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A EUROPEAN RECOVERY PROGRAMME

by **Jean Pisani-Ferry**
Director of Bruegel,
jean.pisani-ferry@bruegel.org

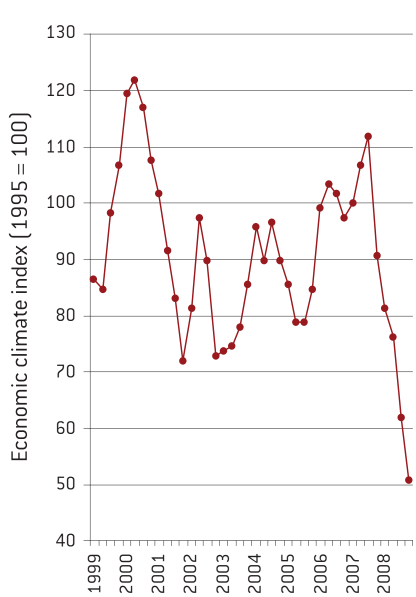
André Sapir
Senior Fellow at Bruegel
andre.sapir@bruegel.org

and **Jakob von Weizsäcker**
Research Fellow at Bruegel
jvw@bruegel.org

SUMMARY As a severe recession unfolds in the aftermath of the financial crisis, Europe must avoid entering a vicious circle. To that end, a budgetary boost is needed on top of the rescue package for the financial sector and further lowering of interest rates by central banks. This budgetary boost should be closely coordinated at EU level to ensure consistency and avoid free-riding behaviour. However, structural deficit levels in some EU member states are already high. There is a risk, therefore, that a budgetary stimulus could undermine budgetary sustainability. To address this concern, the stimulus needs to go hand in hand with a strengthened budgetary framework, complementing and reinforcing the Stability and Growth Pact (SGP).

POLICY CHALLENGE

Ifo economic climate index for the euro area (last decade)



Source: see Figure 1.

Budgetary boost: Harmonised VAT cut of one percentage point across the board plus national measures, especially targeted relief, tailored to country-specific circumstances in order to reach a total of one percent of GDP, to become effective by 1 January 2009 and to be phased out in 2010. *Reform commitment:* Compensation for deficits above three percent of GDP through sustainability-enhancing reforms. *Enforcement:* Correction of excessive deficits to be implemented as early as 2010 if reform commitment is broken. *Prudent borrowing:* Agreement by all euro-area countries not to borrow at more than 200 basis points above the lowest euro-area government bond yield.

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THERE IS A BROADENING CONSENSUS that, beyond emergency support to the financial system, the current global financial crisis is a once-in-a-generation event calling for exceptional policy responses in order to preserve jobs, livelihoods, financial stability and ultimately political support for open markets.

Since the crisis suddenly took a turn for the worse in September, governments and central banks have acted quickly and forcefully through emergency measures to avoid a collapse of the financial sector. But in spite of such action the financial sector is experiencing a severe contraction and the economic outlook for the non-financial sector is deteriorating extraordinarily sharply (Figure 1).

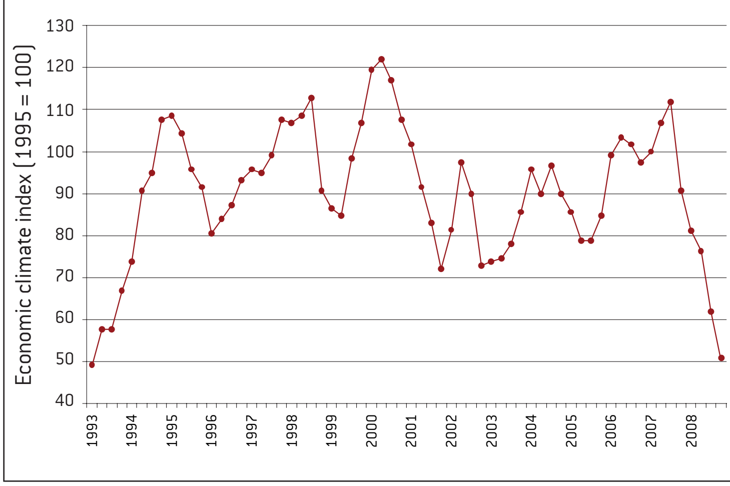
Forecasts for 2009 and beyond are constantly being revised downwards (Figure 2). Although crucial, bank recapitalisation, credit guarantees and the easing of monetary policy are clearly not proving sufficient. The sudden drop in financial wealth, across-the-board deleveraging, credit rationing and the rise in the prices of capital and debt, as well as the drop in demand worldwide, are coming together to make a severe recession on both sides of the Atlantic a likely prospect. The first global recession since the second world war has even become a possible scenario[1]. The drop in commodity prices, which is a welcome trend for the industrial countries, is itself a consequence of this recession and, as such, is too weak to reverse the bleak outlook.

Markets in the major economies are pricing in a recession and their downward adjustment in turn further weighs on the balance sheets of financial institutions, leading to additional losses, added strains in the interbank market, and supplementary credit constraints.

This exceptional Keynesian situation requires an exceptional Keynesian budgetary stimulus in addition to the financial rescue package. The increasingly accommodating stance of central banks has been helpful, and the ECB should still do more soon. But it would be risky to rely on monetary policy alone given the clogging of key monetary transmission mechanisms.

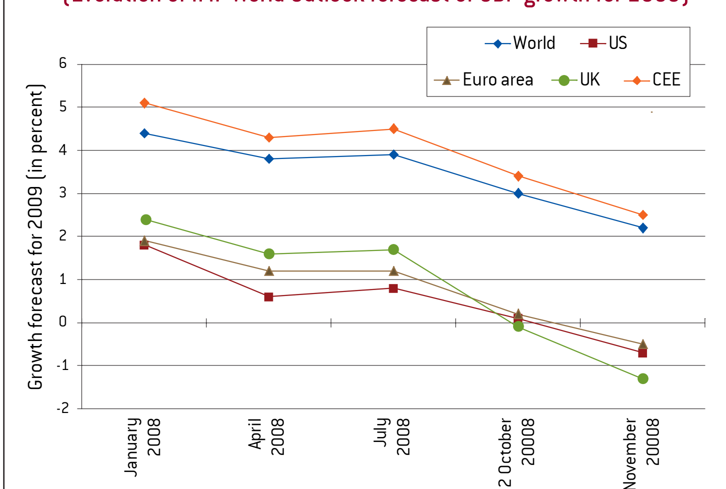
To be effective, action needs to be bold, timely and significant. As far as Europe is concerned, it should also be coordinated in order to ensure consistency and avoid free-riding behaviour. The decision on whether to act now through a budgetary stimulus should be viewed as a watershed, as was the

Figure 1: Ifo economic climate index for the euro area 1993-2008



Source: Ifo Institute.

Figure 2: Major world economies heading for recession
(Evolution of IMF World Outlook forecast of GDP growth for 2009)



Source: IMF. CEE: central and eastern European countries.

[1] On 11 November 2008 the World Bank revised its growth forecast for 2009 downward to one percent – more than one percentage point lower still than the November forecast of the IMF released on 6 November 2008.

decision on whether to act to save Lehman Brothers or to let it go down. An overcautious wait-and-see strategy would risk producing a drawn-out recession with dire economic and political consequences. National governments might be tempted to engage in subsidy wars to support sectors in distress and promote national champions. Just as in the Lehman case, there is a real possibility that inaction may ultimately turn out to be more expensive than action and inflict damage on the internal market and our market-based system.

Though crucial, coordinated EU action is difficult for two reasons. First, it is always a major task to coordinate action among a large number of countries. Second, this task is even more complicated because some countries are in relatively good budgetary shape, whereas others, which already recorded significant structural deficits before the downturn, now find themselves in trouble. Furthermore, some of these countries have repeatedly committed to medium-term objectives, but have not delivered on their commitments[2]. There is thus legitimate concern that a budgetary stimulus could undermine European public finances at a time markets are wary of risk. Hence a coordinated European budgetary stimulus must be accompanied by a strengthened budgetary framework to ensure that earlier mistakes are not repeated.

Clearly markets share the concern about budgetary sustainability, as indicated by the fact that spreads have widened markedly across euro-area government bond markets in recent weeks (Figure 3). While this partly reflects uneven liquidity, concerns about the sustainability of public finances have also intensified.

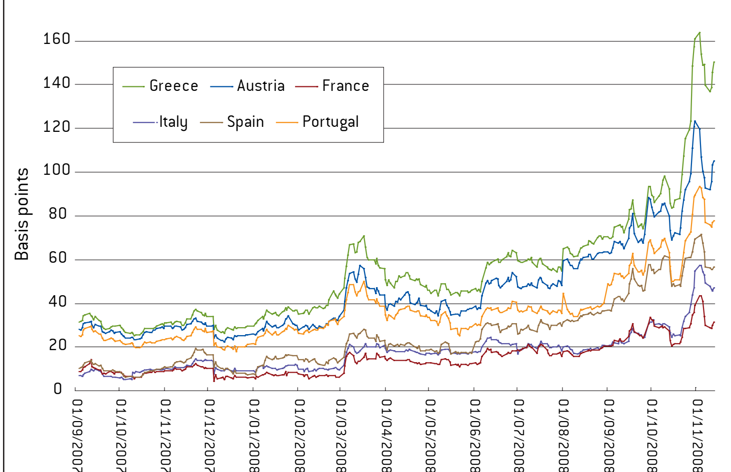
Against this backdrop, the temptation is to eschew joint EU action and simply let individual member states use whatever room for manoeuvre they have. But such an approach is unlikely to produce results. Experience has shown that, in open economies, budgetary policy has only limited effect. The more open the economy is, the more governments would be tempted to free-ride and rely on their neighbours' stimulus. Hence a loosely coordinated response is unlikely to deliver.

What we propose instead is to combine a substantial coordinated stimulus with measures that improve the long-term sustainability of public finances. Instead of recommending restraint to the member states whose budgetary situation is weaker, we recommend that all countries should participate equally in the stimulus and that those whose situation is weaker should go further in the implementation of sustainability-enhancing reforms.

This proposal raises the issue of enforcement. Although it has helped foster a gradual improvement in the budgetary situation of the euro-area countries, the SGP still suffers from a credibility gap. Especially, it offers ample flexibility in crisis time. This flexibility is unlikely to reassure markets. It is important, therefore, to have credible enforcement mechanisms to ensure that the budgetary boost will be accompanied by sustainability-enhancing measures.

The remainder of this policy brief spells out our argument in more detail. The next section provides a brief overview of the budgetary situation. In the third section we discuss our budgetary stimulus proposal. The fourth section is devoted to the strengthening of the budgetary framework. We conclude in the fifth section with concrete recommendations for the Action Plan due to be presented by the European Commission on 26

Figure 3: Select euro-area government bond spreads
Spread over German benchmark bond (1 Sept 2007-13 Nov 2008)



Source: Thomson Datastream.

[2] See http://ec.europa.eu/economy_finance/sg_pact_fiscal_policy/ for the Stability Programmes and their assessments by the European Commission.

November and scheduled to be tabled at the European Council of 11-12 December.

BUDGETARY DEFICITS IN THE AFTERMATH OF THE FINANCIAL CRISIS

We first need to establish that the link made in the introduction between a budgetary stimulus in the present financial crisis and a strengthened commitment to budgetary sustainability is relevant in practice. To this end, we develop a very simple scenario for the coming years, focusing on the euro area for the sake of presentational simplicity.

We start from the recent autumn 2008 economic and budgetary forecast by the European Commission, which puts the growth prospects for the EU at 0.2 percent of GDP in 2009 and 1.1 percent in 2010 (0.1 percent and 0.9 percent respectively for the euro area). This is projected to lead to a deterioration of the budgetary balance from -0.9 percent of GDP on average in 2007 to -2.6 percent in 2010 for the EU and from -0.6 percent to -2.0 percent in the euro area. The 2009 deficit would exceed the three percent threshold in Ireland and France, and would come close to it in Spain, Italy, Portugal and Malta.

In spite of a sharp downward revision compared with the spring 2008 forecast, this outlook is still optimistic. The Commission notes that risks to the growth forecast are 'firmly tilted to the downside' and that 'public finance projections are subject to significant downside risk' because of macroeconomic perspectives, the potential impact of changes in the composition of growth and the cost of measures taken to support the financial sector. Indeed, the recent IMF projections are markedly darker: what is predicted for the euro area is an outright recession (-0.5 percent) in 2009. Yet the IMF also notes that 'financial conditions continue to present significant downside risks'.

In our scenario we therefore start from the Commission forecast and assess the budgetary impact of a downward adjustment of growth by one percentage point for 2009 and 0.5 percentage points for 2010 (Table 1).

Figure 4 presents the consequences of our scenario for public finances. For assessing the consequences, we assume a 0.1 expenditures-to-output gap elasticity and a unitary revenues-to-GDP elasticity. These parameter values are consistent with estimates used by the European Commission for the evaluation of the so-called minimum benchmarks[3]. They are likely to err on the cautious side, as during abrupt reversals the income elasticity of government receipts often exceeds average values. This scenario does not include any cost estimates for the bank rescue packages beyond those included in the Commission forecast. Their costs are chronically difficult to estimate. Historically, some government rescue packages have led to major budgetary losses while others have even ended up producing a minor surplus[4]. Also, the deficit scenario in Figure 4 does not include any budgetary stimulus

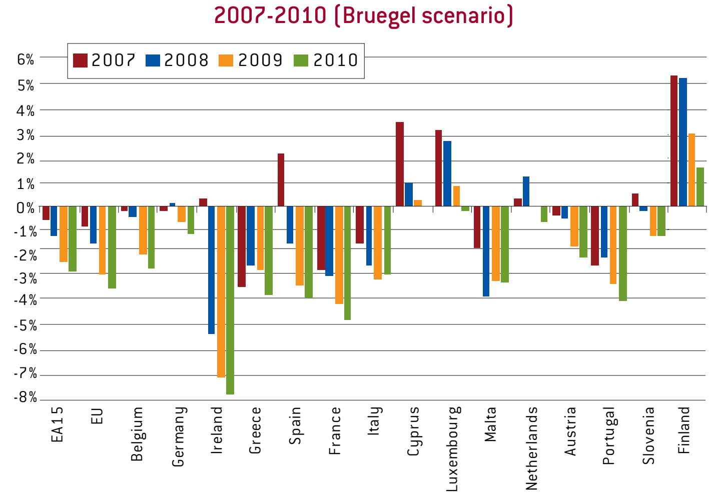
Table 1

Growth assumptions for the euro area (in percent)

	2007	2008	2009	2010
European Commission forecast 10/2008	2.7	1.2	0.1	0.9
IMF forecast 11/2008	2.6	1.2	-0.5	n/a
Bruegel scenario		1.2	-0.9	0.4

Source: European Commission, IMF, Bruegel calculations.

Figure 4: Projected budgetary deficits for euro-area countries, 2007-2010 (Bruegel scenario)



Source: Bruegel calculations.

[3] European Commission, 2005, 'New and updated budgetary sensitivities for the EU budgetary surveillance', DG ECFIN, 30 September 2005, Brussels.

[4] Luc Leaven and Fabian Valencia, 2008, 'Systemic Banking Crises: A New Database', *IMF Working Paper* Nr. 08/224.

beyond the automatic stabilisers that we have estimated with revenue and expenditure elasticities relative to the output gap.

Even without such additional factors, it is clear that a substantial number of countries in the euro area – Ireland, but also France, Italy, Greece and Portugal – are likely to exceed the three percent deficit limit in 2009 and even more in 2010.

Based on these findings, we conclude that the link made between the financial crisis, a possible budgetary stimulus and a strengthened commitment to budgetary sustainability is indeed relevant in practice.

WHAT BUDGETARY STIMULUS?

The condition of the European economy prevailing in this crisis corresponds almost exactly to the textbook case for a budgetary stimulus. It can be characterised as a sudden and generalised dash for liquidity combined with an across-the-board heightening of the aversion to debt. This situation dampens the effectiveness of monetary policy since financial as well as non-financial agents tend to hoard liquidity despite the opportunity cost of holding cash balances. The fear of illiquidity has become overwhelming. And the general aversion to debt is leading to deleveraging, which implies a drop in demand for goods as spending on consumption or investment takes second place to paying down debt. In such conditions where the propensity of private agents to spend experiences a sudden and dramatic drop, budgetary policy must step in to boost aggregate demand. Keynesian policy is needed and it can be effective.

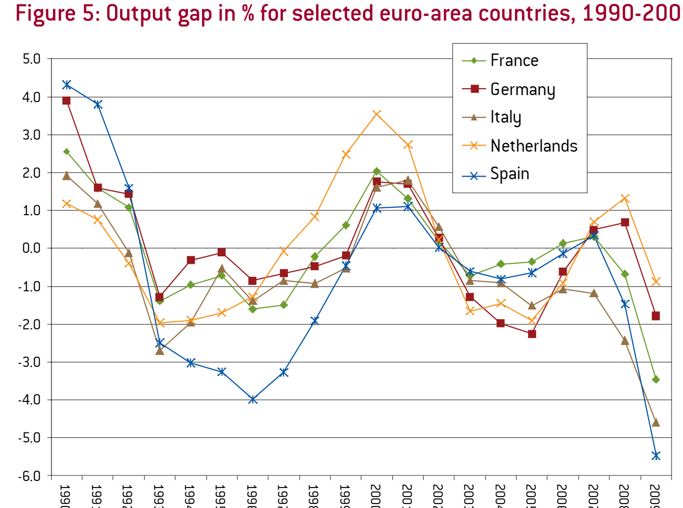
The appropriate magnitude of the budgetary boost depends on the depth of the recession, which can be approximated by the projected output gap shown in Figure 5 and the existing budgetary situation discussed in the previous section (Figure 4). While these figures suggest that countries in the EU are in different situations, all will find themselves in negative output-gap territory.

How large should a uniform stimulus be? For Germany, the largest EU economy, the German Council of Economic Experts[5] has just recommended a budgetary boost of between 0.5 and one percent of GDP for 2009. The output gap is projected to be substantially larger in other countries. But many of these countries may have less budgetary room for manoeuvre than Germany because of higher structural deficits. Therefore, reaching a European consensus rapidly is likely to prove more difficult the more ambitious the European scheme sets out to be, especially if it goes beyond one percent of GDP. This is a key reason why we suggest that Europe undertakes a coordinated one percent budgetary boost.

The budgetary stimulus to support the real economy needs to be timely and substantial to be effective. In the current crisis Europe should therefore look for ways to deliver the budgetary boost without delay. Measures that require thorough preparation, such as coordinated increases in R&D or infrastructure spending are thus generally unsuitable unless they have already been fully prepared. Admittedly, such projects would have the advantage of favourable supply-side effects but would typically only be effective in 2010, whereas it is crucial to deliver the budgetary impulse in the course of the critical year 2009.

This is why we advocate that a substantial portion of the budgetary boost be delivered through a coordinated cut in VAT rates[6]. There are several shortcomings to the use of VAT. It is not

Figure 5: Output gap in % for selected euro-area countries, 1990-2009



Source: OECD and own estimate based on growth assumption in Figure 4.

[5] Sachverständigenrat zur Begutachtung der gesamtwirtschaftlichen Entwicklung, 2008, 'Die Finanzkrise meistern – Wachstumskräfte stärken', Jahresbericht 2008/2009, Statistisches Bundesamt, Wiesbaden.

[6] The minimum standard and reduced VAT rates in the EU (15 percent and 5 percent respectively) would have to be lowered accordingly to allow for a VAT cut in all countries.

targeted, reductions in VAT rates are less easily reversible than for other measures and, depending on the degree of competition on product markets, part of the tax rebate may not be passed on to consumers.

But there is a significant premium in a coordinated and transparent move. Also, a temporary VAT cut provides a substantial incentive to bring spending forward given the subsequent return to the previous, higher VAT rates. By the same token, care needs to be taken to minimise the delay between the announcement of the VAT cut and the cut itself, because during that period there would be an obvious incentive to postpone spending.

If there is a significant price pass-through, there may be concern that headline inflation might decrease further, bringing it close to deflation. However, since the prospect of a price increase, which would come with the VAT increase when the measure is phased out, would create inflationary expectations, we believe that concern about deflationary risk should not be exaggerated.

The proposed VAT cuts should be complemented by other measures tailored to specific national circumstances in order to deliver the full budgetary boost of one percent of GDP. The detail of these additional measures need not be coordinated at European level but there should be agreement on the desired orientation. Suitable measures include relief to segments of the population likely to be most affected by the crisis, especially the working poor, and strengthened incentives to improve energy efficiency. While implementation at member-state level would differ, there could be EU-wide agreement on the proportion of the budgetary packages that should be devoted to these two additional goals. In any event, there should be agreement that the full budgetary equivalent of these measures be phased out in 2010.

STRENGTHENING BUDGETARY SUSTAINABILITY

In this section we explore the weaknesses of the SGP in light of the current crisis and propose how to embed the budgetary boost in an agreement to strengthen budgetary sustainability.

The crisis and our proposal for a short-term budgetary stimulus are likely to trigger the launch by the Commission of an excessive deficit procedure (EDP) against a significant number of EU member states (see box). However, the EDP is unlikely to bite until at least 2012. The prospect of such a long time lag before corrective action must be taken may not provide markets with adequate reassurance of budgetary sustainability.

We therefore propose that the relevant provisions of the SGP should

BOX 1: CORRECTION OF EXCESSIVE DEFICITS UNDER THE STABILITY AND GROWTH PACT (SGP)

The Stability and Growth Pact (SGP), provided for in Article 104 of the Nice Treaty, was adopted by the euro area in 1997 in order to safeguard budgetary sustainability for the common currency. The Pact prescribes a ceiling for annual budget deficits of three percent of GDP and sets out procedures for enforcing corrective action in case this ceiling is breached, with the ultimate sanction of hefty fines for non-compliance.

During the 2003 economic downturn both France and Germany fought to introduce more budgetary flexibility into the Pact and to inject economic judgement into mechanical rules. They were ultimately successful and the SGP was reformed in 2005.

According to the reformed SGP any breach of the three percent deficit threshold leads to the opening of an excessive deficit procedure (EDP), unless the excess over the reference value is exceptional, temporary and close to the threshold value (Article 104.2 (b) and 104.3 of the Treaty). However, this clause providing for exceptional circumstances offers relatively little budgetary flexibility since it only applies when the deficit is close to the three percent limit. The real flexibility in the SGP instead lies in the long time lag before full application of the EDP. This procedure states that the breach of the three percent threshold is only established the year after the breach has occurred, once reliable data is available. A deadline for correction is then usually set for the following year, ie the second year after the breach. Furthermore, the 'code of conduct on the SGP' permits the deadline for corrective action to be 'as a rule' postponed to the third year after the breach in case of exceptional circumstances. Hence, countries with large budget overruns in the current crisis might, in effect, face no substantive constraint under the SGP until the year 2012, or even later.

be complemented by an ad-hoc EU agreement designed to ensure that the proposed exceptional budgetary stimulus does not mark a departure from budgetary sustainability[7]. This ad-hoc agreement would not amend or replace the SGP but complement it.

In concrete terms, we suggest the following:

1 Compensation of budgetary overruns with countervailing reforms to enhance budgetary sustainability

Countries expected to exceed the three percent deficit limit with the proposed budgetary stimulus in 2009 would commit to table immediate reforms to improve budgetary sustainability, offsetting the short-term overrun. Such reforms would have to be submitted to the European Commission for evaluation and would be assessed in light of the projected deficit overrun.

Reforms may include, for example, a decision to cut specified public spending items and benefit entitlements in the future or to increase specified taxes and social security contributions. However there is no commonly agreed metric to evaluate any savings generated by such reforms. We thus propose to entrust the Commission with the task of proposing and implementing a methodology for evaluating the budgetary equivalent of the reforms. Conceptually, the method should rely on an evaluation of the future effects of reforms and a standardised computation of the present value of future budgetary savings. Measures introduced to improve the medium-term sustainability of public finances could imply a reduction of the implicit, rather than the explicit public debt. The financial debt of a country in the form of government bonds makes up only a fraction of total government liabilities. Commitments to pay out future benefits, such as pensions, over and above future contributions, are part of an implicit debt and are not included in the Maastricht Treaty definition of government debt.

However, implicit and explicit debt should not be treated in the same way, first because the computation of a present value relies on technical assumptions, and more importantly because the implicit debt can often be reduced by simple changes in legislation (such as pension reforms). One euro of explicit debt must therefore be considered to be more serious from the perspective of budgetary sustainability than one euro of implicit debt[8]. A workable approach could thus be, for example, to apply a 50 percent haircut when counting reform-related reductions in the stock of implicit debt.

With such an approach the stimulus would increase the deficit in the short run but it would at least preserve sustainability in the medium run.

2 Accelerated corrective action in the aftermath of the budgetary stimulus

In our proposed package, the stimulus would come first and the reforms would follow, because the urgency of the situation calls for rapid budgetary action. But in order to enhance the credibility of their commitment to compensate the stimulus by sustainability-enhancing reforms, member states would agree upfront to dispense with the time lag of the SGP's excessive deficit procedure. Normally, corrective action would be required only in 2012 or later in case of a substantial budgetary overrun above the three percent ceiling. But, under the proposed agreement, failure to comply with the required reforms to improve sustainability would lead to corrective action as early as 2010, thus significantly accelerating application of the SGP procedure without replacing it.

3 Low-interest borrowing commitment

As a back-stop to ensure that situations which are sustainable on paper are not viewed as unsustainable by markets, member states should commit not to borrow at abnormally high interest rates. Specifically, we propose that all euro-area countries commit not to borrow at an interest rate of more than 200 basis points above the lowest government bond yield within the euro area[9].

As Figure 3 shows, the interest differentials for government bonds within the euro area have in fact increased substantially during the present crisis. If the proposed limit of 200 basis points is reached, we propose that this should trigger an emergency procedure where the member state in question would be allowed only to roll over existing debt until its budget and any borrowing plans have been approved by the EU Council. This temporary strengthening of budgetary surveillance is designed to pre-empt

[7] Countries wanting to do more could introduce budgetary rules domestically such as the "Schuldenbremse" under consideration in Germany.

[8] Benoît Coeuré and Jean Pisani-Ferry, 2005, 'Fiscal Policy in Emu: Towards a Sustainability and Growth Pact?', Oxford Review of Economic Policy, Vol 21 Issue 4, 598-617.

[9] See Daniel Cohen and Richard Portes, 2004, 'Towards a Lender of First Resort', *CEPR Discussion Paper* No.4615, for a similar proposal for the developing world.

unsustainable positions and, on balance, we consider that markets would be reassured by such a backstop process.

We propose that the European Council in December 2008 adopt these ad-hoc agreements to ensure that the proposed coordinated budgetary boost is embedded in a framework of strengthened budgetary sustainability. The elements of this agreement could then be evaluated by 2011 with a view formally to incorporating them into the SGP once they have passed the test of the current crisis.

AN ACTION PLAN FOR THE EUROPEAN COUNCIL

The final question is how the ambitious package proposed in this paper could realistically be implemented by January 2009. For this, the proposed budgetary boost and the strengthened budgetary framework would need to be included in the Action Plan for the current crisis due to be presented by the European Commission on 26 November. Subsequently, the main parts of the package would need to be agreed by the European Council at its meeting on 11-12 December.

Specifically, such an agreement by the European Council should contain the following items:

- As many EU member states as possible[10] and at the very least all countries of the euro area are to agree to participate in a temporary European Recovery Programme (ERP) with national budgetary support amounting to one percent of GDP.
- Part of the ERP is implemented through a harmonised one percentage point cut in VAT rates across the board, effective January 2009, to be reversed in all participating countries in the course of 2010. The remainder of the ERP is to be implemented by national measures selected from a commonly agreed menu which includes targeted relief especially to the working poor, and incentives to improve energy and CO2 efficiency.
- The measures introduced within the framework of the ERP are to be phased out or financed by equivalent receipts in the course of 2010. In particular, incentives to improve energy and CO2 efficiency introduced as part of this package may be made permanent if budgetary improvements of equal value are enacted.
- All countries whose deficit would exceed three percent in 2009 after the ERP is implemented are to undertake to submit by 30 March 2009 the reforms they intend to implement to improve budgetary sustainability and compensate the overrun above the three percent threshold. The Commission certifies the budgetary equivalent of the reforms within two months.
- If by 1 September 2009 a member state whose budgetary deficit exceeds three percent of GDP has implemented the budgetary stimulus but failed to enact commensurate flanking reforms, it is subject to an accelerated excessive deficit procedure and the deadline for the adoption of corrective measures is brought forward to 2010.
- All participating euro-area countries commit not to borrow at interest rates higher than 200 basis points above the lowest government bond yield in the euro area, even during a crisis. They agree to submit to special budgetary oversight in the event of the yield on their debt breaching this threshold.
- The ad-hoc measures introduced to strengthen budgetary sustainability as part of the ERP are to be evaluated by 2011 with a view to their formal incorporation into the SGP.

[10] Realistically, this would have to exclude countries currently subject to an IMF programme, such as Hungary.

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Bruegel - Rue de la Charité 33, B-1210 Brussels - phone (+32) 2 227 4210 **info@bruegel.org**

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