

Preventing Recession in Europe: National vs. European Approaches

Policymakers in the EU member states are currently shaping rescue packages to prevent the financial crisis hitting their economies with unmitigated force. Each government is responding to the emerging problems with a country-specific set of measures. Given the global nature of the crisis, would coordinated action at the European level not be a better approach? Was the German government – much-criticised for its initial reluctance to adopt massive fiscal stimulation measures – right after all to exploit the option value of waiting in a situation of high uncertainty?

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The Case Against a Common Fiscal Boost in Europe

Almost all European economies have fallen into their worst recession in many decades. We expect a decline in GDP in 2009 of close to 3% for most major members of the European Union.¹ Fiscal policy has to respond forcefully. Even more so, Europe needs a common fiscal boost. After all, the economies are more closely linked to each other than ever before. On their own, individual countries would not do enough because too much of a national stimulus would spill over to free-riding neighbours. Worse, the stimulus in one country may come at the expense of its neighbours if the programme is designed badly.

Yes, the case for a strong common European fiscal boost is easy to make, at least in theory. But as so often in life, we need to take a closer look, not least because the amounts of money thrown around in the discussion are staggering.

Two Reasons for a Fiscal Stimulus?

In normal cyclical downturns, an activist fiscal policy with a major increase in government spending or counter-cyclical tax cuts is usually not necessary. By lowering the cost of credit for the economy as a whole, central banks can deal with unwarranted shortfalls in demand for goods and services better, faster and with fewer long-term costs than parliaments and governments can with their laborious decisions on how much to tax and spend.

Of course, the world is not facing a standard downturn this time. After the fall of Lehman Brothers and Washington Mutual in mid-September 2009, the glo-

bal economy suffered the monetary equivalent of a heart attack. Governments and central banks reacted with unprecedented measures, providing safety nets for their financial systems, cutting interest rates and using intensive microsurgery to unblock the clogged arteries of money and credit markets.

But these measures have not restored a healthy flow of credit to households and businesses yet. Lower interest rates from the central bank can stabilise household spending, stimulate business investment and ease debt service burdens only if the stimulus can pass freely through the financial system. While the system itself is in intensive care, as it still was in January 2009, it cannot. As a result, central bank rate cuts will probably affect the real economy only later and at first more hesitantly than usual. This is the first reason to consider a fiscal stimulus to bridge the time gap until the monetary policy response has fully arrived.

Secondly, scared savers around the world rushed into the safest of safe havens in late 2008, putting their faith into the currencies and the government bonds of the leading Western countries while shying away from once-standard financial investments that are now perceived as more risky. As a result, yields for 10-year German government bonds (“Bunds”) fell to 2.8% in January 2009, their lowest level on record. Although the yield spreads between the German benchmark and the comparable bonds from some peripheral EU countries such as Ireland, Spain and Greece widened substantially to their highest level since these coun-

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¹ Cf. Holger Schmieding: European Themes 2009: Not Quite a Lost Year, Bank of America, Economic Brief, 5 January 2009.

Announcement

Intereconomics: New partnership between ZBW and CEPS



The German National Library of Economics (ZBW) is joining forces with the Centre for European Policy Studies (CEPS) in the publication of **Intereconomics**, with the aim of making the prestigious journal the leading forum for research-based discussions of major European economic policy issues.

ZBW is the world's largest specialist library for economics, with locations in Kiel and Hamburg. Its mission is to procure and supply economic information and literature nationally and to offer its users comprehensive services that will facilitate efficient and effective utilisation of economics-specific information.

Founded in Brussels in 1983, the Centre for European Policy Studies (CEPS) is one of the most experienced and authoritative think tanks operating in the European Union today. It is distinguished by a strong in-house research capacity covering all major policy domains of the EU, complemented by an extensive network of partner institutes and associated researchers throughout the world.

Intereconomics – Review of European Economic Policy is a platform for economic and social policy debates in Europe. It represents over 40 years of economic policy oriented publishing. The journal is organised into 3 sections:

- Forum: Policy debates on highly topical themes based on short contributions from researchers, and experts from industry and politics (mainly by invitation)
- Articles: Papers concerned with economic policy issues and trends
- Economic Trends: Analyses of business cycle trends

Call for submissions

Authors are invited to submit papers for the articles section that make a contribution to policy debates in the EU or its Member States. Papers should be written in English and should not have been published elsewhere. They should be between 3 000 and 8 000 words in length (18 500-50 000 characters incl. blanks).

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tries had qualified to join Economic and Monetary Union, even these countries can still finance themselves at much lower nominal yields than usual.

Acting through their governments, taxpayers in the Western world can thus collectively borrow at unusually attractive rates while, individually, they face unusually tough credit constraints. During such a period of tight credit conditions for the private economy, it can thus pay to outsource some of the consumption smoothing, that is the temporary borrowing in a downturn, from the individual to the collective level. By running higher deficits and augmenting aggregate demand, governments can satisfy the increased demand for government bonds and raise consumption more

cheaply than households could if they were to borrow themselves. This is the second argument in favour of a fiscal stimulus in the current situation.

Three Criteria to Judge a Fiscal Stimulus

Higher public deficits shift the tax burden onto future generations. To justify this, a fiscal injection has to meet three criteria:

- it has to be fast to actually help while the economy needs it most;
- it has to improve the long-term growth potential so that future gains in tax revenues make it easier to reduce the public debt again afterwards;

- it should minimise the risk that it gets hijacked by special interest groups.

A key issue is whether a joint European Union fiscal programme has a better chance to meet these criteria than a motley collection of independent national measures. In this respect, a comparison between the centralised US response and the largely decentralised European response to the immediate banking crisis in late September and October 2008 is quite revealing.

Financial Bailout Programmes: A Revealing Example

The USA seemed to have all the advantages: one central administration staffed with financial market experts at the highest level who could rely on well-established procedures of cooperation between the Treasury (finance ministry), the central bank, the financial regulators and the two chambers of parliament. The USA thus could act fast and forcefully. And it did when the Administration realised the extent of the problem.

The US Administration proposed a massive programme to take bad assets off the balance sheets of banks (troubled assets relief programme, TARP) on 19 September 2008. Despite full support from President Bush, the two contenders for his succession, the central bank, the regulators and countless financial market experts, the programme foundered in a first vote in the US Senate on 29 September. The result sent financial markets into a tailspin. Shortly thereafter, both houses of parliament passed a modified version.

But what happened then? Initially, hardly anything. As it turned out, the TARP had a central design flaw. There simply was no way to find a general mechanism to determine the price at which troubled assets, which had become untradable, could be taken off the books of banks. Over time, the US Administration changed the nature of the \$700 billion TARP programme completely, using the money to inject capital into banks and to guarantee banks against losses instead. The U-turn became obvious by 14 October. When even this did not seem to help enough, the USA finally changed tack again, returning to the idea of shifting the risk of troubled assets from banks to the government for a fee. In the end, it was the Swiss example – that is the tailor-made rescue package of the Swiss National Bank for UBS – which provided the blueprint for how the US authorities finally ended up dealing with the problems of major banks on a case-by-case basis.

Now look at the messy ways of crisis control in the European Union. First, Ireland shocked its neighbours by doing what Sweden had successfully done in late 1992 to prevent a ruinous run on its banks: it guaranteed all bank deposits on 30 September 2008. The

resulting flow of deposits from British banks into Irish banks infuriated the UK authorities and forced them to accelerate their own crisis response. Other countries also started to seriously discuss national bank bailout plans, sometimes openly, sometimes behind closed doors.

A first Paris summit failed spectacularly to agree on a common European position on 4 October 2008, except for the unspecific promise to let no major bank fail in Europe and de facto suspension of the fiscal deficit limits enshrined in the European Stability and Growth Pact. Right after her return from Paris, German chancellor Merkel – apparently on new information about the problems of some German banks – assured all Germans that their deposits were safe, de facto promising a blanket deposit guarantee. Like the Irish coup, this unilateral move raised eyebrows across Europe. But it also forced other European governments to look even harder at the issue. Britain then came up with a comparatively sensible anti-crisis programme on 8 October, including enhanced deposit guarantees, an offer to recapitalise banks with public money and to guarantee bank funding for three years. Other European countries endorsed the main principles of it at a Eurozone summit meeting in Paris the Sunday thereafter, 12 October 2008. Within three days, most West European countries then came up with national bailout programmes based to a significant degree on the British example while taking national peculiarities into account.

The political process in Europe certainly was not pretty. But it did still show Europe at its best. Instead of trying to devise one joint approach from the very beginning, Europe used its diversity and its internal divisions to its advantage. Being forced to react to each others' unilateral moves, learning from one another by seeing close-up what seems to work – or not work – in one country, the European Union ended up within a few weeks with a set of largely compatible national bank bailout programmes. Competition, imitation and an institutional setting which reduces the risk of solving national problems too much and too openly at the expense of one's neighbours due to the frequent interaction of the various national leaders on a wide variety of issues (repeated games) are the hallmarks of the European approach. The messy European way delivered better results, with much less subsequent need to correct design flaws afterwards, than the centralised "grand-design" US approach.

This carries a lesson for fiscal policy: in theory, national stimulus programmes may be suboptimal because they may not take trade and finance linkages