High Level Group on the Financial and Economic Crisis

Opinion addressed to PES Leaders

Brussels, 22 May 2009

The High Level Group on the Financial and Economic Crisis was created by decision of the PES Leaders at the PES Council of December 2008 in Madrid, in order to provide advice and recommendations on an effective and progressive response to the financial and economic crisis.

Dear PES leaders,

This is our advice on the actual situation of crisis. Our starting point is to **put into historical perspective what could happen if we take no more action** by comparing the current crisis with that of the 1920s-30s. When the Great Depression emerged, governments all over the world and many social democratic leaders did not understand its real nature and implications, paving the way for what happened next. This time, socialist and social democrat leaders can make the difference and pave the way towards a more sustainable and united Europe.

The prospect of minus 4% economic growth in the EU should be counteracted through more effective financial instruments and an **Alliance for Recovery with social justice**. Our recommendations are presented below.

It is important **to understand the nature of this crisis: we should have no illusions** - this is more than a slow-down to be overcome by 2010 and we cannot assume that things can go back to normal as in the past. This means that a faster way out of this crisis will only be possible through European and international coordination. This also means that some important transformations and reforms should take place in our European market economies, notably regarding the financial system, corporate governance and income distribution. It is fundamental to correct the gap which has emerged between, on the one hand, short-term shareholder value management and remuneration of top managers and, on the other hand, the need for long-term investment, sustainable growth and the creation of good quality, well paid and stable jobs.

This is now a central reforming task which can only be led by social democrats, if we want to have a successful and lasting recovery.

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We must underline that any reform should keep the focus on the most important objectives. This means that **effective regulation of the financial markets** should be made in view of long-term sustainable growth and promotion of social cohesion, addressing consumer protection, investor protection, market integrity, market stability (and prevention of systemic risk) and social externalities. Regulation principles must not rely on self-regulation and codes of conduct, which are intrinsically unable to address the issues we are faced with. The belief in the self-regulating properties of markets which led to deregulation and a widespread mistrust of government intervention must be transcended.

Moreover, it is important to bear in mind that the aggregate demand deficiency preceded the financial crisis, and was due to structural changes in income distribution.

Besides the imbalances of income distribution at global level, some relevant changes have also taken place in the US and in Europe. In the US the compression of low incomes was compensated by the reduction of household savings and by mounting indebtedness that allowed spending patterns to remain virtually unchanged. In Europe, the redistribution to higher incomes resulted in an increase of national savings and depressed growth.

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European integration is at a crossroads. Either we move forward with a clear roadmap to overcome this crisis, or Europe will be undermined by the crisis. In fact, this crisis requires not only stronger national actions, in quality and quantity, but also European coordination of these actions and the development of new and effective use of existing European instruments. This is the case because the recession is deep, our economies are very interdependent and the European economy is now considered a single entity in the global economy. Therefore, we need to complement these national actions with stronger European instruments. This is valid not only to rescue the banking system, but also to avoid similar crashes and to safeguard employment and living conditions. We call for national and European action to go forward:

- to strengthen "good banks", which did not create the crisis and will play an important role in a quick recovery, and to regulate the financial markets with more public responsibility;
- to improve the resilience of European economies and societies against future crises by increasing investment in the future and by creating and safeguarding jobs in sustainable sectors;
- and to strengthen social safety nets and ensure workers' rights. The right to organize and to act cannot be undermined by the single market. We must prevent the European economy from slipping and getting trapped into deflationary wage competition. The revenue base of our social security and public services systems must be protected from tax competition inside the internal market.

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Let us be aware of the work we have undertaken: we, **social democrats, do have a plan and a good one at that, which is the only effective and sustainable plan.** After a unique process of joint work involving our political parties, governments, parliamentarians, experts and actors of civil society, clear and detailed political priorities were adopted by the leaders on 19th March. Our economic recovery plan is clear and based on a 7-point strategy: more job-creating investments; more credit facilities in the banking system; a Pact for Employment to safeguard jobs as far as possible, support the unemployed back into quality employment as fast as possible and stimulate the creation of new jobs; a Social Progress Pact to tackle the social dimension of the crisis; economic solidarity with more support for Member States suffering particular difficulties; better regulation of the financial markets; and global action, notably with commitment to a global new deal following the G20 meeting in London.

What is now missing are the financial and political instruments to implement this stronger and progressive European Recovery Plan. The current European elections provide a unique opportunity through renewed European leadership to pave the way for these new financial and political instruments.

The recent forecasts of minus 4% in EU economic growth fully confirm our predictions at the beginning of this crisis. This recession requires **a bigger, intelligent, efficient and sustained fiscal stimulus** to foster green and smart growth and job creation as well as to safeguard many viable companies, jobs and skills which are being destroyed by this crisis. Moreover, basic solidarity must be ensured across the board because many workers will be hit, including the most vulnerable workers who will be hit hardest.

The growth and public revenue effect of a well designed stimulus is clear: each one percent of GDP for fiscal stimulus will increase GDP by one percentage point at impact and by as much as two to three percentage points of GDP when the effect peaks a few years later[1].

What is a good stimulus package?

- it is more about investments and less about consumption, to improve productivity and to use multipliers;

- it should be timely, targeted and temporary; we emphasise especially that implementation has to be timely to work against the crisis;

- it should lead to more sustainability;

- it should be financially efficient, and therefore rather about loans and guarantees than about grants; on average loans and guarantees are, to a very high degree, self-financing and reduce therefore the burden for future generations significantly;

- and it should amount to 2% GDP in 2009 and 2010, to create the necessary impact in order to make the crisis less deep and achieve an earlier recovery.

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The following 7 proposals will ensure that we can combine our efforts to **build a new, stronger fiscal stimulus**, which should be above **2% GDP** (without taking account of automatic stabilizers):

First, we consider the stimulus across Europe is not sufficient. It makes no sense that:

- one level of administration waits for the other;

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[1] The Case for Global Fiscal Stimulus, by Charles Freedman, Michael Kumhof, Douglas Laxton, and Jaewoo Lee, IMF Staff Position Note, March 6, 2009, page 4.

- countries hesitate because others may wish to free-ride;

- the overall size to be effective is not achieved.

So we call for a clear distribution of labour and clear targets for all (additional activity with respect to the base-line before anti-crisis activities have been started):

- the European level has to achieve an annual 0.5% GDP for the stimulus package in 2009 and 2010 - the current package contributes to this objective;

- the national level has to achieve an annual 1.0% GDP each in 2009 and 2010;

- and finally, the local and regional level has to aim for an annual 0.5% GDP in both years.

Especially vulnerable states may need additional support to achieve these objectives. We emphasize this approach, because limiting a larger stimulus package to the stronger Member States, thereby relying on a "trickle-down-effect" to weaker Member States, will not help the latter with the catch-up process, but on the contrary will deepen the gap.

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Second, regarding **European Structural funds and Cohesion Funds**, it is not enough to simplify the systems for advances and reimbursement, which is still to be ensured in practical terms. It is necessary to anticipate the multi-annual programming and to strengthen management structures. To increase financial capacity, corresponding to actual needs, we must go beyond the classical grant mechanisms. We ask for rapid implementation of **schemes with interest rate subsidies** for (i) energy efficiency and (ii) small and large urban development to address private and public investors at a municipal level. Eight billion Euro fund money for these projects will create between 40 and 80 billion EUR in investments for small companies with many jobs. This can be done - successful examples exist - via an interest-rate subsidy of 1 percent-point for a long-maturity-loan of 10 years. With such a scheme each Euro of the European Budget creates a leverage of a factor 10 on investments on the ground and provides a 100% loan-financing of the projects.

Third, regarding the **community budget**, it is necessary to **shift the priorities** for the next years, using the mid-term review to go further in this purpose and prepare a clear re-direction of the next financial perspectives. A new inter-institutional agreement could be necessary. Moreover, the margin for enforcing events, of around 50 billion EUR, can also be mobilized.

Fourth, the **European Investment Bank** can add **a guarantee instrument** to the first anti-crisis package, which should be focused on major initiatives for climate protection, public transport and large infrastructure projects in the new Member States, where neither the volume nor the long maturities of financing are provided by the market system due to significant market failures. A guarantee volume of 20 billion EUR until the end of 2010 could mobilize 40 billion EUR in investments, doubling the current effort. As these programmes are driven by loans and paid back out of resulting revenues, there will be no burden for the next generations. As the European Investment Bank has the power to borrow on international capital markets, this power should be used so that savings from the rest of the world and the countries with high saving quotas in Europe are used to invest to make the European economy sustainable and stronger. Central banks in Europe can be invited to back this initiative up by buying these kind of European Bonds.

Fifth, the **Community Facility** for countries with problems of balance of payments should be further strengthened to reduce the need of EU Members to use IMF instruments and its related conditionality.

Sixth, Member States should consider **new tools to issue public bonds**. Most of the Member States have already started additional anti-crisis programmes. The range is from close to zero up to 1.4% GDP. If they fit into the criteria mentioned above, additional incentives for macroeconomic coordination have to be created. Therefore we suggest that for the whole volume of the 2 years – hence a ceiling of €375 bn - an offer is made to use newly created Euro-Bonds for interested Member States. In the present context, characterized by international competition for financial resources, it could be useful to examine the possibility of **converting national bonds into Eurobonds** for this stimulus package and with this incentive to realize a stimulus package of the size we need in each single Member State. The aim would be to reduce the spreads which are being paid by public debt to launch new investment projects, supporting business in general by decreasing the cost of capital, and attracting domestic and foreign savings and preventing hostile takeovers by foreign investors. Building on national debt management structures, a European agency could be created to organize the common issuance of **EU denominated bonds**, with the guarantees to be provided by all participating Member States.

Finally, EU Member States should promote their structural reform agenda in order to resolve structural shortcomings responsible for the crisis, meeting the major challenges of climate change and demographic change, as well as promoting growth and employment. The post-2010 Lisbon strategy debate can be the adequate platform for European social democrats to address these challenges, to put Europe on track again.

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New political means should be mobilized to implement this stronger European recovery plan. An **Alliance for Recovery with social justice** should be built, bringing together all social and political forces which can support it. A new political majority in the European Parliament should strengthen social democratic influence in the European institutions.

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