



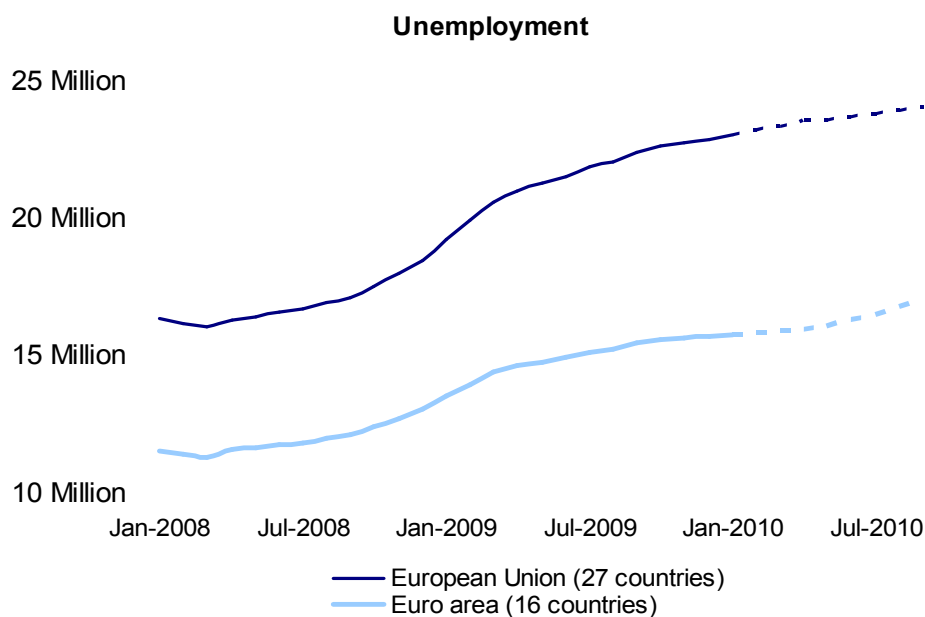
A Progressive way out of the Crisis Recovery vs. Austerity: PES strategy to resolve the dilemma

The Facts – we cannot continue this way

The current policy environment in the European Union is greatly constrained by the financial and economic crisis. The crisis has resulted in a huge drop in the level of output – the largest recession witnessed in Europe in a generation – and a tremendous increase in unemployment, which threatens our social cohesion.

By the end of the year, the GDP of the EU will still be almost €500 billion below the 2008 level. Had the recession not occurred, and our economy continued to grow at pre-crisis pace, the level of GDP in Europe would be €500 billion more in 2010. On this scale, the crisis has already cost us €1,000 billion. That is €2000 per citizen.

On top of this, no one can yet say the recession is over. In annual terms, GDP growth is still negative. A very modest rebound was recorded in the third quarter of 2009, at 0.4%; but recently released figures for the fourth quarter 2009 showed a significant slowdown (+0.1%) which illustrate the fragility of the 'recovery'.



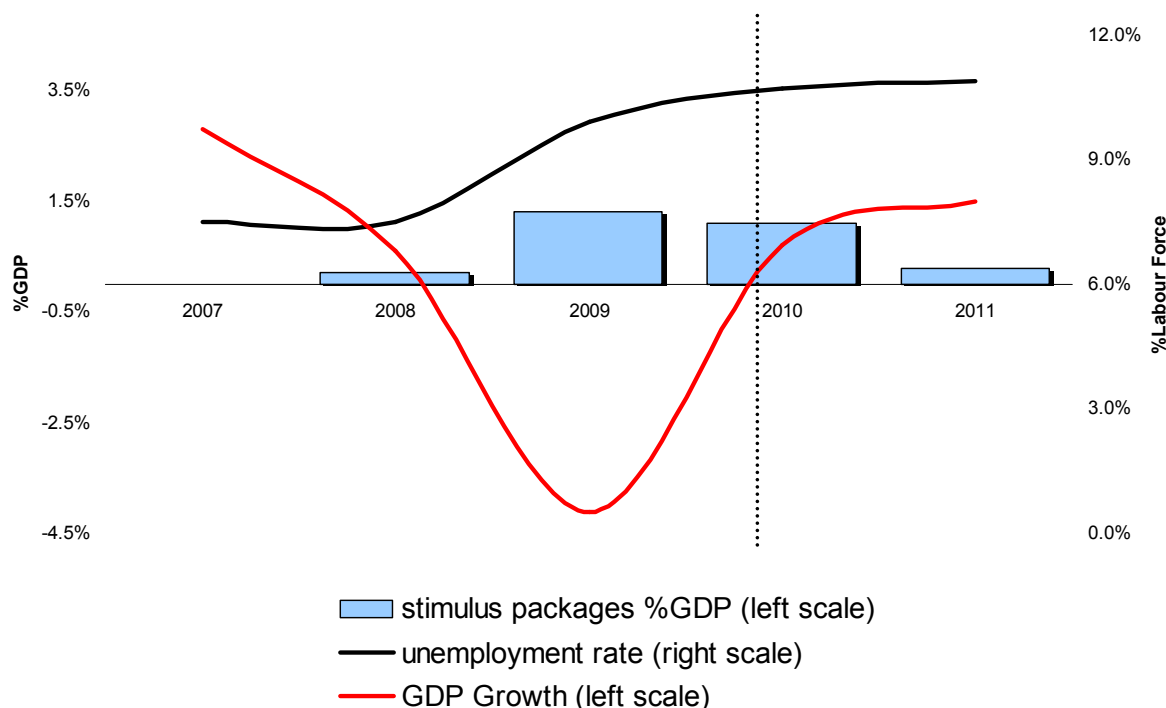
data source: Eurostat

By destroying production, the crisis is also destroying jobs: 7 million, and still counting. By the end of the year, another million is likely to be added to the unemployment count, corresponding to a total of over 24 million unemployed people in Europe.

Furthermore, because governments had to intervene massively to rescue the financial system and the real economy from complete collapse, the crisis has resulted in a record increase in public debt, unprecedented since the 1930's. By the end of next year, average public debt in the EU will be well above 80%, over 20 percentage points more than in 2008. This increase amounts to €3,000 billion, or €6,000 per person.

In 2007, nearly half the EU Member States had positive public balances; today, all record deficits. The EU will have to cope with yearly deficits in excess of 5 or 6% of GDP for at least another few years. The transfer of debt from private to public sector had a major consequence for the conduct of governments' daily business: the service of the debt has jumped by 13% in 2 years, and is set to increase further. This debt, resulting from the rescue of banks and the economy, has already cost us €50 billion extra in interest payments, on top of the already very large price paid for the 'normal' service of the debt.

Macroeconomic performances of the Euro-zone and Fiscal Policy



Source: EU Commission Autumns forecasts; OFCE

The Dilemma

On the one hand, our economy is not yet out of the crisis. Growth prospects are gloomy, and the risk of a double-dip into recession cannot be fully dismissed. Our only certainty is that the situation is set to deteriorate further on the labour market. This calls for prolonged involvement of the State in supporting the economy through expansionary fiscal policies. **Any withdrawal of fiscal stimulus now would be detrimental to both growth and jobs** and would undermine the so-called automatic stabilizers from our public sector as well as our Welfare States.

On the other hand, the fact that our Welfare States' automatic stabilizers functioned and that our governments have already spent billion of euro in bailing out banks and counter-acting the crisis have led to substantial increases in deficits and debts.

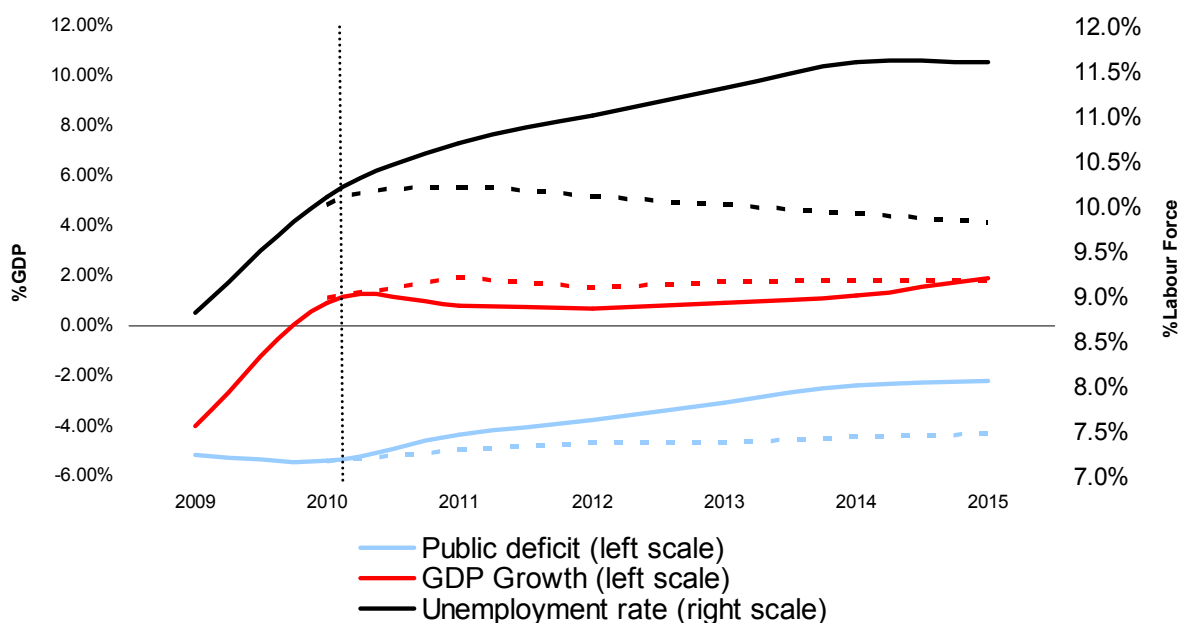
But the financial markets have not accepted this development. Now, once again, they are putting pressure on our Member States with soaring interest rates on sovereign debt for all and speculative attacks on certain.

In this situation, the traditional reaction from conservative finance ministers is to call for fiscal consolidation strategies to be implemented with no delay, because – they argue – continued fiscal expansion would drive Europe to the verge of sovereign default. We believe such a reaction would kill the recovery before it even starts.

Their Way

The European conservatives' solution to that dilemma is fiscal consolidation. The last EU Council of Finance and Economic Ministers recommends fiscal stimulus measures going beyond 2010 to be withdrawn as soon as possible. The Council's conclusions call for the "exit strategy" to start as early as mid-2010. Their answer is simple: cuts, cuts, cuts.

What the Conservatives have in store: an 'Exit Strategy' that would march Europe's jobs out of the door



The dashed lines represent the baseline scenario if the EU Council's recommendations are not implemented.
Source: AE, OECD

But the conservative majority in Europe is completely ignoring the fact that virtually all Member States are still being hit by the recession. This makes it simply impossible to use cuts to get out of the crisis. If implemented, this unsound strategy which intends to impose an overall 3.5% fiscal contraction on most EU countries over the period 2010-2014, would prolong the crisis and cause an even greater increase in unemployment, with a price tag of extra 4.5 million jobs losses by 2013, and only a marginal improvement in public finances.

Our Way

The PES' way out of this dilemma leaves no workers or businesses behind. It is about continuous support for the real economy, coupled with a strategy for structural changes and fiscal consolidation. **This policy brief will present the four steps of the PES strategy.**

Step One: Ensuring that public policies are not dictated by the financial markets

The first step in our Progressive strategy out of the crisis consists in providing governments with **breathing space**, necessary to conduct the policies that are required by the current economic context. States are today pressurised by the markets into doing what is economically wrong in the current context: raising taxes on labour and businesses and cutting down expenditures.

Governments have to work with the fear of being downgraded by the very rating agencies whose short-sightedness was instrumental at the onset of the crisis. If a Member State is downgraded they become vulnerable to speculative attacks by bailed-out banks and unregulated hedge-funds. The example of Greece is representative of this: some cuts were necessary, but aggressive speculation dramatically exacerbated the need for tough austerity measures.

With no effective protection against speculative pressure, sovereign debt in many Member States will soon become impossible to finance, with or without expansionary policies. There is only one solution against these attacks: to stand together in solidarity.

The PES has been promoting the establishment of a **“European Mechanism for Financial Stability”**, which acts as a mosquito net against speculators. This mechanism, described in more details in a separate PES document, consists of the establishment of a trustee fund by the Member States, managed by the Commission, which can issue bonds on the market and provide conditional loans at a fair price to any country facing difficulties. The very existence of the trustee fund means that it will most likely never be used. If such a guarantee would be put in place, it would rule out any risk of sovereign default in the euro-zone, and thus take ammunition away from speculators. It would thus benefit growth and job creation in the euro-zone.

Finally, to achieve overall protection of Member States against speculators and provide room for manoeuvre to our Governments, financial reform must be fully completed. The shadow finance casino must be shut down. Hedge funds and private equity must be tightly controlled. All derivative products, including Over-The-Counter (OTC) must be regulated; some derivatives, such as Credit Default Swaps (CDS) on sovereign bonds, as well as harmful practices – such as naked short-selling – must be banned.

Step Two: Yielding new public revenue, through fair and sustainable instruments

Fiscal consolidation must be achieved at medium term. If Governments are, however, to continue spending to support the economy and to save our Welfare States from massive cuts, the consolidation will have to come from the revenue side. A number of instruments can be explored to ensure that an increase in the Member States' available resources is not achieved at the expense of those who have already suffered the most.

New fiscal instruments must be developed to generate new and sizeable sources of revenue. Fair green taxes constitute part of the solution in the medium-term. In the short-run, we must seize the momentum for a Financial Transaction Tax (FTT) and implement such an instrument at the European, and possibly global, level.

The PES has been calling for the introduction of a 0.05% tax on all financial transactions, including OTC derivatives, in Europe first, then globally. It is a fair tax, which leaves ordinary people and

businesses untouched. It is a powerful tool to change the business model of speculators and raise huge revenues.

A European FTT of 0.05% would yield nearly €200 billion a year, leading to an increase by 1.3% in EU growth and creation of more than 2 million new jobs.

The Financial Transaction Tax: 0.05% for an extra year of recovery plan and 2 million jobs

Country	Revenu potential of the Tax in 2011	In % of recovery plan 2010	In % of recovery plan 2009	Job Creation Potential
EU27	€195.8bn	230%	140%	2,200,000
Eurozone	€148.1bn	200%	140%	1,300,000
Germany	€39.4bn	90%	110%	380,000
France	€32.4bn	1600%	160%	340,000
United Kingdom	€26.5bn	no stimulus	110%	180,000
Italy	€25.3bn	no stimulus	no stimulus	130,000
Poland	€5.7bn	110%	160%	130,000
Netherlands	€9.3bn	160%	180%	110,000
Czech Republic	€2.3bn	320%	160%	70,000
Spain	€16.9bn	270%	70%	60,000
Portugal	€2.7bn	1600%	180%	60,000
Belgium	€5.6bn	400%	400%	50,000
Sweden	€5.1bn	100%	110%	50,000
Austria	€4.6bn	90%	90%	30,000
Denmark	€3.7bn	200%	400%	30,000

data source : Eurostat.

revenu potential: own computation based on coefficient from S. Schulmeister; M. Schratzenstaller & O. Picek "A General Financial Transaction Tax. Motives, Revenues, Feasibility and Effects", Austrian Institute of Economic, march 2008. We use in this table the medium reduction in transaction volume scenario, for a FTT on all products, including OTC derivatives, set at 0.05%.

Job creation potential: own computation based on correlation coefficient between GDP growth at *n* and employment Growth at *n+1* based on historical series 1996-2008.

This revenue potential of the Financial Transaction Tax, although sizeable when compared to the size of the recovery plans implemented in Europe in 2009 and 2010, represents a mere fifth of the overall public deficit forecasted in the EU next year. This illustrates how much a new revenue stream is currently needed to support our Governments' budgets.

Step Three: A two year moratorium to secure economic recovery

With protection against speculation, and new tax revenues, Governments will be able to conduct additional contracyclical economic policies, provided that the rules applying macroeconomic policies are adapted to the exceptional circumstance of the crisis.

The Conservatives' "exit strategy" must not be implemented. A two year moratorium must be imposed on the application of the Stability and Growth Pact (SGP), effectively pausing all ongoing "Excessive Deficit Procedures" (EDP) – which currently concerns 20 out of 27 EU Member States.

The current Council recommendations impose, on these Member States, fiscal contraction ranging from 0.5% to 4% of GDP per year. The bulk of Member States under an EDP – running deficits typically in excess of 7% – have only until 2013 to go back under the Maastricht limit of 3% deficit.

This is absolutely unrealistic, and if implemented would result in a major backlash on employment and the Welfare State as a whole.

A moratorium on the application of the SGP will thus allow Member States to conduct policies really needed to get out of the crisis, and thus serve objectives of fiscal consolidation, too.

In prolonging expansionary fiscal policies, attention must be paid to the prioritisation of spending. Measures with higher long-term or permanent fiscal multipliers, such as public investment, must be favoured. The measures which have proven to be useful in the initial recovery package but are mostly efficient when implemented as a one off for a timely limited period of time, such as support of private consumption, should be gradually phased out.

It is however inevitable that some cuts will have to be made in the process of redirecting public spending. In doing so, governments must carefully assess all economic and social implications of cuts. In particular, social transfer measures must only be affected by spending reduction under the fulfilment of the fair burden-sharing principle.

The structural reform at the scale of the EU must be coordinated, through the implementation of a strong progressive “Europe 2020” strategy. This strategy must be given the appropriate tools to succeed: a renewed framework for macroeconomic policy coordination in the EU.

The current framework – consisting only of the largely insufficient Stability of Growth Pact– needs to be completely revamped. The SGP will require a further reform at medium-term, to transform it into a really effective instrument of sustainability. In the design of new normative rules framing the conduct of fiscal policy in Europe, the focus needs to be shifted from public deficit to public debt, and enlarged to other key indicators, in particular current account imbalances within the European Union. In addition, the economic governance of the EU must be strengthened, to allow not only for the protection of the single currency, but also for a greater efficiency of economic policy.

Step Four: Using our European investment instruments for better coordination

Non-national budget lines must be used to their full extent, such as the credit facilities granted by the European Investment Bank for specific investment projects, or EU structural funds.

The implementation of collective funding instruments, such as Eurobonds, must be explored to finance structural policies. Eurobonds are an important mechanism to reduce the cost of the long term investments for a greener and a smarter economy.

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, attracting domestic and foreign savings and preventing hostile takeovers by foreign investors. 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.

With respect to the EU2020 process, Europe needs to develop a new mode of economic governance in order to ensure that policies are made more efficient, with stronger instruments and with multilevel actions combining the local, national, European and global levels.

The political accountability of the European institutions and governments regarding the implementation of coordinated policies must also be strengthened. The participation of all the relevant stakeholders and the exploitation of the full potential of the Lisbon Treaty with respect to policy coordination must also be ensured.

The Choice

The Conservative's strategy of going back to "business as usual" and trying to cut the Welfare State is now framing the public debate on the post-crisis policy environment – and already threatens the EU's economic and social future. European Conservatives are the only ones in the world insisting on this very aggressive "exit strategy". This strategy's only result would be to march Europe's jobs out of the door and to kill any signs of positive growth.

A clear choice has to be made. The choice is between rushed fiscal consolidation or safeguarding jobs and growth, between the "exit strategy" and the "entry strategy" into the labour market. The choice is between more of the same, or an ambitious structural reform strategy. It is between continuing to reinforce social inequality, or reversing the trend.

The Progressive European family, led by the PES, must fight for its voice to be heard. Together, we must ensure that Europe will come out of the crisis stronger and better off than it entered it.

