



## **ACTION FOR RECOVERY!**

A European plan to relaunch the economy: Investing in people, the environment and innovation.

### **Executive summary**

Economic policy in Europe is currently relying on interest rate cuts and automatic stabilisers to save the real economy from depression. Both actions are extremely necessary but not enough. Therefore, in addition, a rapid, ambitious and joint fiscal policy stimulus plan is necessary.

To ward off the recessionary tide that is sweeping in and to avoid the economic depression from becoming entrenched, European policymakers need to:

- invest in people and productivity to keep the economy going in the very short term. A rapid and massive deployment of labour market policies aimed at getting money to those who need it most, while also providing more security to workers. From January 2009, each Member State should invest an additional 1% of GDP in order to strengthen unemployment benefit systems, provide training and lifelong learning and to set up social economy employment programmes;
- invest in innovation and the environment to climb out of the crisis. Each Member State should prepare an investment package worth 1% of GDP – such a package should kick in no later than mid 2009. Priority should be given to those areas of investment that also strengthen the long-term potential of the economy, for instance sustainable development, social housing and European networks.

To make this plan work, Europe will have to mobilise forces to work together as one team:

- a coordinated and joint fiscal stimulus will have a double effect on economic growth compared with Member States acting in isolation from each other;
- Europe is to facilitate the practical implementation of such a stimulus plan by making it clear that all of the different forms of flexibility provided for by the 2005 reform of the Stability Pact are to be used;
- a European Sovereign Investment Fund is to be launched. By issuing European bonds through the European Investment Bank (EIB), Member States will benefit of accessing worldwide capital flows at lower rates of interest;
- a European industrial policy should be developed to equip the EU economy with a new and sustainable industrial basis;

- a coordinated policy process which aims to establish a downwards floor in wage developments of at least 2% in order to take out insurance against a deflationary wage spiral;
- Europe should provide its own emergency lending and do so in a sufficient way and without blindly following the International Monetary Fund (IMF) conditionalities: central and eastern European countries are not to be left at the mercy of IMF.

# ACTION FOR RECOVERY!

A European plan to relaunch the economy: Investing in people, the environment and innovation

## 1 – A false sense of security

There is now wide recognition of the fact that the real economy also needs saving. Besides engaging in interest rate cuts, the official policy consensus seems to be that the flexibility which the reformed Stability Pact is offering is to be used: automatic stabilisers in fiscal policy should be allowed to do their job, even if this implies rising deficits or deficits breaching the 3% Maastricht benchmark.

Both approaches are extremely necessary and useful. At the same time, they are far from enough of what needs to be done to save the real economy:

- The crisis hitting the real economy is accelerating. To avoid negative growth expectations from becoming entrenched, as well as to avoid triggering a strong process of disinflation turning into deflation, this recessionary tide cannot be allowed to hit the economy in full over the next quarters. Given the substantial time lags involved, this implies that interest rate cuts are simply coming too late in order to get the European economy through what is likely to be a rough ride over 2009.
- This is not just one shock but a series of negative shocks<sup>1</sup> hitting the real economy. And among this series of shocks, this particularly vicious shock of debt deflation emerges which is driving down excessive private debt in combination with a bust in asset prices and a freeze in credit markets. Even if the automatic stabilisers are allowed to do their job and cushion a part of the shock, the net negative shock that remains afterwards will still be nasty enough. The economy will still be going through a serious downturn, raising the risk of getting trapped into a low confidence/low spending/deflation trap. Therefore, simply pursuing *neutral* fiscal policies will not do the job. To counter and to turn around the cycle we need fiscal policy to become *expansionary*.

The idea that the Stability Pact is already flexible, alongside long overdue interest rate cuts, is providing policy makers with a false sense of security. The risk is still high that the real economy will go down in a more than expected way and that the dominos will continue to fall. If this happens, the crisis in the real economy, the financial crisis, and the crisis in wage bargaining that follows will all react on and feed back on each other, pushing the economy deeper and deeper into trouble.

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<sup>1</sup> A turnaround in the construction boom, a business cycle downturn, a downturn in the global economy and, above all, a debt deflation process combined with a severe credit squeeze paralysing banking activity and credit flows.

## 2 – A plan to relaunch the European economy

To ward off the recessionary tide that is sweeping in, demand-side policy needs to move fast and it needs to move in an ambitious way. The following paragraphs outline how this could be done.

### Emergency action to keep the economy going in the very short-term...

The real economy has rapidly ground to a halt. To prevent multiplier effects from intensifying the slowdown, fiscal policy needs to raise demand in the economy in a rapid and effective way. Cutting labour taxes or distributing lump sum cheques to everyone is however not the best way to organise this. Indeed, such action runs the risk of households simply saving up these additional funds instead of spending them.

Instead, we propose a rapid and vast deployment of labour market policies of all types<sup>2</sup>. The aim of such an approach is double: first, it is to deal with the feelings of insecurity coming from a labour market that is going through very rough times; secondly, it is also to get money to those workers who are hit most by the crisis and who are most likely to transform this money into effective demand.

Member States should be invited to invest an additional 1% of GDP in stronger labour market policies. Depending on a Member State's labour market characteristics, this may take different forms:

- **strengthening unemployment benefits systems** – In those Member States where unemployment benefits, eligibility and duration are relatively low, priority should go to a structural strengthening of benefit systems;
- **increasing security for the most flexible workers** – The crisis once again reveals that labour markets in Europe are already highly flexible: from the moment the economic activity stalls, this is immediately followed by a massive restructuring of employment. However, the security dimension is lacking. In particular, workers with short-term employment contracts, such as agency workers and fixed-term workers, are being severely hit by the economic slowdown. At the same time, workers on such contracts tend not to benefit of full social security rights and only have little access to company training measures. It is only fair that these workers would be compensated for the huge flexibility they are showing by giving them additional unemployment benefits in the form of a one-off payment. This can also be considered to be an 'employment' bonus which the unemployed people concerned could use to finance their search for a new job;
- **supporting internal flexicurity** – By keeping existing workers engaged during the downturn, internal flexicurity provides businesses the benefit of disposing of skilled and trained workers when the next upturn arrives. These models of internal flexicurity are promoted, on the one hand, by robust job protection systems and, on the other hand, by social security financing 'technical' unemployment. In this case, workers keep the job and work part of

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<sup>2</sup> This includes both active labour market policies as well as policies providing income security.

the time with part-time wages being topped up by unemployment benefits. Member States wishing to do so can devote (part of) the 1% of labour market policy investment aimed at developing or strengthening internal flexicurity.

- **investing in skills and lifelong learning** – Unemployment benefit systems should be complemented by programmes aimed at retraining and improving the skills basis of unemployed people. In this way, periods of unemployment are used as an opportunity to improve the human capital basis of the economy, thereby avoiding the bottlenecks which typically arise when the economy recovers;
- **job programmes to boost employment in the social economy sector** – Besides training for unemployed people, another way to keep these people in touch with the labour market and avoid the depreciation of human capital is to set up job programmes. The jobs created through these government-sponsored programmes are to respond to social needs for which there would be otherwise little attention, such as in the elderly care sector, for childcare facilities or neighbourhood workers.

In addition to these labour market policy initiatives, a temporary cut in VAT could also be investigated and whether such a cut in tax rates over the next six months would represent another way to support the economy over the very short term. Such a cut in VAT rates would temporarily increase the purchasing power of European households. After a year during which household revenue has been swept away by rising oil and foodstuff prices, households would certainly welcome such a measure. Importantly, such an increase in purchasing power can only be realised if households actually spend their money. In contrast to income tax cuts, the money cannot be saved. Even more importantly, a cut in taxes on added value will proportionally benefit the lower income groups more than the higher income groups, thereby adding again to the demand effect since the former are much more inclined to spend. Moreover, the prospect of VAT rates returning to previous levels in six months' time will provide a strong incentive to households and investors to spend now and bring longer term spending plans forward. During the next six months, this policy measure may also act as an additional shield against the tide of recession.

### **Investing ourselves out of the crisis**

The previous operation gives the European economy some 'breathing space'. Member States, in turn, should use this opportunity to set up additional investment plans, programmed to kick in no later than mid 2009. So, when the demand effect from some of these labour market measures and the temporary VAT cut dwindles, public investment spending is ready to take over for the next period.

Such an investment programme will not only help the economy to get through of what otherwise would be a period of seriously depressed activity; it will also strengthen the economy's long-term growth potential. This situation offers the opportunity to combine the battle against the financial crisis with an agenda of investing in the development of new industries, rational and sustainable energies, European networks and social housing.

Practically, fiscal policy should aim to increase investments by another 1% of GDP.

### **3 – Mobilising the strength of Europe working together**

These twin investment and progressive labour market policy packages are to be implemented by the Member States at the national level. At the same time, the European level is also important and Europe has several roles to play.

#### **Europe as a force strengthening national action**

Europe is a highly integrated economy. Member States are mostly exporting to and importing from each other. This implies that there are important gains to be reached if Member States' fiscal policies are coordinated. If one Member State acts alone, part of the fiscal stimulus disappears into imports from other Member States. However, if the different countries of Europe take action to boost aggregate demand at the same time, then one country's imports will be another Member State's exports and vice versa. As a result of a European coordinated action, the impact of any stimulus package on demand and growth will be twice as high as it would be the case when action is undertaken on a merely national basis. Europe is stronger when it acts as one team.

#### **Europe as a facilitator of national actions**

Europe's macroeconomic policy framework has traditionally been designed to do the opposite, that is, to organise joint and European-wide *restrictive* fiscal policy. However, two important exceptions exist to this standard rule of fiscal contraction:

- The 2005 reform of the Stability Pact has indeed introduced different elements of flexibility in this European framework of fiscal contraction. One element is that Member States are allowed to exceed the 3% deficit threshold in exceptional circumstances. This is the flexibility element to which Economic and Financial Affairs Council (Ecofin) ministers and the Commission are currently referring. The financial crisis, pushing the economy into a recession and a protracted period of low growth, is considered to be such an exceptional circumstance. Nonetheless, the Commission would be well advised to clearly tell Member States that their deficits can increase in line with the cyclical downturn from their 2008 levels. For 2009, and on the level of the euro area average deficit, this implies a cyclical increase of 1% of GDP if there is zero growth in the economy or even 1.25% of GDP if growth is minus 0.5, as recently projected by the IMF.

However, this increase in the tolerated deficit by 1%–1.25% for 2009 is only about letting the automatic stabilisers do their job. This does not cover the 1.5% of GDP stimulus plan that is necessary to turn the economy around and go beyond of simply letting fiscal policy catching and easing somewhat the blows of the business downturn. At this stage, the other flexibility element that the reformed Stability Pact offers comes into play. If Member States undertake structural reforms that, to a certain extent, impact on public finances, deviations from the standard Stability Pact discipline are allowed. In other words, if, as we do in our proposal, Member States invest in the long-term growth potential of the economy and in well functioning labour markets, then this other flexibility element of the Stability Pact can and should be mobilised. Of course, the message is not that 'anything goes'. The

Commission and the Council have an important role to play and define more precisely which type of investments fit the profile of the agenda, by investing in new industries and sustainable development, and which investments do not.

Combining these two elements implies that there would be a swing in public finances in the euro area of 2.75% of GDP – 1.15% coming from the automatic stabilisers and 1.5% from additional investments. This would compare to the fiscal policy as operated in the US and would certainly be sufficient to protect the European economy from a meltdown in 2009.

- Alongside these elements of flexibility to be used in the Stability Pact, another option is to mobilise EIB (see also below). Since loans issued by EIB to Member States do not enter into Member States' deficit and public debt, Europe can provide Member States with additional leeway beyond the reformed Stability Pact. Again, this approach should only be developed under the strict condition that the money is to be used for a well defined investment agenda, with the Commission and the Council overseeing the process.

## Europe as a financial force

Europe as a team is not only stronger when fiscal policy is concerned. Europe as a team is also much stronger when facing financial markets and ensuring the least costly access to finance. The latter is especially important given the fact that public deficits and debt will necessarily increase to compensate for the trend for private sector to fall.

However, Europe is not using its financial power to the fullest extent possible. As a consequence, Member States do not have the access to the reasonable or low cost finance they should be having. This is clear from interest rate spreads on national debt. Although average debt for the whole of the Euro area is similar to the US, European governments are now paying up to 50 (10 year bonds) to 180 (two year bonds) base points more than the US government.

Part of the reason is the difference in the monetary policy stance of the ECB and the Fed. Despite recent interest rate cuts, ECB policy rates are still at 3.25% which is high compared to a level of 1% in the US.

However, another part is due to structural reasons. The European financial marketplace is a constellation of separate markets in which sovereign debt paper of unequal quality is being issued. This does not compare to the US financial system where the market is much broader and more liquid.

Moreover, there is the fact that US federal government bonds are ultimately backed up by the Federal Reserve: even if the worst happens – such as a bankruptcy of the federal government – investors know that they will still get their money back since government will call on the Federal Reserve to print money to pay back the borrowers. In the euro area however, the European Treaty outlaws such a 'monetisation of public debt'. European governments can not call on the European Central Bank (ECB) to invest directly into government debt paper. Whereas such a legal restriction was meant to reinforce the credibility of the engagement to price stability, thereby supposedly resulting in **lower** long-term interest rates, this provision is now working the other way around. Indeed, the prime concern of financial markets these days is not so much inflation, but deflation. In such a situation, the interdiction

to print money to finance public debt is undermining the effectiveness of the single macro economic policy instrument that remains to confront a deflationary liquidity trap.

So, as a result, capital is not coming to the same extent to Europe as to the US. However, capital is also badly needed over here, both to shore up the shaken financial system, as well as to keep the real economy, including growth and job creation, going.

One solution for Europe would be to use the EIB to issue 'European growth bonds' backed jointly by EU Member States. This would level the playing field with the US somewhat and put Europe in an improved position to attract more of the international capital flows which are now massively fleeing from private debt and searching for a secure, non-risk investment backed up by a government guarantee. As a result of such European action, governments in Europe would have access to more capital at lower rates of interest. And with a lower cost of capital, governments can run public deficits which are temporarily higher without having to fear snowball effect from interest rates to be paid on rising levels of public debt.

## **A European industrial policy**

Creating a strong European industrial base is fundamental to securing the foundation of the EU's economy, and ensuring a sustainable progression towards a flourishing economy and an environmentally-friendly production.

The current crisis stemming from the financial markets not the real economy, in the context of intense pressure from globalisation and environmental challenges, demands a fundamental change in Europe's social and economic policy framework. It is not too late to act and there are opportunities for industrial workers in these challenges.

Under the threat of recession and growing unemployment, we urgently need coordinated and sustainable social, economic and industrial policies to ensure public confidence in the economy and stimulate economic demand, protecting jobs in the real economy.

To this end, a coordinated approach on industrial policy is indispensable. And because of the rules on the single market and the need to avoid national protectionism, there is a need for an EU-wide approach. The US is clearly considering a stimulus for their automobile companies and the EU must be able to organise similarly as the need rises to encourage sectors and move forward to a more sustainable future.

## **Europe as a barrier against a downwards wage spiral**

The 'real economy' (growth and jobs) is not the only domino to fall. With the economic crisis spreading in Europe, the bargaining position of trade unions and workers will come under renewed pressure. Wage growth will decelerate rapidly and there's a danger wage developments may even become so low that price stability is threatened from the downwards side: Wage developments substantially below 3% will work to push inflation below the ECB's objective of 'below but close to 2%'.

Until now, wage formation systems in the euro area have been able to avoid such a scenario by putting in a downwards floor: Wages do decelerate but when the 2% rate is reached, wage growth tends to remain stable from that point on. However, this 2% nominal wage floor is an average for the euro area. Behind the euro area average hides

the fact that nominal wage growth has actually been zero in one part of the euro area, whereas wage growth in countries enjoying a (housing) boom were able to compensate for this. However, this will no longer be the case. The economic crisis is hitting all European economies without exception. In fact, countries which were able to ride a housing boom in the past are now paying the price for this in terms of an extremely severe downturn. The bargaining position of workers in all European countries will be severely compromised. Together with the fact that opening clauses (allowing companies to pay less than the going rate in sector conventions) are widespread in Germany and Spain, this raises the spectre of close to zero average nominal wage growth for the euro area.

Here, one should keep in mind the European integrated guidelines advising Member States to pursue wage developments 'in line with price stability and the increase in trend productivity'. This implies, for the euro area as a whole, an increase in average wages of around 3.3% (being the sum of 1.9% inflation plus 1.4% trend productivity growth).

To take out additional guarantee against deflation and to prevent the domino of close to zero wage growth from falling, the Commission should base itself on this European integrated guideline in order to propose a new policy process. Member States, together with the national social partners, should be invited to formulate policies establishing or strengthening a downwards floor in wage developments of at least 2% in all Member States. This implies, among other things, making sure that:

- each country establishes a wage floor at the bottom end of the labour market, taking competition on the basis of 'poverty' wages out of the market;
- collective bargained agreements have a wide coverage;
- the hierarchy of collective bargaining agreements is in general respected;
- wages and working conditions, as laid out in collective agreements and/or labour law, are respected and implemented in practice.

A wide scale of instruments exists to do so, such as statutory minimum wages, minimum incomes in social security schemes, support for wider trade union affiliation, legal extension of collective bargaining agreements, public procurement to promote collective bargaining agreements. Given the existing diversity of industrial relations in Europe, it is up to national social partners themselves to decide which instruments are most in line with the national tradition of collective bargaining.

### **Europe not leaving new Member States at the mercy of IMF**

Central and eastern European Member States need additional attention. Many of them are relying on financial markets to finance current account deficits and are especially vulnerable to banks avoiding any risk investment in these countries. Growth dynamics in these countries will get short circuited, especially if the IMF returns and imposes its usual anti-growth/anti-social stabilisation measures.

Europe cannot allow this to happen. The European Union should be ready to provide sufficient emergency financial lending to these countries and develop its own approach instead of leaving these countries no other option than to blindly follow the conditionalities of the IMF.