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The Crisis
Where do we stand?

The Steering Committee is asked:

- **to take note of this document**

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THE CRISIS: WHERE DO WE STAND?

The crisis and the policy response so far

1. The gravity of the crisis is crystal clear. Jobs are being slashed by the tens of thousands and unemployment is rising rapidly. The Commission is now forecasting a cut in economic activity this year, almost zero growth next year and close to 10% unemployment or 24 million of unemployed in the EU-27 by 2010. There are rising signs of discontent as despair grows about the way the authorities are handling the crisis, combined with anger about the conduct of many banks.

2. The root cause is the massive de leveraging process of private sector debt that is going on. Banks as well as households and companies seek to reduce their relative debt burdens. In the case of banks, this translates into a rationing of credit flows. On top of this, households and companies reduce purchases of durable consumer goods and investment goods.

3. This process of driving down private sector debt burdens will necessarily take several years. In the absence of an adequate policy response, this implies weak demand spilling over into lacklustre growth performance with unemployment remaining high for several years to come.

4. The policy response until now is trying to limit the damage but it is failing to restore the dynamics for lending and demand. Banks and companies are being saved but bank lending and business investment remain in the doldrums:

    a. The banking rescue plans add between 1,5 and 4,5% of GDP to public debt. This has so far preserved the capital basis of the banks from the losses recorded on toxic assets. However, banks have become risk averse and are now looking not only to *stabilise* but to *reduce* debt leverage positions. The result is a tightening of credit conditions and a reduction of lending volumes and this despite the recapitalisation efforts delivered by the public authorities.

    b. By using different techniques (a reduction of VAT advances, credit guarantees, short term unemployment schemes) ,the economic recovery plans basically inject liquidity into companies. This is certainly helpful for business to survive the abrupt slowdown in demand and revenue flows coming on top of the credit crunch. However, in the absence of sufficient demand for their products and services, business will engage in a massive restructuring of employment.

5. Wages, in all of this, are having a rough time. The slump in economic activity is putting massive downwards pressure on wage formation. Discussions on nominal wage freezes and wage cuts are already taking place in different countries (Central and Eastern European countries, UK, Spain, Ireland, others…). Wage cuts however will work to undermine demand further while bringing the prospect of deflation closer. Here, the irony is that weak wage formation and rising pay inequalities contributed to the debt crisis in the first place.

6. Meanwhile, a second round of rescue plans is in the pipeline. Following the US example, the UK banking rescue plan decided mid January is now extending government guarantees to the asset side of the balance sheet of British banks. In exchange for a premium, UK banks can now take out insurance for losses up to 90% on toxic assets, and this up to 25 billion pounds.

   On the side of the real economy, some governments (Germany for example with a 100 billion euro envelope) are now giving credit guarantees to company loans, hoping to restore in this way business' access to banking finance. Other member states will be forced to follow if they want to avoid companies moving investment and employment to member states providing this kind of guarantee.

7. Several questions need to be raised:

   a. Are governments overextending themselves when 'nationalising' risks and insuring toxic assets of banks and billions of private sector investments? Financial markets are already translating public efforts to save banks into higher interest rate premiums on government bonds.
   b. Is the public actor now bailing out banks and companies which have been weakened by their own CEOs enriching themselves through bonuses, capital buy back and stock options schemes? Will the public money guarantee for private sector lending be (ab)used to continue these schemes and finance 'golden parachutes' to CEOs of failing companies?
   c. With political pressure rising to cut social expenditure in order to maintain the sustainability of public finances in the face of rapidly rising deficits and rising interest rate spreads inside the euro area, are governments in danger of organising a perverse redistribution from the

average taxpayer to the wealthy? In this way, the credit squeeze may end up in squeezing Social Europe as well.

d. Are we fixing the consequences (credit squeeze) and not the causes (over indebtedness of the private sector) of the crisis? With household driving down their debt positions, thereby reducing overall demand perspectives, will helping companies to access finance be enough to trigger new business investment? Or will issuing credit guarantees to business simply save a part of existing jobs while transferring investment and jobs to those EU member states offering the most generous credit guarantee?

8. Meanwhile, reform of the financial sector remains limited to a Commission proposal to register rating agencies and to preserve a minimum of 5% risk, leaving it open for banks to pass on 95% of risk to others by repackaging loans into asset-backed securities and selling them further.A public consultancy process on hedge funds is also going on to which the ETUC has responded. Finally, some governments did impose limits on executive pay in exchange for capital funding only to find out that bank management was reluctant to ask for new capital with those conditions attached.

9. The policy response from the ECB has been to cut interest rates but this has been 'too late, too little'. With ECB interest rates still at 2% and with nominal GDP shrinking in 2009, the de leveraging process of the private sector is actually made more difficult. The ETUC has therefore been calling for the ECB to cut interest rates to the bone. It is also most regrettable that the European Central Bank has attempted to undermine the confidence creating effects of the European recovery plan by immediately declaring in public that fiscal policy is impotent because higher public spending causes households to anticipate higher tax burdens and to save more, thereby offsetting the impact of deficit spending on aggregate demand[1].

10. Finally, the crisis is also threatening the economic cohesion of the European Union. Central and Eastern European member states, being over reliant on capital inflows from Western banks, face high credit constraints. In the case of Latvia and Hungary, the IMF with its traditional conditionalities has stepped in. Whereas these countries did receive EU funding from an enlarged 'balance of payments' assistance fund, such a European fund does not exist for members of the Euro area and the question can be raised what would happen if euro area

[1] The so-called Ricardian equivalence

members with high current account and savings deficits were unable to finance their high finance capital needs.

More and better ways to address the causes and not simply the consequences of the crisis

11. Key to economic recovery is to restore aggregate demand dynamics. With the private sector occupied in a deep process of de leveraging, the only actor that can take over and drive demand and the economy forward is the public sector. To do so in the most efficient way, governments need to focus on directly injecting new demand in the economy since tax cuts and government subsidies will to a large extent simply be hoarded in order to bring down high household debt loads while also reducing the financial means for governments to intervene and steer the economy.

12. According to Commission's estimates, the impact of the European recovery plan is limited since it contains only 0.5% of GDP of new measures. Faced with a situation in which actual output will be at least 4% below potential output, a demand stimulus of a mere 0.5% of GDP is inadequate. Moreover, the component of 46 billion or 0.5% of EU 15 GDP of (new and old) public investment spending is also not enough.

    The ETUC therefore calls upon the European Council, Commission and national governments to launch a second European recovery plan of at least an additional 1% of GDP, strictly focussing on productive investment and based on three pillars (investing in a 'greening' of the European economy, investing in our human capital base, investing in the social sectors and needs of European citizens).

13. To address issues of sustainability of public finances and financial market stability[2], central banks in Europe need to step in and back up public sector led investment by (indirectly) buying government bonds at low levels of interest rates. This can evoke 'memoires' of Weimar and hyperinflation but there are nevertheless many good reasons for central banks in Europe to engage in a policy of quantitative easing. Indeed, the impact of interest rate cuts on aggregate demand is now

[2]Avoiding a future 'bust' in government bonds when financial investors become less risk averse and shift lending back to the private sector

limited[3], policy rates can not be cut much further since a zero interest rate is already very near and there are downwards risks to price stability (deflation).

The ETUC proposes the European Council and Commission to define a number of big investment projects with an European dimension and with a total value of 1% of EU GDP in the areas of clean and renewable energies, European infrastructure and networks, materials of the future, modern cars and future transportation systems….The European Central Bank and other central banks in Europe need to create a special 'productive investment lending' facility to buy the bonds backing up such investment. In this way, public led investment supporting the future growth and competitiveness potential of the European economy can act as a new driver for growth while being based on a stable access to finance. Moreover, these European wide investment projects could also be allocated with a view to manage economic diversity both inside monetary union as inside Europe as a whole.

14. A New Social Deal is urgent to keep the crisis from deepening in the short run and to replace debt and bubble driven growth by distributive justice as a new driving force for aggregate demand over the medium run.

The ETUC sets forward the following demands:

- **Public credit guarantees can only be granted to those companies that do not seek to cut wage levels and respect wage and working conditions as agreed in collective bargaining agreements.**
- **To ensure a level playing field in the fight against excessive CEO bonuses, stock options and golden parachutes, a European wide and coordinated crackdown on these systems is needed. This should start with attaching the condition that the money lend under a public credit guarantees should under no circumstance be used to finance these CEO payment systems.**

[3] In present circumstances, interest rate cuts simply assist the private sector in deleveraging existing debt positions, they do not incite households to spend more by taking on more debt.

- **A new policy process: in the context of the European Employment Strategy: Member States, together with the national social partners, should be invited to formulate policies establishing or strengthening a downwards floor in wages with wage dynamics to be in line with trend inflation and trend productivity increases**[4].

15. To strengthen demand dynamics, tax policy needs to engage in redistribution, shifting income gains from capital and wealth back to middle class workers and households. **Given the level of economic integration and tax competition in Europe, this implies a European agenda including tax coordination, attacking tax havens, regimes of zero or flat taxes and adressing issues such as a minimum rate of taxation and a harmonised tax basis for corporate profits, capital gains taxes and taxes on high fortunes**[5] .

    At the same time, European tax policy coordination also allows to address the question of the sustainability of public finances. To maintain the sustainability of public finances when beefing up public investment to react to the crisis, new tax resources will be necessary and these can be found with those incomes and fortunes which until now have highly profited from casino capitalism. The credible 'exit' strategy from rising public indebtedness runs through economic recovery and distributive tax policy, not through a liquidation of the European Social Model.

Summarising, we need a New Social Deal for European workers

Although necessary, the initial policy response to the financial and economic crisis is far from sufficient. Efforts need to be stepped up and we need to construct a New Social Deal for European workers along the following lines:

Jobs : Productive investment for new jobs by launching a second European Recovery Plan of 2% of European GDP , including large European Investment projects financed by

[4] As endorsed by the resolution of the ETUC Executive Committee meeting of December 2008 on a European Recovery Program.
[5] As endorsed by the resolution of the ETUC Executive Committee meeting of December 2008 on a European Recovery Program.

European Growth Bonds and backed up by European central banks buying these bonds.

Collective Bargaining: No to wage freezes and cuts in nominal wages. Instead, collective bargaining needs to be strengthened to turn wages into an anchor of price stability in times of looming deflation and into a sustainable driver of demand and growth.

Rights: For companies facing difficulties, consultation and information of workers and their representatives and exploration of all alternatives to firing workers must be the first resort. Short – time working schemes, backed up by unemployment benefits, need to be generalised.

Do not let workers fall into the abyss of unemployment. Strengthen unemployment benefit systems while massively expanding training and retraining of workers and developing a special guarantee for young people leaving school or college in 2009.

Distributive Justice: No to the perverse distribution of governments bailing out bankers and CEO's who have failed their company and putting the entire economy at risk while grossly having enriched themselves. Instead, we need a European wide and coordinated crackdown on CEO bonuses, stock options and golden parachutes. To provide governments with the means to steer the economy and to turn rising inequalities around, we also urgently need to stop tax competition in the internal market.

These arguments will, if endorsed by the Steering Committee, be used as the basis of our interventions to the Macro Economic Dialogue and be developed into a plan for a New Social Deal to be launched at the Executive Committee in March.

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