

The role of « Stimulus packages » in the crisis resolution

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Under the title *Can France Do More in the Face of the Crisis? Comparative Study of 5 European Stimulus Plans*, the Thomas More Institute is publishing an interesting comparative study on the various "stimulus packages" adopted by the five most important countries of the European Union (economically speaking) (1). The object of the reflections hereunder is to set this study within the framework of the entire panoply of measures taken to alleviate the crisis.

The stimulus packages implemented by governments throughout the world aim at countering the deepening of the economic crisis, the effects of which became particularly acute after the failure of Lehman Brothers on September 15th 2008. Up until then, the crisis had been considered to be largely restricted to the financial sector. Its handling had been entrusted primarily to monetary policy authorities (Central Banks). Its subsequent spreading to other sectors of the economy and its social impact as well as its propagation on a world scale took place at breath taking speed.

Generally speaking, confronted with the situation, political and monetary authorities have reacted rapidly by mobilising impressive amounts of resources. In many ways, real efforts aiming at closer international coordination have been undertaken: coordinated reductions in interest rates by Central Banks worldwide – cooperation at European level (European Council – de Larosière Group) and world level (G20), accompanied by welcome appeals to avoid protectionism. However, in reality, a strong undercurrent of nationalistic measures is emerging. At European level, this is evidenced by a visible strengthening of "intergovernmental" activity to the detriment of further "supra governmental" integration, marginalising commensurately the ability of the European Commission to act efficiently. This transpires both in the "autonomous" responsibility for designing and handling national stimulus plans and the approach for financial sector regulation/supervision recommended by the de Larosière Report (2). If closer cooperation constitutes undoubtedly real progress, it is nevertheless broadly accepted that such - often complex - processes tend to lose their operational efficiency in times of stress when urgent decisions are called for. The absence of binding uniform rules renders decision making in such circumstances particularly arduous, precisely at the time when it is most needed.

The questions surrounding stimulus packages need to be considered within this eminently political context. If it is illusory to aim at a global "binding" set of rules, such an ambition should not be discarded at European level. There can be no doubt that European Monetary Union (EMU) and the Euro have proved to be – to date – one of the main factors of relative stability within the EU. So far, it has avoided the amplification of the financial crisis, spurred by competitive devaluations, which otherwise would have been inescapable under the twin pressures of a deteriorating economy and speculative flows that would have amplified these trends. One should therefore question whether it would not be to the advantage of all 27 Member States to push for deeper EU integration in order to spread shocks more evenly throughout the "single market" - which is, with its 450 million, citizens the richest in the world – and simultaneously present a united front towards the outside world to better represent and defend its vital interests.

This underscores the necessity for boldness such as considering a rapid extension of EMU to all Member States under significantly more flexible conditions than those imposed by the Maastricht Treaty. This enlargement should be accompanied by a further integration of economic and fiscal policies, the need for which has been

expressed repeatedly, including by President Sarkozy. If it goes without saying that there can be no question of implementing formally such reforms in the near future, it is nevertheless imperative to manage the crisis – and therefore the relevant stimulus packages – as a function of these long term objectives. Permitting even temporarily the reinforcement and preponderance of “intergovernmental cooperation” is the recipe for ensuring its perpetuation in the post crisis era, if the aggravation of the crisis does not lead in the mean time to internal tensions capable of putting the cohesion of the Union itself into question.

Let us briefly recall the history of the crisis: it finds its origins in the bursting of a “bubble” characterised by excessive leverage in the financial system, which itself was subject to unsustainable structural imbalances on a global basis: this concerned in particular the perpetuation of the US balance of payments deficit, a level of US consumption that exceeded revenues and (negative) savings, an excessive accumulation of savings in emerging and oil producing countries looking for redeployment etc.

Once the bubble had burst (the trigger rather than the cause being the excesses in the subprime market) an irreversible mechanism of de-leveraging of the financial sector got underway. In the banking sector, this translated into the freezing of the interbank market following the loss of trust between bankers. The Lehman bankruptcy then led to the crisis spreading to the entire American economy and in short order to the world at large.

Monetary authorities had reacted, by and large, rapidly and vigorously from the outset of the crisis: unlimited supply of liquidity at its intervention rate by the ECB as of August 2007, rapid reduction of key official interest rates in the United States rapidly followed everywhere else, increased flexibility (collateral and maturities) in access to Central Bank refinancing facilities and finally, introduction of “quantitative easing” measures, the most recent of which is straightforward monetary creation of £75 billion by the Bank of England. If all these measures have not proved so far sufficient to remedy the problem, they are far from having been ineffective as they certainly contributed significantly to avoiding last October the eruption of a major systemic crisis that would have led to the complete melt down of the world economy.

In such an environment, the sharp de-leveraging of the banking sector created unavoidably a credit crunch precisely at a time when “access to credit” is considered a precondition for engineering a recovery in economic activity. This explains why governments intervened massively with a first set of measures aimed primarily at recapitalising banks and/or purchasing/guaranteeing their “toxic assets”. Restoring health to the banking system, however important, cannot solve the problem of credit availability by itself because the share of bank credit in financing the American economy has shrunk from 60% to 20% over the last several decades, as explained by Jamie Dimon, Morgan Chase’s CEO. It is the increasing participation of “non bank” entities, lightly or un-regulated, in the credit explosion which is largely responsible for the excessive leverage within the financial system. In the face of the crisis, these entities have been subject to the same de-leveraging imperatives as banks but they do not have access to refinancing mechanisms such as a Central Bank. The pressure is therefore transmitted through “market” mechanisms which quickly develop into a self fulfilling vicious circle, aggravated by the often penalising consequences of the “mark to market” accounting rules.

Following on these first set of actions, Governments turned to broader measures aiming at the economy in a much broader sense (investment – employment – consumption) taking the form of national stimulus packages.

It is therefore important to consider these plans within the context of the entire set of measures undertaken to deal with the crisis because there are strong linkages between monetary policy, the rescuing of the financial system and the stimulation of the economy.

What appears self evident is the overwhelming rationale for all these measures taken as a whole; their individual efficiency cannot be judged independently one from another. There are, however, some preliminary questions that deserve to be addressed: they concern the amount of resources mobilised (are they sufficient?), secondly, what is the impact of different “exit strategies”, and thirdly, what is their impact on future generations?

The main difficulty in confronting the crisis is defining its precise contours. Indeed, up until now, many unknowns remain such as: the value (under or over estimated) of toxic assets, the amount of de-leveraging that still needs to happen (or of new capital to be injected) to provide a rebalancing between assets and a sound financing structure, or the cleaning up of unregulated markets such as the CDS market estimated at some 60 trillion dollars. As long as these questions remain unanswered, or not dealt with, it will be difficult to restore confidence and impossible to assess whether the measures undertaken are sufficient to deal with the problem.

At the present time, even allowing for the time necessary for the intended effects of the measures to take hold, the speed of the deterioration of the economy (unemployment – production – consumption) seems to exceed even the most optimistic benefits that are expected from the stimulus packages. It is the message implicit to the behaviour of stock prices whose relentless downward trend indicates a belief that the remedies remain inadequate or that it remains impossible to anticipate a credible scenario on which a recovery could be based. The continued appetite of investors for safety, translated into their appetite for Government (mainly US Treasury) securities offering low returns, even for long maturities, confirms this analysis and indicates that inflation is not a preoccupation for the time being. If these leading indicators turn out to be correct in their predictions then, clearly, the already staggering amounts of the stimulus packages (and accompanying financial measures) will prove insufficient to counter the crisis and confirm that a deflationary spiral is underway with all its disastrous consequences.

In such an environment, in which the de-leveraging process of the private sector must – and will – continue, it is indispensable to increase public deficits so as to be able to keep a measure of control over the process because a unilateral de-leveraging by the private sector, with no counterweight, would unmistakably accelerate the catastrophic deflationary/depression scenario.

Having thus to charter their course as they plod onwards, the authorities will have to re-evaluate constantly their position which will probably entice them to increase the amounts affected to crisis management and to the stimulus packages. The consequent increase in budget deficits and ensuing indebtedness will severely mortgage the future equilibrium of public finances and harbour the premises of future significant inflationary pressures as soon as the first signs of a recovery surface. Both European and American monetary authorities proclaim that they are fully aware of the challenges posed by implementing appropriate “exit strategies” and vow to curtail liquidity as soon as necessary to contain inflation. But it will take great courage to be the first to take such measures and contend with the critics who will bandy accusations of stamping out the recovery before it can take hold. Political pressures will likely prove irresistible.

The ideal scenario proposed by monetary authorities seems therefore to lack credibility. If one succeeds in arresting the crisis, then the likely outcome is a prolonged period of significant inflation. It is indeed through this time tested mechanism that a suitable equilibrium of personal, corporate and State balance sheets will be reached through the process of reducing the value of debts. Time has come to “pay the price” for the excesses that have pervaded a system in which outmoded regulation, incompetence and greed allowed the situation to grow completely out of hand. The best one can hope for is that authorities manage to attenuate its more extreme effects and avoid the dramatic social consequences that could in turn upset the geopolitical balance of the planet.

It is important to take all these factors into consideration when evaluating the various stimulus programs adopted by Governments. Stimulating the economy through investment or consumption has long term different implications which must be considered when formulating policy. Agreement at European level appears desirable - if not necessary - to ensure the coherence of the internal market and also that decisions, taken at national level, do not create additional distortions induced by selfish protectionist measures.

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(1) See <http://institut-thomas-more.org/showNews/319>.

(2) See P. Goldschmidt, “The Larosière Report on Financial Supervision: More Efforts are Needed...”, Thomas More Institute, 3 mars 2009, available at <http://institut-thomas-more.org/showNews/312>.
