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Spread of the Crisis – Impact on Public Finances

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NOTE

Abstract

We have reviewed the financial rescue and economic recovery measures taken in the EU at the end of 2008 and during 2009. Many member states have undertaken recapitalization efforts and provided debt guarantees to help systemically important institutions and restore confidence in financial markets. They have also stimulated purchasing power, pursued active labour market policies and spurred investment and business to fend off the recession. However, in doing so, some countries have not taken appropriate measures. Especially with regard to competitiveness on a EU (and even a global) level, the government rescue packages have done serious harm. This has occurred in the banking sector, but also in the automotive industry. The European Commission should give higher priority to creating a European level playing field, instead of focusing on the national level when considering the approval of state aid. Furthermore, several member states have not yet planned how to reverse the fiscal stimulus in the medium term and consolidate their financial budget. With worsening issuance conditions due to growing sovereign debt and higher interest rates, it may become more difficult to roll-over public debt in the future.

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DISCLAIMER

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1. Introduction[1]

In response to the global crisis in the autumn of 2008 the European Commission has coordinated support to the financial sector in October 2008, and presented an economic recovery plan[2] aimed at spreading the financial burden of support between the Member States and the European Union (EU) in November 2008. The European Economic Recovery Plan (EERP) was accepted by the European Council in December 2008.

While the plan for the financial sector is aimed at restoring confidence in financial markets and increasing credit in the economy, the EERP is based on "short-term measures to boost demand, save jobs and help restore confidence". In the longer term it promotes "smart investment to yield higher growth and sustainable prosperity". Several large EU economies have taken substantial 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:

- Support of purchasing power with income support for vulnerable groups and tax cuts; either general or specifically targeting home-owners to stimulate consumption and the housing market.
- Labour market policies aimed at sustaining employment and increasing flexibility.
- Advancing planned public investments in infrastructure and the housing market.
- Supporting business mainly with financial measures for Small and Medium-Sized Enterprises (SMEs) in the form of guarantees and soft loans.

In Section 2 we review the measures taken in the European Union to support the financial sector, while in Section 3 we will review the economic stimulus packages deployed. In Section 4 we evaluate the consequences of these measures for the European level playing field, especially considering banking and the automobile industry. Section 5 assesses the consequences for public finances. Section 6 concludes.

[1] The author gratefully acknowledges the very helpful comments of Prof. Dr. Hans J. Blommestein and the excellent research assistance of Mr. Rob Nijskens, MSc.

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

2. Overview of financial sector rescue plans

Let us first take a look at the EU level, where concerted action to rescue the financial sector has been taken from October 2008 onwards. From the European Commission's report on the crisis (European Commission2009b) we know that a total of € 3.5 trillion has been approved for state aid to financial institutions, of which € 1.5 trillion (comprising 13% of EU GDP) has been effectively used for capital support, debt guarantees, liquidity support and treatment of impaired assets. Debt guarantees constitute the largest commitment (about € 2.9 trillion or 25% of GDP), which only materialize when banks actually make use of them. Impaired asset purchases have not been widely used in Europe, as opposed to the Troubled Assets Relief Program (TARP) in the US. Conditions on which assistance is provided are set according to guidelines from the ECB, with costs reflecting market considerations (between 6 and 9.3%), a preference for early repayment, avoidance of excessive recourse and strict rules on business conduct such as executive compensation, dividends and lending.

Before turning to describe the rescue measures in several large EU countries, let us first make some observations regarding Table 1 below. This table ranks countries by total financial support that is in effect. As already noted in (European Commission2009b), there are considerable differences among member states. Ireland has committed by far the most resources as a part of its GDP, mainly because of the large size of its banking sector. This also holds for the United Kingdom, Luxembourg and to a smaller extent the Netherlands. Exposure to impaired assets from the US (UK and Germany) and to the collapse of real estate markets (UK, Ireland, Spain) are other factors determining a large commitment to rescue the financial sector.

Table 1: Public interventions in the banking sector (as % of GDP)

	Capital injections		Guarantees on liabilities		Impaired asset relief		Liquidity and funding support		Total	
	Appr.	Effect.	Appr.	Effect.	Appr.	Effect.	Appr.	Effect.	Appr.	Effect.
Ireland	5.1	2.1	225.2	225.2	-	-	-	-	230.3	227.3
Belgium	4.2	5.7	70.8	16.3	5.7	5	NA	NR	74.6	35.3
United Kingdom	3.5	2.6	21.7	9.5	-	-	25.1	18.7	50.3	30.8
Netherlands	7.9	7.9	34.3	5.7	-	4.9	-	5.8	42.2	24.3
Luxembourg	6.9	7.9	12.4	NR	-	-	-	-	19.3	18.5
Sweden	1.6	0.2	48.5	8.8	-	-	0.1	-	50.2	9
Latvia	1.4	-	10.9	2.8	-	-	10.9	6.1	23.2	8.9
Austria	5	1.7	27.3	5.1	0.4	0.4	27.3	1.5	60	8.7
Germany	4.2	1.6	18.6	7.3	3.6	0.4	-	NR	26.4	6.3
Spain	-	-	9.3	2.8	-	-	2.8	1.8	12.1	4.6
France	1.2	0.8	16.6	3.1	2.3	0.3	-	-	20.1	4.2
Portugal	2.4	-	12.5	3	-	-	-	-	14.9	3
Greece	2	-	6.1	0.4	-	-	3.3	1.7	11.4	2.1
Denmark	6.1	0.3	253	NR	-	-	NA	NR	243.8	0.5
Hungary	1.1	0.1	5.9	-	-	-	-	-	7	0.1
Slovenia	-	-	32.8	-	-	-	-	-	32.8	-
Slovakia	-	-	-	-	-	-	-	-	-	-

Romania	-	-	-	-	-	-	-	-	-	-
Poland	-	-	-	-	-	-	-	-	-	-
Malta	-	-	-	-	-	-	-	-	-	-
Lithuania	-	-	-	-	-	-	-	-	-	-
Italy	1.3	-	NA	-	-	-	-	-	1.3	-
Finland	-	-	27.7	-	-	-	-	-	27.7	-
Estonia	-	-	-	-	-	-	-	-	-	-
Czech	-	-	-	-	-	-	-	-	-	-
Cyprus	-	-	-	-	-	-	-	-	-	-
Bulgaria	-	-	-	-	-	-	-	-	-	-
European Union	2.6	0.5	24.7	7.8	12	0.5	4.3	3	43.6	11.8
Euro Area	2.6	1.4	20.6	8.3	12	0.7	1.3	0.7	36.5	11.1

Note: Countries ranked by total effective support, NR = not reported by the Member State, NA = not available, Appr. = approved, Effect. = effective.
Source: European Commission.

Now let us consider the rescue plans in a number of large EU countries (as measured by GDP). In Table 2 we review the financial sector rescue plans in Germany, France, the United Kingdom (UK), the Netherlands, Italy, Spain and Belgium. This section draws heavily on (Panetta et al.2009), who have summarized and assessed the financial sector rescue programmes for 11 large countries from September 2008 until June 2009. See this contribution for a more elaborate overview. Below, we will add more recent measures when necessary.

Table 2: Financial rescue plans in large EU Member States

Country and measures taken	Budget consequences
<u>Germany</u> - All actions are administered by a special fund, the Sonderfonds Finanzmarktstabilisierung (SoFFin) - Recapitalization programme for banks, insurance companies and pension funds (up to € 10 billion per institution). - Debt guarantees for the same institution range (limit depending on equity), including interbank borrowing. - An asset purchase facility (up to € 5 billion per institution), unused yet. - Asset guarantees, unused yet. - Bailouts of BayernLB, IKB and Nordbank. - Specific guarantee for Hypo Real Estate, and later nationalization by SoFFin[3]. - Set up of a “bad bank” for WestLB, subject to approval by competition authorities[4].	- € 80 billion for recapitalization and asset purchases, of which € 22 billion used in total. - € 420 billion for debt guarantees (specifically € 20 billion for HRE), of which € 129 billion used. - Up to € 200 billion for asset guarantees. - Total: € 700 billion (26% GDP) committed, € 151 billion (6% GDP) used.
<u>France</u> - Recapitalization for all French banks and insurance companies, administered by the Societé de Prise de Participation de l'Etat (SPPE) and executed with subordinated debt and preferred shares. - Debt guarantees to a new entity (SFEF) that lends funds to credit institutions. - Asset guarantees for the medium term, to stimulate financing for businesses. - Capital assistance and debt guarantees (together with Belgium and Luxembourg) for Dexia. - Asset guarantees for FSA, a subsidiary of Dexia.	- € 43 billion committed for recapitalization, of which € 28 billion used. - € 320 billion commited for debt guarantees, of which € 72 billion used. - € 5 billion for asset guarantees, fully used. - Total: € 368 billion (20% GDP) committed, of which € 104 billion (4.5% GDP) used.

[3] *Summary of Government Interventions in Financial Markets: Germany,* Mayer Brown Client Alert, September 2009.
[4] Antitrust probe into attempt to bail out WestLB, *The Financial Times*, December 23, 2009.

UK - Bank recapitalization for Tier One capital with common equity and preferred shares (with 12% dividend). - Special liquidity scheme: short-term swap of illiquid assets for T-Bills. - Debt guarantees for non-complex debt instruments, although asset-backed securities are also included. - Asset Protection Scheme (APS) for asset guarantees, made use of by RBS and Lloyds Banking Group, paid for with equity shares to the government. The banks take a first loss position. - Nationalizations of Northern Rock and Bradford & Bingley.	- £ 50 billion committed to recapitalization, fully used. - £ 269 billion committed for debt guarantees, € 113 billion used. - £ 523 billion committed and used for asset guarantees. - Total: £ 845 billion (54% GDP) committed, £ 690 billion (44% GDP) used.
The Netherlands - Recapitalization scheme - Debt guarantee scheme (which has been scarcely used for fear of stigma) for non-complex debt - Specific capital assistance to Fortis Bank Nederland (Holding) NV and the Fortis share in ABN AMRO Holding NV (complete nationalization), ING, AEGON (possible further access to use TARP), SNS REAAL and NIBC. Structure: preferred shares with fixed dividend to the government of 8.5%, bonuses of board members for 2008 are cancelled and existing shareholders can redeem the state participation after 3 years at 150% of the nominal value. - Asset guarantees for ING's US Alt-A mortgages, where the state bears 80% of the risk without a first loss clause. ING will grant an extra €25 billion credit and suspend bonuses.	- € 37 billion for capital injections, of which € 31 billion used (also by specific assistance). - € 200 billion committed to debt guarantees, € 40 billion used. - Up to € 28 billion for ING asset guarantees (80% loss). - Total: €265 billion (42% GDP) committed, € 99 billion (16.6% GDP) used.
Italy - Very general measures, including announcements of recapitalisation and debt guarantees. - Capital has been requested (but the assistance has not been finalised); there is a per-institution limit. Subordinated debt and preferred shares are used. - No debt guarantees have materialized yet; their overall limit is unspecified, but there are per-institution limits.	- 20 billion committed for capital injections, 10 billion (0.6 % of GDP) has materialized. - Total: commitment is unspecified, 10 billion (0.6% GDP) used.

Spain - Recapitalisation facilities (not used) - Buying up healthy assets to provide liquidity - Provide bank debt guarantees for marketable debt. - Enlarge deposit insurance coverage. - Bank restructuring fund for small regional banks (which has not been used yet)[5].	- € 50 billion committed to buy-up. - € 100 billion committed to debt guarantees, 31 billion used. - Restructuring fund of €99 billion. - Total: € 31 billion (2.8% GDP) used.

Belgium - Nationalization of Fortis, which has been partly sold to BNP Paribas - Capital injections for Dexia and KBC Bank - Stabilizing the interbank market - Asset & debt guarantees (mainly Dexia, joint with France) - Buying up impaired assets	- €19.9 billion for bank bail-outs and specific guarantees. - € 90 billion for guarantees in the interbank market and liabilities and assets guarantees - Total: €109.9 billion (28% GDP), € 19.9 billion (5% GDP) used

[5] The Economist, *Savings and groans,* Nov 19th, 2009.

3. Overview of recovery plans

In December 2008, the European Council approved the European Economic Recovery Plan (EERP) as a coordination framework to address the crisis, with fiscal stimulus to curb the recession and structural reforms and smart investment to reinforce competitiveness. This plan must ensure coherence between immediate fiscal actions and the EU's medium- to long-term objectives, and prevent unwanted spillovers between member states. The fiscal policies have been set up to fulfill three important criteria: they must be timely, targeted and temporary. When these criteria are not met (i.e. the response is slow, too broad or permanent) the effectiveness of the measures may be severely compromised. We will further analyze this issue in Section 5.

To see which countries provide fiscal stimulus, we compare the same set of countries from Section 2 in Table 3 below. Table 3 also comprises structural measures as defined in the EERP and specified in the Lisbon strategy. These include labour market policies such as improving flexibility, business support (short run) and investment (long run) and supporting purchasing power. The overview is based on the European Commission's report on the crisis (European Commission2009b) and its Annual Report on the Euro Area (European Commission 2009a).[6]

Table 3: Fiscal and structural policies in large EU Member States

Country and measures taken	Budget consequences 09/10 (in % of GDP)
Germany	
- Supporting purchasing power: income tax cuts, travel costs deductibility for commuters, special designations for families, support low-income households.	- 2.1%
- Labour market policies: extending duration of work-time reduction scheme, reimbursing employers' social security contribution, stimulating training and education.	- 0.2%
- Investments in infrastructure, housing, structural programs for specific regions, R&D loans, tax credits, deprecation rules and subsidies (especially green technologies)	- 1.0%
- Supporting business: credit guarantees for SMEs, stimulus of CO_2-savings, car-scrapping scheme	- 0%
France	
- Supporting purchasing power: support to low-income households	- 0.2% - 0.1%
- Labour market: extending duration of work-time reduction scheme, unemployed persons will be retrained, reducing employers' social security contribution conditional on job creation	- 0.4%

[6] A more elaborate overview of fiscal and structural measures can be found in: European Commission2009c.

- Investment projects in automobiles, housing, construction (i.e. infrastructure and energy-efficient public facilities) and maintenance, subsidies for R&D investment and green technologies. - Supporting business: SMEs will get tax breaks, accelerated depreciation and VAT payments, support to the automobile industry in the form of a car-scrapping scheme but also more direct subsidies.	- 0.3%
UK[7] - Supporting purchasing power: reduction in VAT, home owners' support package and additional social safety. - Labour market: improving job placement, investment in re-training. - Advancing investments in housing, energy, infrastructure and schools. - Supporting business: postponing corporate tax increases, and small firms can defer payments, guaranteeing 50% of small and medium-sized firm lending up to £ 20 billion.	 - Total: 1.5% - Excl. tax cuts: 0.4%
The Netherlands - Supporting purchasing power: focus on low-income households and families with children. - Labour market: extending duration of work-time reduction scheme, trade off wage moderation against reduction in social security contributions, tax breaks for workers, support female labour market participation - Advancing investments in housing, energy-efficiency, infrastructure, hospitals; granting R&D tax credits. - Supporting business: speeding up government payments, guaranteeing 50% of company loans up to 50 billion, extra export insurance, car-scrapping scheme, reducing administrative burdens, reducing corporate taxation temporarily.	 - 0.5% - 0.3% - 0.9% - 0.2%
Italy - Supporting purchasing power: 4% cap on mortgage payment, tax breaks for low-income households, reinforcing social protection and temporary freeze of road- toll increases. - Labour market: extending duration of work-time reduction scheme, re-training, modifying unemployment insurance to stimulate working. - Investment: stimulating green technologies. - Supporting business: delay of value- added tax payments to companies, reducing administrative burdens, car-scrap scheme and explicit support to the automobile industry.	 - 0.0% - 0.0% - 0.0% - 0.0%[8]

[7] Prasad and Sorkin2009
[8] Italy's fiscal measures are deficit-neutral.

Spain	
- Supporting purchasing power: income tax deduction, assistance to low-income households, extension of housing construction support, abolition of wealth tax.	- 0.5%
- Labour market: investment in re-training, reducing employers' social security contribution conditional on job creation, modifying unemployment insurance to stimulate working.	- 0.0%
- Investment: public infrastructure investments, maintenance and investment in R&D (tax credits, subsidies for green technologies).	- 0.9%
- Supporting business: car-scrapping scheme, explicit support to the auto industry, credit provision to SMEs, reducing corporate taxation temporarily, improving start-up conditions for new companies.	

Belgium	
- Supporting purchasing power: assistance to low-income households, higher unemployment benefits and energy rebates for households	- 0.1%
- Labour market: food and energy vouchers for workers, extending duration of work-time reduction scheme, re-training, reducing employers' social security contribution conditional on job creation.	- 0.5%
- Investment: Accelerating infrastructure projects, stimulating R&D.	- 0.2%
- Supporting business: tax cuts including lower VAT on construction, delaying VAT payments for companies, accelerating government payments to companies, credit guarantees for SMEs and improving start-up conditions for new companies.	- 0.0%

4. Impact on European level playing field

As stated in the European Commission's Annual Report on the Euro Area (European Commission 2009a), the banking rescue packages and recovery plans are subject to state aid control. As banking rescue plans grossly violated level playing field conditions, the European Commission kept a close watch on the competition effects of bank support. However, they have focused almost entirely on the national level of competition. There was hardly any attention for the effects on the European level playing field. Considering that the Euro area shares a common currency and has very well integrated banking and capital markets, this approach acts as a brake on a further move towards a truly Single Market for banks in the EU. In some instances it may even represents a step backward.

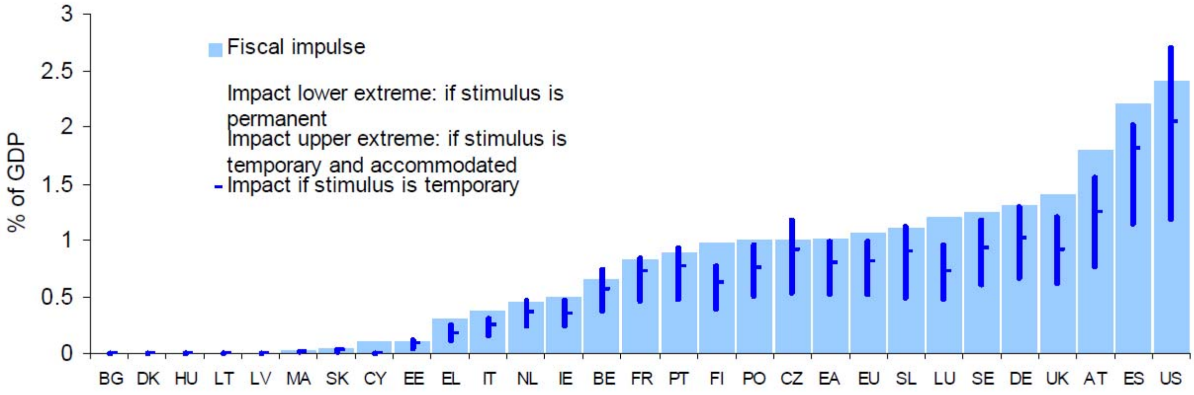
Moreover, inequality is created between banks from big, middle-sized and small EU-countries. Small and middle-sized EU-countries with a large banking sector, such as the Netherlands, suffer more than large countries. In the sample of countries reviewed in this note, we find that Germany, the United Kingdom and France have provided support to banks that is potentially harming European competition. Although this has also happened in the Netherlands and Belgium, the European Commission has forced the governments to break up large banking groups that have received specific assistance to guard national competition. The French government has provided assistance to all French banks, but this was not regarded as a threat to national competition. However, the French move represented the creation of a serious obstacle towards a level European playing field. Brussels should therefore calibrate its policy towards creating a level playing field for banks on the European level and thus make sure that there is no discrimination in that field between big, middle-sized and small EU-countries.

This does not only apply to the financial sector. While Germany and the Netherlands have only stimulated the demand side of the automobile market with scrap premia, countries such as Italy, France and Spain have specifically aided the automobile industry with large support packages. This has happened under Article 87 (3) (b) of the EC Treaty: "to remedy a serious disturbance in the economy of a Member State". However, as in the case of cross-border banks, this may harm competition on the European level even though it does not hurt the national level playing field.

5. Impact on European public finances

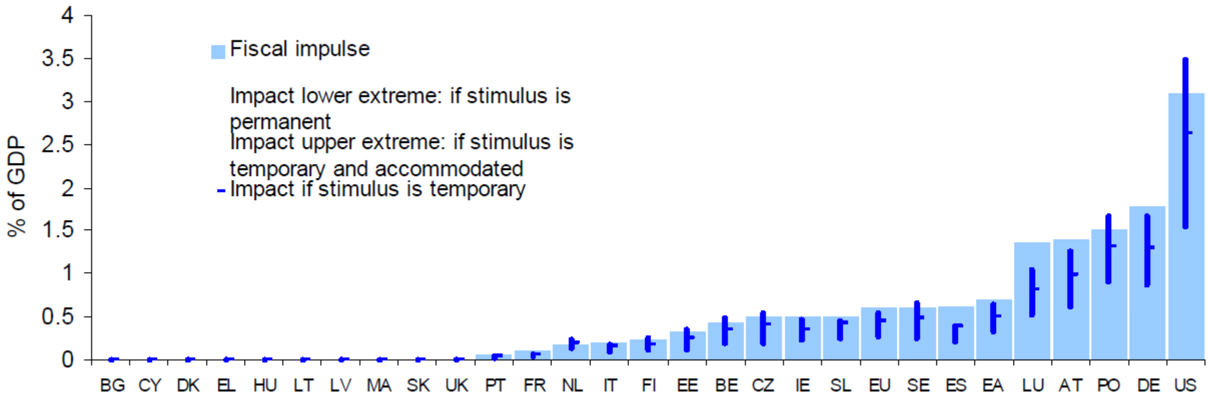
The European Commission in its report on the crisis (European Commission2009b) has simulated the effectiveness of fiscal measures with and without fulfillment of the criteria from Section 3, and additionally when monetary policy is accommodative. This can be seen in Figures 1 and 2 below.

Figure 1: Fiscal stimulus in 2009 and its effects



Source: European Commission

Figure 2: Fiscal stimulus in 2010 and its effects

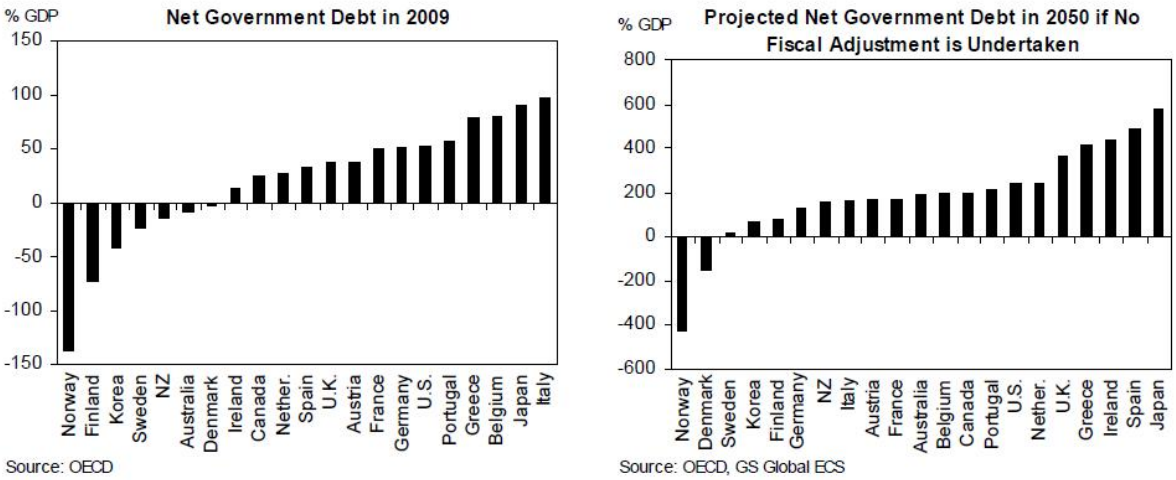


Source: European Commission

We see that it is important that the measures are temporary, since permanent measures will lose credibility and are less effective than temporary ones. As another important observation, the European Commission notes in its Annual Report on the Euro Area of 2009 (European Commission 2009a) that member states with a small “fiscal space”, i.e. the room in the government budget to execute sustainable fiscal measures, should not be encouraged to engage in fiscal stimulus. Instead, because of the integration of the EU, they should benefit from fiscal stimuli by other member states.

In this respect, it is also very important that fiscal stimulus is temporary so member states can consolidate the government budget as soon as recovery allows them to by reducing the stimulus. This enhances sustainability of public finances, which is especially relevant when considering uncertainties about financial guarantees that may materialize in the near future. As the projection in Figure 3 shows, not consolidating may lead to significant increases in public debt.

Figure 3: Forecast of government without consolidation



In our group of large member states, Germany, the Netherlands, Belgium and Italy plan to consolidate their fiscal balance in the medium term (before 2013). This mainly holds for the government deficit; public debt is projected to remain high (OECD2009). In contrast, France, the UK and Spain are not planning to consolidate their budget within three years. They have no clear plans to substantially reduce the deficit and debt within the medium term.

Not consolidating can become a severe problem for sustainability, as also shown in Figure 3. It will be an even larger problem when debt issuance becomes difficult, even though governments have become more flexible with issuance procedures. Although there are signs that issuance conditions are becoming tougher, most debt managers have been successful in financing the surge in funding needs. Thus far, there is no solid evidence of systemic market absorption problems. The future could become more challenging though, given that rising issuance is occurring in tandem with increasing overall debt levels and debt service costs. Governments must therefore think about medium-term exit strategies or consolidation. As central banks determine the interest rates, they in turn should take the same issues into account when determining their exit strategy by tightening monetary policy (Blommestein and Gok 2009).

6. Conclusion

We have reviewed the financial rescue and economic recovery measures taken in the EU at the end of 2008 and during 2009. Many member states have undertaken recapitalization efforts and provided debt guarantees to help systemically important institutions and restore confidence in financial markets. They have also stimulated purchasing power, pursued active labour market policies and spurred investment and business to fend off the recession. However, in doing so, some countries have not taken appropriate measures. Especially with regard to competitiveness on an EU (and even a global) level, the government rescue packages have done serious harm. This has occurred in the banking sector, but also in the automotive industry. The European Commission should give higher priority to creating a European level playing field, instead of focusing on the national level when considering the approval of state aid.

Furthermore, several member states have not yet planned how to reverse the fiscal stimulus in the medium term and consolidate their financial budget. With worsening issuance conditions due to growing sovereign debt and higher interest rates, it may become more difficult to roll-over public debt in the future. This problem may be aggravated when central banks will begin to tighten monetary policy as part of their exit strategies, which may also include the reversal of non-conventional monetary policies. This quite complex situation requires a clear understanding by the monetary authorities of the market impact of their exit programmes, a proper communication strategy, and an effective two-way exchange of information between the government issuer and central bank (Blommestein 2009).

Both these issues are summarized in Table 4 below. As we can see, there is a clear separation between countries pursuing a general recovery policy with medium-term consolidation and those with possibly harmful policies and no medium-term consolidation plans.

Table 4: Countries divided by stimulus characteristics

	Consolidation	*No consolidation*
General	Germany Netherlands Belgium	
Specific (possibly harmful)	Italy	France United Kingdom Spain

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