal market

The competitive impact of emergency liquidity provisions by central banks is comparatively small. While, initially, different strategies were being followed by central banks and instruments varied, in the course of the crisis, central banks have essentially aligned their policies on eligible assets, access conditions and eligible parties allowed to access central banks facilities. It goes without saying that competitive distortions within the EU were also limited thanks to the fact that the ECB sets a uniform policy for a substantial number of member states and the equivalent of more than 2/3 of EU total banking assets.

Having said this, it should also be mentioned that recent action by Banca d'Italia to establish, in association with the Italian Banking Association, a central counterparty (CCP) for money market operations is worrisome, as only Italian banks are allowed to participate. There is still an open discussion whether the establishment of a money market CCP is a useful step; but if one decided to do so, only a pan- European scheme, at least one for the euro-area as a whole, made sense. Any other model would be another step towards market fragmentation.

In contrast to central bank support, the negative impact on competition is more critical in the case of state support: While the elements of the support packages are broadly similar across countries, they differ in detail. Instruments and conditions for capital injections vary substantially. For instance, while the UK government has mostly used ordinary shares, subordinated notes have been used in France and silent partnerships in Germany. As regards the remuneration of state guarantees, there are still differences in the costs of these schemes, though the schemes are converging – not least thanks to the ECB's guidance on this – towards a fee of 50bp for issues with tenors of less than one year and 50bp plus the median 5Y CDS spread between 1 Jan 2007 and 31 Aug 2008 for issues with maturities of more than one year.

Against this background, it is useful that the European Commission takes a critical look at the conditions of individual rescue packages with a view towards identifying potential distortions of competition in the internal market. These can essentially take three forms:

- Between banks domiciled in different EU member states (see above on differences in the specifics of national rescue packages);
- between those banks that receive support and those that do not;

[99] This issue has also been taken up by ECB President Trichet recently, who called on markets not to assume that capital ratios increase in times of crisis.

— more broadly, a danger to the future of the internal market due to increased state influence in the financial sector.

As regards the first, this is a direct consequence of the fact that the rescue packages have all been designed within the national frameworks. As regards the second, competitive distortions come in various forms. Examples are the crowding out of unguaranteed bonds, distortions in credit allocation decisions, and more intensive competition by government sponsored banks. Another issue is that government capital injections have raised the benchmark for capital levels and capital quality. As a general rule, governments, when injecting fresh capital, seem to aim at a Tier 1 target rate of 10%. If this is viewed as the new benchmark, banks that have not received capital support may be forced to seek fresh capital or reduce their leverage, even if their business model might be perfectly viable even at lower capital ratios. Finally, a particularly worrisome form of competitive distortions is the consolidation of national banking system backed by state support, as happened, for instance, in the cases of the merger of Lloyds with HBOS and Commerzbank with Dresdner Bank respectively. In these cases, state support clearly goes beyond the objective of stabilising financial markets in the face of a crisis; instead, the future structure of national banking markets is actively being shaped.

As regards the third, there is a distinct danger that, in response to the crisis, national will follow their national instincts. There is a serious risk that governments' involvement in the rescue packages – needed though they were – will ultimately result in a re-fragmentation of the single market for financial services. Even if it is not an explicit condition of government support, there will be a natural tendency for banks, in which the state acquired a stake, to concentrate their lending business on the domestic market and there may well be a tendency for state owners to make state-owned banks concentrate their expansion strategies on domestic markets rather than on foreign ones. This will inevitably cause a retrenchment of banks from other European countries. This would unravel the closer integration of the EU financial market, which had been achieved over recent years.

Exit problem

Understandably, little thought has so far been given to the exit problem, i.e. the question how state support can be unwound once the crisis subsides. This is understandable to the extent that government and the financial industry alike are currently still pre-occupied with fighting the deepening of the crisis which will extend the period for which government support measures are needed. Against this background, addressing the exit problem of government support measures may appear frivolous. Nonetheless, it appears advisable to keep the exit problem in mind and to start working on it – if only because the exit problem must be given due regard when support measures are being designed, as this will help to keep the exit problem small.

Again, central banks are probably most aware of the issue and have indicated their concern about it: As long as central banks continue to provide huge liquidity, normal markets will not restart – which, in turn seems to support the need for a continuation of extraordinary liquidity measures. Central banks will therefore gradually try to nudge market participants back to normal markets using, successively, the following steps, which will be implemented with a sense of proportion to avoid disrupting markets:

— Verbal intervention

— A reduction of the interest rate on the central bank deposit facility

— A tightening of collateral requirements for repo transactions with the central bank (haircuts and range of eligible collateral)

— A return to variable rate tenders

— An increase in official interest rates

However, the exit problems hold similarly true for the government-sponsored elements of rescue packages:

- In the case of guarantees, the key issue is that these are available with a time-cap. Commendably, this is meant to safeguard taxpayers' interests and to forestall competitive distortion. However, the time limit has other economic consequences: First, it entails that a huge amount of guaranteed bonds will mature around the same time (mainly: end-2012 to end-2014)[100] causing a bunching of refinancing needs around that date, which will then weigh on markets. Second, the time cap on guaranteed bonds affects banks' funding structure; specifically, it may induce banks to move towards a more short-term funding structure, a development supported by the fact that short-term rates are so low.
- As regards equity, at some stage governments will want to re-privatise banks. Again, there is a need for governments to coordinate these moves in order to avoid that the shares are put to the market all at the same time, which would depress market prices that governments could realise. Similarly, it needs to be prevented that individual governments, anticipating this problem, try to jump the gone to be first at the market, which may carry the danger that this is done prematurely, i.e. before market confidence has been fully restored. Obviously, getting off to a bad start would make subsequent privatisations more difficult. Furthermore, EU competition policy must make sure that governments do not use the disposal of their stakes in national financial institutions in order to pursue strategic objectives as regards a desired structure of the banking industry, e.g. by transferring their stakes to strategic domestic investors rather than putting them up for open tender. Obviously, the temptation for misusing the disposal of equity stakes for the purpose of industrial policies is great and would further damage the internal market.
- As regards the revocation of blanket government deposit guarantees, governments will need to decide whether they make a formal announcement on this – which may obviously cause renewed nervousness in the market. Given the fact that these blanket guarantees were political declarations only (i.e. did not have a definitive legal quality, based on which claims could be made against governments), such a tacit withdrawal would look like an option. Alternatively, national implementation of the changes made to deposit guarantee schemes in EU countries based on the recent amendments to the respective Directive (especially the rise in the minimum coverage to EUR 50,000) or the possible increase of the coverage to EUR 100,000 by end-2010 may provide a window for a more formal exit.

[100] Irish guarantees already expire in September 2010; hence, Ireland may be the obvious candidate for an extension of the guarantees in the near future.

Figure 1

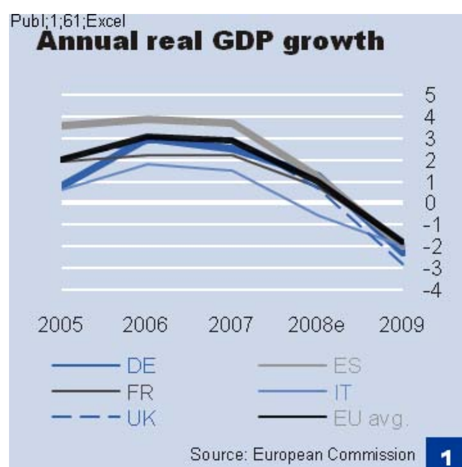

Figure 2

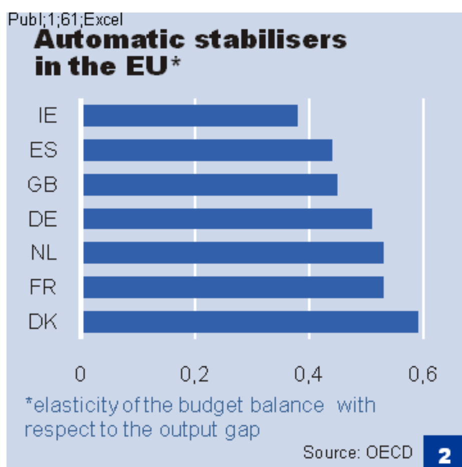

Figure 3

	Germany: Pedal to the metal	France: Strategic deal	UK: Demand-side pragmatism
	Germany	**France**	**UK**
Real Fiscal Stimulus	EUR 36 bn (1.4% GDP)	EUR 14 bn (0.7% GDP)	EUR 17 bn (1.0% GDP)
Fulfillment of EU specifications	116%	58%	83%
Public deficit (% BIP, 2009 forecast)	2.9%	5.4%	8.8%
Public Debt (% BIP, 2009 forecast)	69.6%	72.4%	62.6%
Main measures	Infrastructure investments Tax reduction	Direct public investment	VAT cut
Timely?	Tax cuts implemented only by July 2009	Risk of undesirable implementation and operational lags	VAT cut with immediate effect
Temporary?	Exit possible as long as political preferences do not change	Exit from spending programs politically difficult	VAT cut can be easily revoked
Targeted?	Too fragmented to send clear signal	Spending programmes allow a clear targeting of sectors and industries	VAT cut sends clear signal for consumer confidence

Source: Bruegel, DB Research

Economic recovery plans: key principles

Briefing Paper for the Annual Meeting of the Committee on Economic and Monetary Affairs with the National Parliaments on 11-12 February 2009 at the European Parliament in Brussels

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Executive Summary

Contrarily to optimistic expectations, the EU is now in recession. With monetary policy largely impotent, the only macroeconomic stabilization tool left is fiscal policy.

There exist good reasons to be sceptical about the effectiveness of the fiscal policy instrument. Even if the instrument is less effective that believed years ago, it can make a difference and, anyway, the only alternative is to let the recession run its course, which could bring us back to the Great Depression.

Fiscal policy is a delicate instrument, subject to economic and political limitations. A number of principles ought to be kept in mind in the current circumstances:

1. A very large number of measures are possible, with various speeds of implementation and effect. The priority should go to measures that can be rapidly implemented.

2. All measures should be front-loaded.

3. Effectiveness may seem to depend on measures favouring domestic producers. While this makes sense at the national level, such a protectionist approach could undermine all efforts.

4. Much harm can be done by mixing up recovery programmes and industrial policy through support targeted at particular industries. The best policy is the one that promptly restores demand for all goods and services.

5. In particular, supporting SMEs to make up for difficult access to bank credit is sensible as long as the measures are general.

6. Trying to achieve both countercyclical and long-term structural policies is likely to fail both objectives. Long-term goals require sustained commitment while short-run countercyclical policies require immediate effects.

7. The view that tax reductions are ineffective because much of the impulse is saved is too extreme to be true. The US experience has shown that medium and low-income households respond swiftly and powerfully to any increase in their incomes.

8. The magnitude of the crisis calls for very significant policy action. For most EU countries, this means discretionary actions – in addition of the automatic stabilizers – that raise the deficit by 2 to 3 %, or more.

9. A precondition for a sharp fiscal expansion to work is that it be accompanied by an exit strategy.

The rationale for fiscal policy action: end of monetary policy

Hopes that the EU would "decouple" from the rest of the world and avoid a recession were always misguided and have now been unambiguously dashed. The recession is likely to come down as the worst in history since the Great Depression. In fact, in many respects, the origin of the current crisis is quite similar to that of the Great Depression. In many respects, the challenge is to make sure that the consequences will be more benign this time around. A voluminous, although somehow controversial, literature concludes that the depression of the 1930s deepened because both central banks and governments were mostly preoccupied with preserving monetary and fiscal discipline, ostensibly to reassure the public. Strangely enough, similar views have been voiced a few months ago when the economic situation started to deteriorate.

Monetary policy is a flexible and easily implementable instrument. It can be decided quickly with little political interference and its effects are reasonably predictable. This time, however, the effectiveness of monetary policy is very much in doubt. Monetary policy works through bank credit to firms and households, but banks are reluctant to grant loans for several reasons. First, having suffered severe losses, many of them are focused on lending only to the very best borrowers. Second, many banks have over-extended themselves by borrowing to invest in products that have lost value (the leveraging process). Their priority now is to undo the situation, which means no lending at all. Third, the deterioration of the economic situation implies that borrowers may find themselves unable to serve their debts. Banks are reluctant to lend as risks grow. Finally, potential borrowers understand the risks and they too are reluctant to borrow. All of this means that credit cannot play its usual role, independently of its cost. It follows that towering interest rates, the usual instrument of monetary policy, is unlikely to have much of an impact.

By lowering quickly their interest rates, central banks have at least made sure that monetary policy will not act as a drag on the economy. Many of them have now brought the interest rate close to zero. Having reached the zero lower-bound means that traditional monetary policy cannot be used anymore.

It should be noted that the ECB has been moving much more slowly than most other central banks. The justification has long been that the economic situation in the Euro area is less deteriorated than elsewhere, for example in the US or in the UK. This argument is losing validity with each new piece of information.

Arguments for caution

With monetary policy unable to lift the economy, fiscal policy emerges as the only macroeconomic instrument that is left to face the most ferocious situation. Yet, that does not mean that fiscal policy should necessarily be used. A number if arguments have been put forward.

A first argument is that fiscal policy is ineffective because people well understand that any deficit generates a debt that will have to be reimbursed. This leads households to save, which means that any fiscal impulse is undone by a reduction in private consumption. The idea, known as Ricardian equivalence, has been subject to extensive empirical scrutiny. While some increase in private saving indeed reduces the impact of fiscal policy actions, the evidence is that the offset is partial. Fiscal policy is less effective than otherwise, but it still works.

A second argument is that fiscal policy takes a long time to be put in place. Governments must draw up plans, subject their proposals to their parliaments and then work through the bureaucracy. The risk is that the effects kick in when the recession is over and that fiscal policy fuels an economy already recovering. In other words, lags in decision, approval and implementation make fiscal policy pro-cyclical. This is true, but not hopeless. To start with, delaying action is the best way of making fiscal policy pro-cyclical. The slow response of many European governments deserves strong criticism. While the Spanish authorities started to use fiscal policy as early as August 2008, the German government only started to move forcefully in late January 2009, and many of the measures under discussion will not be implemented until 2010. Lags are not a fatality. The speed at which the Obama administration has moved is an example that can be emulated.

A third argument is that much of the increase in demand will feed into imports, with limited effect on the domestic economy. Indeed, many European countries are very open. This observation means that it is of the utmost importance that all countries act together. If each country imports more from the others, the effects of fiscal policy are shared by all. The risk is that individual governments be tempted to free-ride on the others, hoping to benefit from fiscal expansions elsewhere at no domestic cost. This concern has prompted the European Commission to propose coordinated action. This is the only rational response to the risk of free-riding. The irrational response is that no government takes any action. The attitude of the Italian authorities is suggestive of free riding.

A fourth argument is that many European countries already suffer from high public indebtedness. Adding more debt is likely to raise concerns with some adverse implications. Markets may refuse to finance the debt or to require punishingly high interest rates, as for Greece. Worried consumers may react by cutting spending even more than the government raises demand. This is very possible. The implication is that countries with lower debts and better credibility should act more forcefully, another reason for some coordination.

A fifth argument is that fiscal policy involves the government and the parliament, which opens the door to politicization. In addition to monetary policy, which boils down to changing the interest rate, fiscal policy actions can be varied ad infinitum, and the choices are almost unavoidably redistributive. The risk is that all involved parties loose track of the macroeconomic objective and focus on idiosyncratic objectives irrespective on the cyclical impact on the economy. This, in fact, is happening on a large scale.

Finally, people will inevitably compare the fiscal packages with the large sums of money committed to the financial system, even if the latter do not represent any spending. The (correct) perception that the crisis has been caused by bank reckless behaviour is feeding deep anger. The fact that many banks are being bailed out at taxpayers' expense, or at least risk, creates a feeling of injustice. Any fiscal package that is perceived as unfair may trigger counter-productive resentment.

Principles for fiscal policy action

Given the above, a few principles can be drawn.

1. Fiscal policy measures must have fast effects. This means that the measures should be prepared and presented as a coherent package of actions known to have a rapid impact. For example, public spending on new infrastructure projects, which may take years to be actually undertaken, are not a good idea. Measures that move forward already planned spending are a good idea, if the time shift is sufficiently long.

2. Spending must be front-loaded. Packages that are spread over time are unlikely to be helpful and could even be pro-cyclical. The aim ought to be to pull the economy up by the end of the year and to cushion the decline already under way.

3. Measures that have explicit or implicit protectionist features are most dangerous. Not only do they discourage the little good will toward coordination that exists, but they may trigger defensive measures that would harm trade and undermine the positive effects of the package. For example, many governments tend to favour public spending that falls disproportionately on domestic producers (for example, infrastructure). Great care ought to be taken that this choice does not come at the expense of long lags.

4. Direct support to firms is problematic because it is often inspired by industrial policy objectives. Many firms, sometimes whole industries, actively lobby for such support, claiming that unique technologies are at risk. The best way to support truly innovative firms is to strengthen demand for their goods, which means to hasten the end of the recession. Other firms or industries claim that they deserve support to protect employment. Facing weak demand, firms will use any subsidy that they receive to shield their profits – or reduce their losses – and will base their employment practices on production needs, i.e. the demand that they foresee.

5. Most, if not all, governments have set up special support systems for SMEs. The argument is that the credit crunch particularly hurts SMEs. This may be a sensible approach as long as the schemes are not directed at special industries, for example general tax credits or tax cuts. Directed schemes, on the other hand, risk being chosen for the wrong reason and without due attention to their counter-cyclical effects.

6. Many governments are tempted to kill two birds with one stone by implementing programs that "are needed anyway". For example, the British government pushes green policies and the French government emphasizes research. This may lead to spending that will come too late and that will not be rolled back, crating a permanent source of future deficits (see point 8 below). National priorities must be decided and supported on a permanent basis, not temporarily or without appropriate long-term financing.

7. A particularly controversial question is whether the measures should consist of public expenditures or tax reductions. Quite obviously, every euro of expenditures is spent while one euro of tax reduction is likely to lead to spending of a lower amount. This has led to the conclusion that spending is more effective than tax reductions. This conclusion is not fully warranted, though. Public spending can rarely be effective instantaneously for it generally requires an appropriation procedure, which can be lengthy. New spending on public infrastructures, in fashion partly because they represented the heart of President Roosevelt's New Deal, in fact requires considerable time before it can be implemented. Tax reductions, on the other hand, are effective from the very day they are decided. In particular, the procedure of sending cheques to the tax payers, which has been used in the US in early 2008, has proven to be surprisingly effective at raising private consumption.101 Targeting the lower half of income earners goes a long way in reducing leakages through savings. An important advantage of such a measure is that it redresses the perception that governments protect firms and banks and ignore the plight of ordinary people.

[101] Convincing evidence is provided by Christian Broda and Jonathan Parker (2008), "Evidence is The Impact of the 2008 Tax Rebates on Consumer Spending: Preliminary Evidence, unpublished paper, University of Chicago Graduate School of Business.

8. The size of the packages must be commensurate with the slowdown. If GDP growth is expected to fall by 5 percentages point from early 2008 to late 2009, for instance, the total increase in the budget deficit must be of at least 2% of GDP, possibly when possible, in the current fiscal year. Spreading the deficit also spreads the impact.

9. It remains that the increases in the public debt that will materialize – as the result of both the automatic multipliers and discretionary policies – will be huge by historical standards. They will be totally unsustainable. It is extremely important that governments provide credible reassurance that the deficits will be promptly eliminated once the recession ends and that debts will be reduced during the next phase of the cycle. Failure to provide credible reassurance is bound to undermine the whole package and could even lead to speculative attacks on public debts, with immeasurable consequences.

Credible reassurance will require some, and possibly all of the following elements of an exit strategy:

- The expansionary measures must be designed and explicitly presented as strictly temporary. Statutory tax cuts, new spending programs or the hiring of civil servants are measures that are very unlikely to be temporary for obvious political reasons.

- Every measure must be explicitly accompanied by an end-date or a trigger that would bring the measures to an end, for example evidence that growth is back. For example, the British VAT reduction is explicitly temporary and income tax increases have been preannounced; this is good although the dates may turn out to be difficult to respect.

- Mechanisms ought to be put in place to guarantee future budget surpluses sufficient to bring back down public debts at least to pre-crisis levels. Examples include mandatory pluriannual spending ceilings of the kind in place in Sweden, preannounced increases in specific taxes, or the setting up of Fiscal Policy Councils with the power to request a particular evolution of the public debt over the government's mandate period.

Announced packages

The Commission's note on "Concise Overview of Measures Taken or Announced by Member States and Key Trading Partners in Response to the Economic Crisis", SEC(2008) 3000, is now outdated as new measures have been announced. More recent, but much less detailed, information is provided in the following table.

Announced Fiscal Stimulus Programmes

	Size	Size (% of GDP)	Budget balance (2009)	Contribution to growth	
				2009	2010
USA	$ 1000 bn	4.9	-8.1%	1.1%	2.6%
Euro Area	€ 140 bn	1.5	-2.8%	0.3%	0.4%
U.K.	£ 20 bn	1.4	-6.4%	0.4%	0.2%

Source: Bank of Canada, January 2009

A general feature of these programmes is that they are spread over a wide variety of measures. Many of them are targeted at particular industries (housing, automobiles) and at SMEs, with dubious effectiveness as argued above. Tax reductions are also present, usually targeted at vulnerable segments of society, which is much more desirable.

With the exception of Spain, the amounts that are to be actually disbursed in 2009 are small, barely exceeding 1% of GDP. The comparison with the US is disappointing, especially when one realizes that the announced programmes often include measures previously decided for other reasons than hastening the recovery.

If European countries are to soften the recession and bring about an early recovery, much more remains to be done. Not only must most countries commit more resources and target them more effectively on measures whose main effects will be felt in 2009, but some coordination is highly desirable. Given the high degree of trade integration within the EU, the danger of free-riding is acute. Efforts to choose measures that focus on purely domestic producers are pervasive and should be seen as protectionism in disguise. In addition, some countries with large public and external deficits are probably facing strict limits, as the example of Greece amply demonstrates. This should be recognized and not be used as an argument for limiting fiscal policy actions in countries that are in a better position.[102]

A particular difficulty is that Germany well remembers the precedent of 1978, when it was asked at the G7 summit to act as the world locomotive. This experiment did not work as intended. Because it was agreed upon too late, it ended up being procyclical and left Germany with a large deficits and rising inflation. Today, any coordination effort is likely to start from the premise that Germany, being the largest economy with an external surplus and sound public finances, should act as EU's locomotive. Such an approach is bound to fail and, perhaps, should not be attempted. It may be sufficient that each country acts on its own, which would already be a significant achievement.

Finally, with exception of the British plan, no country has indicated that an exit strategy must be included in the stimulus plan.

[102] A particular difficulty is that Germany well remembers the precedent of 1978, when it was asked at the G7 summit to act as the world locomotive. This experiment did not work but left Germany with larger deficits and more inflation than it wished. Today, any coordination effort is likely to start from the premise that Germany, being the largest economy with an external surplus and sound public finances, should act as EU's locomotive. Such an approach is bound to fail.