BRIEFING PAPER

Assessment of the banking rescue packages and the economic recovery plans of the Member States
- The examples of the UK and Germany -

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Executive Summary

Assessment of the banking rescue packages and the economic recovery plans of the Member States

- The Examples of UK and Germany -

In the following banking rescue packages and economic stimulus programs of Germany and the UK are outlined and assessed. It turns out that the banking sector rescue packages may stabilized the banking sector in both countries to some extent. But up to now they did not succeed to get financial markets back on a functioning track. To achieve that more needs to be done. The assessment of the stimulus programs is also very skeptical. The British programs rely too much on tax cuts that are not very efficient in stabilizing the economy. The German package simply comes too late to prevent the downturn, but may help to stabilize the economy towards the end of 2009.

Introduction

The global economy is in a deep crisis. It started with the financial sector economic slump that has moved like mounting waves from banks to real economy enterprises with a devastating impact. Governments are faced with urgent needs to stabilise financial markets as well as goods and labour markets. The reason is both crises mutually reinforce each other. The financial market crisis worsened the goods market downturn in a dramatic way. If good markets are in recession, the probability of defaulting loans rises significantly and worsens in turn the crisis on financial market. Therefore a simultaneous approach to fight the crisis is necessary. Governments have to address both the banking as well as the real economy sector at the same time. For Britain problems of the financial market sector are of particularly high importance. It was this branch that has fuelled the astonishing growth performance of the British economy during the past decade. But now the very same sector is in a deep structural crisis and will not return to its former strength for the time being. Industry has lost most of its importance during the same period. It is rather doubtful whether it can absorb many of the newly unemployed. Therefore it seems likely, unemployment in Britain will be high by international standards for the years to come. For Germany the situation may be as difficult in the short run, but prospects for the medium run are brighter. In the short run Germany will also be severely hit by the crisis. The reason is its exports will decline dramatically, since the German economy growth performance during the past almost exclusively resulted from exports while domestic demand was slack. The crisis in the German real economy sector will be very severe by all standards. However, in the medium run as soon as the global economy picks up speed again, the German economy should be among the first to recover. Beyond doubt, the German banking sector is also in a deep structural crisis, but its aggregate importance for growth and employment is minor. This basically puts Germany in a better position than the UK. However, urgent economic policy response nevertheless seems necessary to overcome the crisis.

For all these reasons different kinds of rescue packages have been set up by governments all over the globe. At the forefront were the US government, but European governments, in particular the UK, followed swiftly. However different philosophies emerged in due course of all these efforts. While the US and the British government were fast to act, they put great emphasis on a governmental role in stabilising the economy. The German government on the contrary acted much more hesitantly at least with respect to a stimulus package for the aggregate economy. In Germany the government initially was more concerned about a rising debt level rather than about a dramatically declining economic activity.

In the following therefore these different approaches of the British and the German government will be analysed. One has to bear in mind that an assessment necessarily is of preliminary nature. Programmes still change or are amended. Furthermore their impact did not yet unfold completely. Thus a final judgement presently is not possible. What can be done is to compare the measures taken and asses their potential impact. As far as available, appropriate models should be used for that. In the following section the rescue packages for the banking sector will be compared. After that the economic stimulus packages will be outlined.

2. The banking sector packages

2.1 The British case

The break down of the ABS market created an urgent need to set up a safety net for the banking sector. Banks had to write-off significant amounts of their assets putting them into a critical position. In the UK even first signs of a bank run in the case of Northern Rock were seen. The government reacted with its immediate nationalisation. In Germany it turned out, banks among them some public banks, possessed significant amounts of ABS, too. Partly these were hidden outside official balances by placing them into Special Purpose Vehicles. After these shocking discoveries, economic policy set up rescue package in Germany, too.

The British rescue package for banks consists of basically two components. The first components are measures of the Bank of England (BoE). The BoE injects liquidity for banks at an amount of about 200 bn British Pounds (14 % of GDP). Recently the BoE set up an asset purchase facility funds of 50 bill British pounds. Banks could get this money in exchange for high quality private sector assets. The money should serve as an additional incentive for banks to increase their lending activities. Given the already low central bank interest rate, this is seen as a first steps towards a quantitative easing policy of the BoE. All these measures go into the right direction. Nevertheless it is doubtful whether they can change the risk avers behaviour of banks against the backdrop of the global crisis and the corresponding lack of trust.

Furthermore the BoE has lowered interest rates down to 1.5 %. That amounts to a significant easing of monetary conditions. In the same direction works the very strong devaluation of the British Pound in relation to the Euro. However, British exports have mainly consisted of financial services. But these will not recover in line with depreciation because of a necessary structural downward adjustment in this sector. Hence it is likely that the growth stimulating impact of the depreciation remains very limited under present circumstances. That applies basically to the whole monetary easing at least in the short run. Even under normal circumstances, monetary policy needs about a year to show a significant impact. In the present situation while the banking sector is in crisis, it will last even longer. Banks will transfer lower rates only very sluggishly to their customers. Firstly they need to increase their margins to cover accumulated debt. Secondly there is no trust in the banking system what makes banks very risk averse to lend money anyhow. The expansionary monetary policy now primarily serves to stabilise and consolidate financial markets. Only when this is achieved and trust returns, one should expect a significant positive impact of monetary policy on the real economy. Nevertheless all these monetary policy measures are a necessary condition to achieve a stabilisation.

The second component of the British rescue package are measures of the government: It has intervened into the banking sector on a very large scale. First of all, government has guaranteed private savings up to 50 000 British pounds, up from 35 000. This was basically a necessary reaction to the Irish measures, who gave an even unlimited guarantee to savings at Irish banks. They immediately bore the incentive to withdraw savings from British banks and to transfer them to Irish banks bringing British banks into severe difficulties. This highlights the necessity of a co-ordinated answer at least within the EU. But the measure was also taken to ensure trust into banks in order to avoid a detrimental bank run. There were very good reasons to fear that. In case of the Northern

Bank first signs were visible. The government reacted to that by a complete nationalisation. The same applies more recently to the partial nationalisation of Bradford and Bingley. There, the government took over responsibility for more than 50 bn Pounds (63 bn Euro) of toxic assets. Nationalisation is seen as the last mean to restore trust into the presently heavily distorted banking system. The problem is at what price this should happen. The government will not have enough money to pay banks for their assets in a way that they can recover. But if on the other hand it does not pay anything, the value of the toxic assets in the balance sheet has to be set to zero, causing many defaults on a global scale, too. That was the very reason why the US government forsake these kinds of measures. Up to now, most governments follow a case by case approach to nationalise banks only completely when they are in immediate danger to default.

Instead the British government was very fast to take pre-emptive general measures after the default of Lehman Brothers. All British banks were requested to increase their equity ratio to 10 % until the end of 2008 by issuing new shares. They could sell them to private investors or the state would step in taking the rest as preference shares. Furthermore banks were obliged to cut dividend payments and management salaries. In addition to that, the government gave guaranties for debts of the banking system up to 250 bn Pounds for at maximum three years.

As it turned out only a very minor part (0.5 %) of shares have been acquired by private investors. Large banks like the Royal Bank of Scotland (RBS) are now at 57 % in state ownership. Thus the state now has a significant stake at banks. These measures were widely seen as an example how to deal fast with the crisis. By the compulsory nature of the programme, no bank was able to play a wait and see strategy. That would have caused a further worsening of matters and in the end led to higher costs. The short term effect was as desired, banks got stabilised. Some sort of trust returned. Nevertheless recent developments show that the balance sheets of banks still deteriorate as the crisis goes on and on. British banks worked on a global scale hence they are also subject to the global loss of confidence in their assets. Their depreciation threatens successes up to now and the state may be obliged to inject more and more money until there is a complete nationalisation. But then again the question rises at what price.

In sum the banking rescue package in the UK has served to avoid widespread default in the British banking sector and achieved a temporary stabilisation. However the fundamental problem of toxic asset has not yet been solved. Still banks are in a precarious position desperately trying to adjust to changed circumstances.

Therefore the British government recently announced additional measures. The public share at big banks like RBS will be increased to 70% to give them fresh money. Secondly, all banks will be obliged to inform the government on toxic assets they still hold. Banks will then have the chance to insure 90 % of their toxic assets against loss. Details will be published by the end of February. The fundamental question is again at what price. In order to find a proper insurance premium one has to know the probability distribution of default. Any other premium will be biased either towards subsidising banks or burden them with undue costs. This former one cannot be justified towards the taxpayer and gives wrong incentives for banks to take too high risks. The latter one may cause their default.

2.2 The German case

The nature of the German financial rescue package was similar at the start and different later on. At the start the German government also had to react to the Lehman default and the Irish guarantees for savings at Irish banks. The German guarantees were at the same time more far reaching and less precise than the British one. The government announced that it would guarantee for all private savings at an unlimited amount. However this guarantee never found its way into a law it was just announced by the chancellor and the minister of Finance. Therefore it is unclear whether legal claims can be made. The basic reason was as in Britain to establish trust into the banking system and to avoid a bank run, although in Germany there were no such dramatic signs of a bank run as in Britain. Nevertheless people seemed to have transferred a lot of money from private banks to public owned saving banks increasing liquidity pressure on the former.

After the Lehman default the German government was also forced to set up a rescue package. For this reason a financial market stabilisation law (Finanzmarktstabilisierungsgesetz) was decided upon by both chambers of parliament within weeks. By this an umbrella for the German financial sector was set up. The law established a Financial market stabilisation agency (SoFFin) that is in charge of executing the law. The agency has three instruments to help banks.

- Guarantee for newly issued debt securities and other liabilities of financial sector enterprises
- Recapitalisation of banks
- Assumptions of risk positions

The financial volumes for the respective positions are as follows:

Financial market stabilisation funds Germany

Recapitalisation / assumption of risk positions	€80bn
guarantee for newly issued debt securities and other liabilities of financial sector enterprises	€400bn
Total volume	€480bn

This amounts to about 20 % of German GDP. But it is unlikely that all the money for the guarantees will necessarily be spent. Only if all issued debt securities fail the sum would be due. But that is highly unlikely. The government assumes that 5 % will fail and therefore sets asides reserves of 20 bn.

The money is granted on several conditions only.
Conditions for usage based on the regulation appertaining to the Act (20. October 2008):

condition \ measure	Guarantee	Recapitalisation	assumption of risk positions
Solid business policy	X	X	X
Granting of loans to SMEs		X	
Provisions on remuneration incl. prohibition on severance payments		X	X
Prohibition of dividend payments		X	X

Financial support from state requires that future business of the banks is restricted by several aspects. They must not take any high risks and the board members will have to forsake a big stake of their salaries. Banks will not be allowed to buy their own shares back and they are also not allowed to pay dividends. Furthermore the agency requests fees in exchange for the provision of funds. It is also intended that the agency gets preferential shares or silent participation rights as compensation. These measures serve the goal to keep cost as low as possible for the government. In particular by reducing salaries and preventing dividend payments any subsidisation of executives or share holders by state money should be prevented.

Up to now (January 2009) the following banks have made use of the program:

Debentures guaranteed by the government

Financial institute	volume (€bn)
Commerzbank	3
HSH Nordbank	5
BayernLB	5
IKB	2
Association of German Banks (intended)	6,7

What can be seen is that not all German banks have made use of the financial market stabilisation law. In particular the by far largest German bank, Deutsche Bank, is not yet part of it. The fundamental difference to the British programme is that German banks were not forced to participate by imposing e.g. conditions on equity ratios on them. To avoid conditions on salaries and dividend payments banks only very reluctantly used financial support by the state. That is the reason why in relation to the British case, it took so long until German banks moved into that direction. This has worsened their situation considerably and increased the necessary financial injection. But as in case of the British banks, problems have at best been stabilised, but not solved. It remains to be seen how much taxpayers will have to pay in the end.

3.The stimulus packages

3.1 The British case

The British government has set up a recovery plan consisting mainly of tax cuts.

Economic recovery plan I (November 2008)

	Nov 2008 – Dec 2009	**2010**
Financial impact in £bn (€bn) values in parts rounded		
economic recovery plan I (November 2008)		
Value added tax on 15%; period 1.12.2008-31.12.2009	12,5 (13,94)	
Other tax reductions (low income, house owner, SMEs)	7,5 (8,35)	
Sum	20 (22,3)[1 2]	
in % of GDP (2008)	1,34	
Short term		
Government borrowing		
Lasting rise in duty on alcohol, tobacco and petrol		
Middle term		
Increase of top rate tax to 45% from 2011, (income > £150,000 a year), from April 2011 all rates of National Insurance (NI) contributions +0.5%		

As in the case of the banking rescue plan Britain was fast to set an economic stimulus package as early as November 2008 (see table above). At the core of this package is a reduction of VAT by 2 percentage points down to 15 % until the end of 2009. The lowered VAT is supposed to lead to a decrease of consumer prices. That

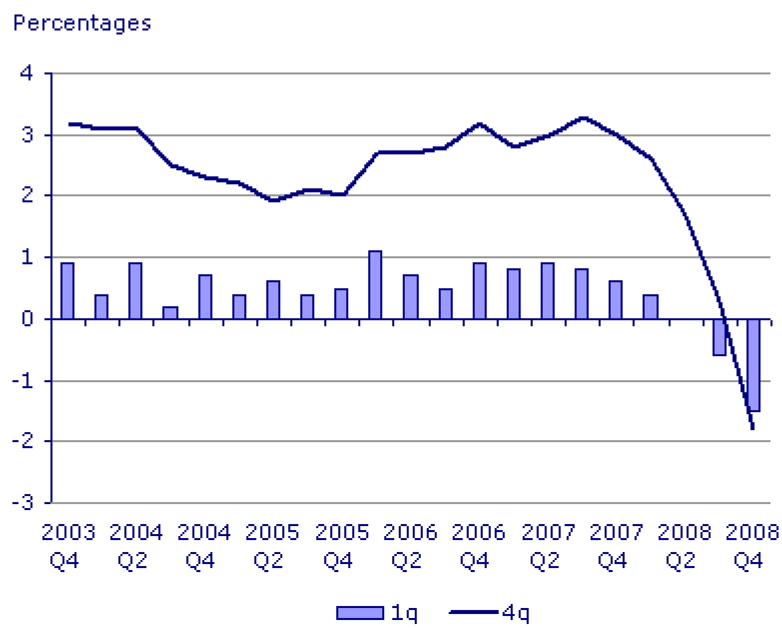
[1] Source: HM Treasury, Pre-budget report, November 2008 (www.hm-treasury.gov.uk/prebud_pbr08_index.htm)

[2] Estimation of additional fiscal spending by BRUEGEL: £14,9bn (€17,06bn; 1,01% GDP)
VAT cut: £12,5bn
Extra spending: £2,4bn

would increase purchasing power of consumers leading to an increased private consumption. Higher consumption should then compensate at least for some of the losses on exports and particularly investment. The government assumes costs of a bit less than 13bn pounds. In addition to that some further tax cuts were given to low income earners, house owners and small and medium sized firms. The total amount involved is 20 bn pounds according to the British government. That is about 1.3 % of UK GDP. The Breugel Institute assesses tax cuts a bit lower hence the volume is considered only at about 1 % of GDP.

There are two questions to answer. Firstly is the volume sufficient to fight the unfolding recession? Secondly, is the money efficiently used? The first question can only be answered against the backdrop forecast for the British economy. Official figures that the situation is very serious indeed.

GDP Growth
UK output decreased by 1.5 % in Q4 2008



Source: http://www.statistics.gov.uk/cci/nugget.asp?id=192

According to official government figures the British economy faced a severe downturn since mid 2008. Most recent forecast of the IMF indicate that the British economy will shrink next year by 2.8 %. This forecast already takes into account the stimulus package. It is reasonable to conclude that the volume is not sufficient by far.

However, earlier forecast by the OECD were much more optimistic (-1.1 %), even without the stimulus package. Given these forecasts the programme would have been more or less sufficient. In the meantime the government has also come to the conclusion that more is necessary. In an economic recovery plan II additional guarantees for business enterprises of about 20 bn pounds will be given. Also the programme on debt equity swaps is extended by another 25 bn pounds.

It is doubtful whether the money is spent efficiently. First of all the VAT reduction can show indirect effects, only. Since firms have to pay, they charge in the end customers. It is likely that they will only reluctantly reduce prices. Instead they may increase their profit margins. In that case tax reductions do not lead to a very much increased purchasing power at least not in the short run. Therefore consumption cannot be expected to show any short run positive impact. All other measures taken have more or less the same disadvantage. In general tax reduction as guarantees do only have indirect effects. They become effective only if firms use them and are no direct injections into the economy. Therefore they may have an effect at best only in the longer run, if any. Given all that and the particular dismal situation of the British economy that is burdened by an imploding financial sector the outlook looks very grim.

3.2. The German case

Initially the German government was very reluctant to acknowledge the necessity of a stimulus package. Therefore the first plan mainly consisted of more or less symbolic measures. Their aim was to calm the public rather than to stimulate the economy. With ever more pessimistic forecasts for the German economy and after a crisis summit with business leaders, trade unionists and economists the government decided to set up a second package. This time the government meant business and made a serious effort for stimulation. The financial volumes of both packages are outlined in the table below.

economic recovery plan I	**2009**	**2010**	**2009+2010**
Financial impact of the protection shield for employment ("Schutzschirms für Arbeitsplätze") on the collective governmental units (Gebietskörperschaften) 2009 to 2012 in billion Euro[3]			
1. increase and grant of investments	**1,32**	**1,40**	**2,7**
investments in traffic infrastructure	1,00	1,00	**2,0**
Joint Agreement for the Improvement of Regional Economic Structures (Gemeinschaftsaufgabe Regionale Wirtschaftsförderung)	0,20	0,10	**0,3**
Program by Reconstruction Loan Corporation (KfW) "energy-efficient building"	0,04	0,22	**0,3**
further RLC-programs, e.g. local authority loan	0,07	0,08	**0,1**
2. tax reduction for private households	**0,38**	**1,04**	**1,4**
Motor vehicle tax exemption 2009/10	0,38	0,14	**0,5**
Intensified tax aid for handcraft services		0,90	**0,9**
3. tax reduction for companies	**2,18**	**4,70**	**6,9**
Degressive depreciation (25%)	1,94	4,33	**6,3**
Special depreciation SME	0,24	0,37	**0,6**
Sum	**3,87**	**7,13**	**11,0**
added for information[4]			
4. measures of Federal Employment Office (Bundesagentur für Arbeit)	**0,30**	**0,50**	**0,8**
Sum:	**4,2**	**7,6**	**11,8**

sources: Federal Ministry of Finance; IMK estimation

	2009	**2010**	**2009+2010**
commuter tax allowance	**5,5**	**1,5**	**7,0**

economic recovery plan II	**2009**	**2010**	**2009+2010**
1. investments by the public authorities	**9,0**	**8,3**	**17,3**
2. acceleration of investments by simplification of the public procurement law	**?**	**?**	**?**
3. credit / guarantee program	**?**	**?**	**?**
4. Extension of the stately secured export promotion	**?**	**?**	**?**
5. promotion of innovation by the federal authorities (ZIM)	**0,5**	**0,5**	**0,9**
6. broadband strategy of the federal government	**?**	**?**	**?**
7. stabilisation of demand for automobiles (scrapping premium?)	**0,8**	**0,8**	**1,5**
8. reforming motor vehicle tax	**?**	**?**	**?**
9. promotion research on mobility	**0,3**	**0,3**	**0,5**
10. job security			

[3] without macroeconomic backlash
[4] IMK estimation

a) social security fees short-time work	**1,1**	**1,1**	**2,1**
b) vitalisation + qualification	**1,3**	**1,3**	**2,6**
c) 5000 additional jobs Federal Employment Office	**0,1**	**0,1**	**0,2**
d) stabilisation unemployment insurance at 2,8 % 2nd half of the year 2010		**1,0**	**1,0**
11. cutting income tax	**2,9**	**6,1**	**9,0**
12. contribution to the compulsory health insurance	**3,0**	**6,0**	**9,0**
13. benefits for children & families			
a) bonus for children	**1,8**	**1,8**	**3,6**
b) standard rate for children	**0,2**	**0,4**	**0,6**
Sum	**20,8**	**27,5**	**48,3**

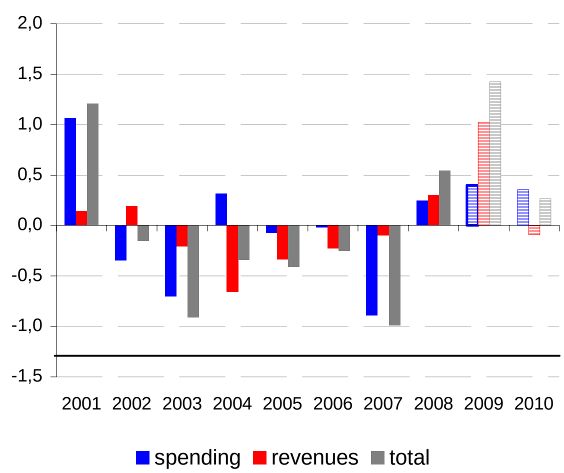
economic recovery plans I + II + commuter tax allowance

Sum	**30,5**	**36,6**	**67,1**
in % of GDP	1,2	1,5	

As in the case of UK two questions have to be answered. Is the volume big enough and is the money used efficiently. In order to assess this, fiscal stimuli of all fiscal policy measures including those that decided upon in advance of the stimulus packages are presented in the figure below.

Discretiony Fiscal Stimulus[1] 2001 -2010

in % of GDP



[1] Computed as fiscal policy measures in relation to previous year. Without revenue from privatisation and without macroeconomic repercussions. Positive (negative) values signifie expansion (contraction).

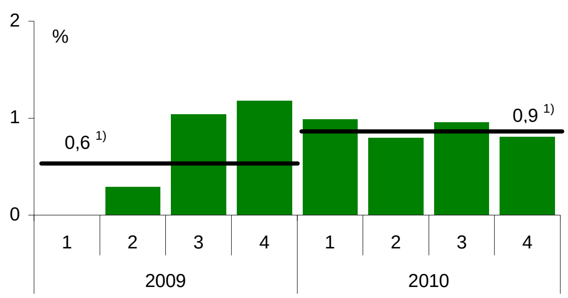
Sources: Federal Office of Statistics; Federal Government; calculations and forecasts of IMK.

The figure shows that there is indeed a major effort being made this year amounting 1.5 % of GDP. The main impulse is from additional spending on public investment. Tax cuts are of significantly lower importance (1 %). Next year the figures are much lower. These impulses were plugged into the IMK econometric model to assess their impact on the economy. One gets the results shown in the figure below.

Stimulus Package II

GDP [1] (real)

Deviations in % from baseline



[1] Average annual deviation.
Source: Simulations on IMK-Model.

The model shows that the second stimulus will raise growth in Germany this year by 0.6 % and next year by 0.9 % . Forecasts for Germany are not quite as grim as for Britain. The main reason is that the financial sector in Germany is much smaller than in the UK and has by far not the same importance for the aggregate economy. Nevertheless the German economy is heavily depending on exports. Given that there is a global crisis with export markets declining Germany is expected to suffer a lot. The IMK forecast without the second stimulus package is a decline of 3 %. Including the package with its positive effect of 0.6 % one gets a decline of 2.4 % as forecast for 2009. This is almost equal of the most recent outlook by the IMF of -2.5 %. Given this figures Germany amidst its worst economic crisis World War II, despite the significant stimulus package. Therefore ass in the case of Britain one must conclude that the volume of the stimulus package is not high enough to prevent the very serious recession. What is achieved is that towards the end of 2009 some sort of stabilisation may be achieved. Simulations with IMK model show that the economy the may enter a stagnative path. The stimulus package does not help to prevent the downturn, but it seems to makes it of shorter duration.

The main reasons why the relatively high amount of money does not show a higher impact on the German economy are time structure and the composition of the programme. Many parts of the programme become not effective before mid 2009. But the downturn started already in the 4th quarter of last year and is expected to continue in the 1st quarter of 2009. Hence the programme comes too late. Furthermore as in the case of the British programme there is a major part in the programme that consists of cuts of taxes and social security contributions. These measures increase net income of private households. These may use it for consumption or savings. Especially high income earners will do the latter and this money does no help to stimulate the economy. The contrary is the case when spending for public investment is concerned. This money directly flows into the economy showing a much higher effect on output and employment. In the end one has to conclude that the German package is better designed than the British one, because public investment has a higher share. However, it comes too late to prevent the downturn.