European responses to the financial crisis

Standard Note: SN/BT/5099

Last updated: 10 March 2010

Author: Tim Edmonds/John Marshall

Section Business and Transport Section

Although some analysts initially predicted that Europe would escape the worst effects of the financial crisis, many countries have been severely affected. Countries such as Ireland, Spain and the UK suffered from bursting asset bubbles, especially property markets, while most of the continent has experienced a severe contraction in credit. Despite the EU's statement of general principles for addressing the crisis, responses have varied considerably by country; some countries such as Germany have deployed a wide range of policy tools while others like the Czech Republic have done very little.

The European Central Bank has been criticised for being slow to lower its interest rates and embark on unconventional monetary policy. The ECB did, however, launch an unprecedented policy of supplying unlimited short- and long-term liquidity at fixed rates to the market. The ECB has consistently argued that supplying liquidity is more suitable for the European economy than the approaches taken by central banks in Japan, the UK and US.

Domestic governments have generally been active in the use of financial policy. Restrictions on short-selling and deposit and lending guarantees have proved to be popular policy tools. Furthermore, many governments have recapitalised some of their banks either as part of a systematic scheme or on an *ad hoc* basis. Other than the UK, only Germany has pursed an asset insurance scheme. Germany and Spain have also announced asset purchase schemes. The European Commission has reported that total crisis liabilities in the EU amount to approximately €3tr.

A number of European governments – including France, Germany and Spain – subsequently passed substantial discretionary fiscal stimulus packages. The European Commission has estimated that the total fiscal impulse in Europe, including automatic stabilisers, amounts to €400bn.

This information is provided to Members of Parliament in support of their parliamentary duties and is not intended to address the specific circumstances of any particular individual. It should not be relied upon as being up to date; the law or policies may have changed since it was last updated; and it should not be relied upon as legal or professional advice or as a substitute for it. A suitably qualified professional should be consulted if specific advice or information is required.

This information is provided subject to our general terms and conditions which are available online or may be provided on request in hard copy. Authors are available to discuss the content of this briefing with Members and their staff, but not with the general public.

Contents

1 Introduction **3**

2 ECB **4**

2.1 Interest rates 5

2.2 Liquidity measures 8

Pre-September 2008 8

Post-September 2008 8

2.3 Asset purchases 10

2.4 Overview 12

3 Domestic government financial responses **13**

3.1 Bank recapitalisation 13

Fortis: the first European bailout 13

Subsequent bailouts 14

3.2 Toxic assets 15

3.3 Guarantees 16

3.4 Short-selling 16

3.5 Overview 16

4 Stimulus packages **18**

4.1 Germany 18

4.2 Spain 18

4.3 France 19

4.4 Elsewhere in Europe 19

5 An early policy assessment **19**

1 Introduction

At first, many commentators thought that mainland Europe was likely to be relatively immune from the worst impacts of the financial crisis – particularly after European governments decided not to partake in a joint bailout effort with the US in September 2008.[1] This view was predicated on the belief that Europe's financial sector was sufficiently removed from the US and UK markets. However, the International Monetary Fund (IMF) and the European Central Bank (ECB) have identified the same problems underpinning the financial difficulties facing both the US and Europe.[2] The IMF explained that Europe's "financial systems suffered a much larger and more sustained shock than expected, macroeconomic policies were slow to react, confidence plunged as households and firms drastically scaled back their expectations about future income, and global trade plummeted."[3]

Both Western *and* Eastern Europe have plunged into a significant recession – in both the real and financial sectors – generated by, amongst other factors, stagnant consumption, frozen lending markets, collapses in global trade and capital flows, and a relatively strong Euro. The IMF forecast that real gross domestic product (ie GDP adjusted for inflation) is likely to fall by 4% in the Eurozone[4] for 2009, "making this the worst recession since World War II"; Europe's emerging economies are expected to contract by 3.75%.[5] Export-orientated nations such as Germany and others in Eastern Europe, as well as countries like Ireland and Spain that suffered collapsing asset prices, have fared especially poorly. Recent evaluations of macroeconomic conditions in Europe are available in the second chapter of the IMF's

---

1. *New York Times*, The U.S. Financial Crisis Is Spreading to Europe, 30 September 2009
2. IMF, Regional Economic Outlook: Europe, April 2008, pp19-20; ECB, EU Banking Structures, October 2008, p26
3. IMF, World Economic Outlook, April 2009, p75
4. The group of 12 European countries that share a single currency.
5. Ibid., pp76-77

report *World Economic Outlook*[6] and the Organisation for Economic Cooperation and Development (OECD) publication *Interim Economic Outlook*.[7]

Some Western European governments have been slower than others to address problems, while there has been only limited movement on a decisive coordinated response from the European Union (EU). However, it should be pointed out that the European Central Bank (ECB) took the quick and unprecedented step of providing unlimited liquidity to financial markets in an attempt to maintain the flow of credit throughout the Eurozone; accordingly, ECB lending to the Eurozone has exceeded €18tr.[8]

At a Eurozone summit on 12 October 2008 – that also included the UK – a common set of principles for responding to the financial crisis was adopted. These principles, which largely reflected the approach taken in the UK, included: bank recapitalisation; government-backed debt guarantees; and improved regulations.[9] On 29 October, the European Commission published a more detailed *European Framework for Action* for the EU's 27 Member States. This plan set out to design a new financial framework, provide support to the real economy and develop a global response to the financial crisis.[10] However, it should be emphasised that Member States are not mandated to act on these principles.

Despite Europe's relatively sluggish and uncoordinated initial response to the crisis, member countries and pan-European institutions have employed a number of policies in response to the financial crisis. In the most part, the policies have resembled the measures taken in Japan, the UK and the US – although often in a more limited form with the notable exception of the ECB's lending practices.

After the initial response to the crisis, a spate of EU regulations were been recommended by the de Larosière Group in February 2009. Both before and after the report's publication, a number of regulatory directives have been proposed (and subsequently passed in some cases); these directives have addressed areas such as capital requirements, credit rating agencies systemic oversight and corporate governance that are believed to have been critical to the evolution of the crisis.

2 ECB

The ECB, which is responsible for monetary policy in the sixteen Eurozone countries, has played an important role in shaping the European response to the crisis. On 28 April 2009, Jean-Claude Trichet, President of the ECB, explained that the differing structures of the US and European financial markets meant that providing support for bank lending needed to be the most important element of the ECB's strategy:

> First, there are profound differences in the financial structures of the euro area and the United States. The United States has a primarily market-based financial system; in contrast, the financial system of the euro area is largely bank-centred. A few numbers illustrate these differences. At the end of 2007, the stock of outstanding bank loans to the private sector amounted to around 145% of GDP in the euro area. The

---

6 Ibid.

7 OECD, Interim Economic Outlook, March 2009

8 ECB, Aggregated balance sheet of euro area monetary financial institutions, excluding the Eurosystem, released on 29 May 2009

9 European Commission, Summit of the Euro Area Countries: Declaration on a Concerted European Action Plan of the Euro Area Countries, 12 October 2008

10 European Commission, Communication From the Commission, From Financial Crisis to Recovery: A European Framework for Action, 29 October 2008

corresponding proportion of bank loans to GDP in the United States is only 63%. This means that the banking sector is more than twice as important in the euro area as it is in the United States. It also means that to be effective, ECB policy must focus first and foremost on the banking sector.

> Similarly, direct debt securities account for 81% of GDP in the euro area. The corresponding proportion in the United States is 168%. This means that market-based financing plays a much smaller role in the euro area and is only half as relevant as in the United States. Therefore, the structures of private credit outstanding in the euro area and the United States are almost mirror images: recourse to banks on our side of the Atlantic makes up two-thirds of non-equity external finance. On this side, the equivalent proportion is only around 30%. Against this background, it is natural that the Federal Reserve's "credit easing" policies mainly target markets for debt securities, whereas our policies of "enhanced credit support" focus on banks.
>
> …
>
> In technical terms, I would say that acknowledging the existence of structural differences between the euro area and the United States is crucial for understanding the mechanisms behind the policy models and concepts that we use in our decision-making processes. Structural differences imply that the policy response has to be calibrated to the structure of the economy.[11]

The ECB has pursued a number of different policy approaches, ranging from conventional tools of interest rates to the unconventional provision of unlimited liquidity and the purchase of market assets through the expansion of the ECB's balance sheet. Trichet has argued that:

> We at the ECB and other central banks have reacted swiftly, flexibly and decisively. The ECB took the lead with some exceptional decisions as early as 9 August 2007. We have, since then, modified our operational framework and used an exceptional set of non-standard policy tools.[12]

2.1 Interest rates

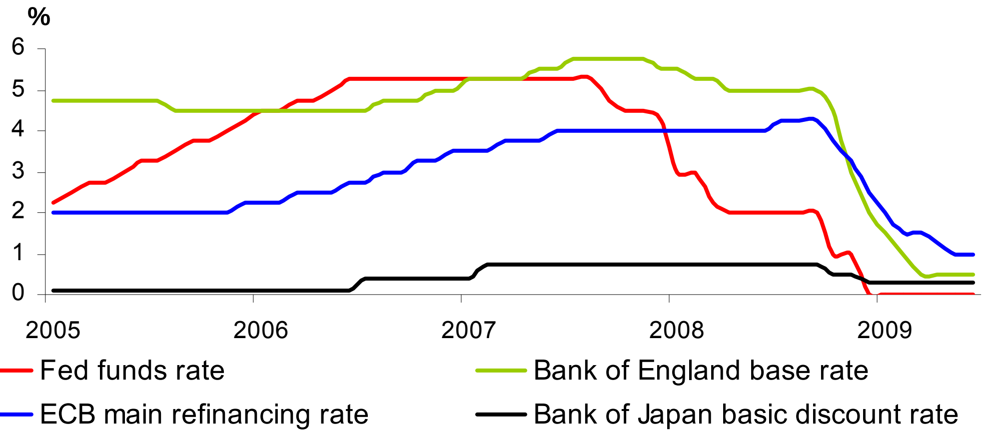
Interest rates have, at least until recently, been widely recognised as the standard tool of any central bank's monetary policy. On 8 October 2008, the ECB partook in an internationally coordinated action to reduce interest rates which saw it lower its main rate by 0.5%.[13] The figure below sets out the ECB's headline policy rate – the main refinancing rate – in comparison with those employed by the Bank of England, Bank of Japan and the Federal Reserve. As the chart indicates, the ECB has been the slowest of the large central banks to reduce its interest rates, and even continued to increase rates until as late as July 2008. As of 4 June 2009, the main refinancing rate stands at 1%.

[11] Jean-Claude Trichet, The financial crisis and our response so far, Keynote address by Jean-Claude Trichet, President of the ECB, at the Chatham House Global Financial Forum, New York, 27 April 2009

[12] Jean-Claude Trichet, The financial crisis and the role of central banks: The experience of the ECB, Keynote address by Jean-Claude Trichet, President of the ECB at the international symposium marking the 50th anniversary of Bank Al-Maghrib, Marrakech, 29 May 2009

[13] *Wall Street Journal*, Central Banks Launch Coordinated Attack, 9 October 2008

Headline Interest Rates at the Bank of England, Bank of Japan, ECB and the Fed, 2005-2009



Sources: Bank of England, Bank of Japan, ECB and Federal Reserve

Trichet has defended the higher rates employed by the ECB, emphasising that although the policy rate is important, it may not reflect the rate facing the market:

> Some observers tend to reduce monetary policy to the level of the key policy rate. Monetary policy is the more effective in response to a downturn, the argument goes, the lower the policy rate. This view is too simplistic. Comparing only the levels of policy rates without consideration of the resulting market rates and other economic variables is looking at just one part of a far broader canvas.
>
> Let me give you a concrete example. At 1.25% at the moment, our rate on refinancing operations is higher than the federal funds rate target range of 0-0.25%. But owing in particular to the very low rate on our deposit facility of 0.25%, this difference in policy rates does not translate into equivalent differences in money market rates.[14]

However, "changes at the operational level of monetary policy imply that overnight interest rates have in fact fallen more, to below 1%."[15] By looking at market interest rates, rather than policy interest rates, Lorenzo Bini Smaghi, another member of the ECB's Executive Board, points out that European market rates in March 2009 were roughly equivalent to those prevailing in the US.[16]

Looking forward, Lucas Papademos, the ECB's vice-president, suggested that the ECB must raise interest rates – "leaning against the wind" – in order to help prevent asset bubbles in the future. This perspective is also supported by Bini Smaghi who has stated:

> Recent experience has shown that the approach followed by most central banks, based on inflation targeting (which involves forecasting inflation on the basis of an economic model and changing interest rates so as to ensure that inflation forecasts are in line with the target), does not sufficiently take into account financial developments, in particular with regard to asset prices, which may affect the stability of the markets and, in time, inflation. It is argued by some that monetary policy should act proactively to avoid the excessive tendencies of the financial markets, known as "leaning against the

---

14 Jean-Claude Trichet, The financial crisis and our response so far, Keynote address by Jean-Claude Trichet, President of the ECB, at the Chatham House Global Financial Forum, New York, 27 April 2009

15 OECD, Interim Economic Outlook, March 2009, p38

16 *La Repubblica*, Letter from Lorenzo Bini Smaghi, 19 March 2009

> wind". In other words, one should be ready to hinder the creation of speculative bubbles, among other things by raising interest rates, before inflationary pressures emerge. This is easier said than done. If it is difficult to forecast inflation, it is even harder to interpret financial asset prices and to derive from them indicators regarding the risks of instability. And it is even more difficult to adjust the course of interest rates on the basis of these indicators. For this reason, the proposition of leaning against the wind remains an abstract concept for now. It would be important to develop economic models which give a more precise idea of the quantitative dimension of these phenomena, in particular of the correlation between monetary policy variables and financial asset prices.[17]

Bini Smaghi has also argued that economists, politicians and academics fundamentally misinterpreted the impacts of low interest rates. Accordingly, he proposed that interest rate decisions be operated on a more prudent basis in future to avoid over-expanding the supply of money in the economy:

> There is now a broad consensus that the policy of very low interest rates, especially in real terms, which was followed in particular in the United States in the period 2002-04, increased the incentives for financial institutions, households and businesses to raise their levels of indebtedness and to take high-risk speculative positions. In a recent paper, John Taylor illustrated that if the Federal Reserve had implemented a less expansionary monetary policy, and had instead followed a simple rule to determine interest rates, in line with past behaviour, less liquidity would have accumulated at the global level. Clearly, this is an ex post evaluation. And it is too easy to lay the blame at the door of the US monetary authority. Looking back at the analyses conducted at the time, it can be seen that this policy met with the approval of the academic world, market analysts and political parties. Following the bursting of the technology bubble and 11 September, there was a general consensus that deflation represented the greatest risk and needed to be countered by strong and sustained monetary expansion.
>
> This line of reasoning was so widespread, propagated by the media (and not just the Anglo-Saxon media), that anyone making different choices was subject to criticism. The European Central Bank (ECB), which had refused to cut interest rates to the same level as the Federal Reserve, keeping them at 2% (compared with the Federal Reserve's 1%), was for a long time the subject of criticism. Not just academics, commentators and market analysts, but also Heads of State and Government were moved to call upon the ECB to ease monetary policy. It was as if the only criterion when deciding on interest rates were not the underlying economic conditions, from a medium-term perspective, but the need to act at all costs, in a single direction, in imitation of what had been done on the other side of the Atlantic. Some even called on the ECB to intervene in the exchange rate markets to establish parity between the euro and the dollar. If this had been done, the speculative bubble would have been larger and the effects of it bursting even more devastating, particularly for Europe.[18]

---

[17] Lorenzo Bini Smaghi, Towards the G8 – strategies for emerging from the crisis, Speech by Lorenzo Bini Smaghi, Member of the Executive Board of the ECB, Università LUISS Guido Carli, 27 May 2009

[18] Ibid.

2.2 Liquidity measures

A second major tool employed by the ECB has been the use of measures to enhance liquidity.[19] A number of specific liquidity policies have been pursued since the emergence of the crisis.

Pre-September 2008

On 2 August 2007, when the first signs of a serious credit contraction were emerging, the ECB flooded the overnight lending market with €95bn of fixed-rate liquidity – in fact, it was the first central bank to employ such a non-standard tool. On 22 August 2007, the ECB supplemented its overnight liquidity measures by providing €40bn for three-month lending agreements.[20] Over the following year, the ECB steadily expanded its liquidity measures and increasingly shifted its lending toward longer-term 3-month and 6-month maturities in order to mitigate the market's growing liquidity and counterparty risk[21] concerns.[22]

In December 2007, the Term Auction Facility was created. This permitted depository institutions to anonymously bid to receive funds underwritten by a wide variety of collateral over a period of 28-35 days.[23] This action was part of a coordinated effort administered simultaneously across five central banks including the Bank of England and the Federal Reserve. That recipients were anonymous removed the damaging market stigma attached to emergency short-term lending.

During the first half of 2008, the size of the auctions, and their frequency, was increased as market conditions worsened. The first few months saw some success in reducing interest rate spreads – the difference between the actual rate faced by banks and the central bank policy rate. However, such reductions generally lasted only for a few days and had no lasting impact on interbank lending spreads – especially after March 2008.[24]

Post-September 2008

Despite these early liquidity-enhancing measures, the interbank lending crisis escalated in September 2008 after the collapse of a number of major financial institutions with significant market reach. Accordingly, interest rates spreads spiked as money market firms believed they faced considerable and uncertain counterparty risk in their short-term lending.

The ECB's immediate response – marking a dramatic shift from its previous approach of auctioning a fixed quantity of short-term loans – essentially agreed to fully replace the market for liquidity, where necessary, by supplying an unlimited quantity of one-week fixed-rate loans to the European lending markets.[25] The ECB also expanded the range of its longer-

---

19 Liquidity is the ease and cheapness of converting an asset into cash. An asset is described as illiquid where it takes a long time and/or great expense to convert it into cash.

20 ECB Press Release, Supplementary longer-term refinancing operation, 22 August 2007

21 Counterparty risk is the risk that the another party to the transaction would fail to meet the agreement.

22 José Manuel González-Páramo, Liquidity, funding and solvency: Policy responses and lessons, Speech by José Manuel González-Páramo, Member of the Executive Board of the ECB Universidad de Alcalá de Henares, Madrid, 16 January 2009

23 Federal Reserve, Monetary Policy Press Release, 2 May 2008

24 Stephen G. Cecchetti, "Monetary Policy and the Financial Crisis of 2007-2008", 3 April 2008, p22; John B. Taylor, "The Financial Crisis and the Policy Responses: An Empirical Analysis of What Went Wrong", November 2008, p12

25 ECB Press Release, Changes in tender procedure and in the standing facilities corridor, 8 October 2008; José Manuel González-Páramo, Liquidity, funding and solvency: Policy responses and lessons, Speech by José Manuel González-Páramo, Member of the Executive Board of the ECB Universidad de Alcalá de Henares, Madrid, 16 January 2009

term refinancing, or lending, facilities on 15 October 2008;[26] accordingly, unlimited liquidity could be obtained at a fixed rate of interest (unencumbered by the huge demand for liquidity that would usually drive up interest rates) for maturities of up to six months. The availability of long-term finance was further expanded on 7 May 2009 when the ECB announced that it would extend its October changes to include twelve-month maturities available at the main refinancing rate.[27] As Trichet subsequently explained, the ECB would "act as a surrogate for the market in terms of both liquidity allocation and price-setting."[28]

Even more than the Bank of England and the Federal Reserve, the ECB has significantly eased its collateral requirements to include a wide range of assets including private securities and commercial paper (in addition to the more conventional collateral of government securities). The ECB's extensive list of accepted collateral has seen it accumulate €12.2tr in debt securities – this represents 130% of Eurozone GDP and 86% of total Eurozone debt securities.[29] Although the ECB has operated a strict policy of applying haircuts[30] to risky assets, it has been prepared to accept assets with considerably riskier profiles than the US Federal Reserve – on 15 October 2008, the ECB announced that it was willing to accept assets rated as low as BBB- (the lowest rating defined as 'investment grade'), and denominated in different currencies, as collateral.[31] In May 2009, the ECB announced that the list of eligible assets would be temporarily maintained until the end of 2010.[32]

Although 1,700 institutions were already eligible to refinance with the ECB before the crisis, the list was temporarily expanded in October 2008 to allow 2,200 financial institutions access to the ECB's liquidity facilities.[33] This reflects the ECB's efforts to ensure that liquidity directly reaches as many financial institutions as possible. It is worth noting that the scope of this list dramatically exceeds that of the Federal Reserve, which operates under the belief that its primary dealers will effectively pass on funds to the market; the Fed narrowly extended its slim list of institutions with which it deals directly in response to the crisis.[34]

On 7 May 2009, the ECB announced that it would continue to provide unlimited short-term and longer-term liquidity to the market for at least a further 12 months.[35] The *Financial Times* suggested that the ECB is considering directly lending to businesses in order to ensure that the real economy does not suffer from the contraction in bank lending.[36]

The ECB has also expanded its temporary currency swap facilities, which allow central banks to borrow currency from one another to facilitate lending. Primarily, this was intended

---

26 ECB Press Release, Measures to further expand the collateral framework and enhance the provision of liquidity, 15 October 2008

27 ECB Press Release, Longer-term refinancing operations, 7 May 2009

28 Jean-Claude Trichet, The financial crisis and our response so far, Keynote address by Jean-Claude Trichet, President of the ECB, at the Chatham House Global Financial Forum, New York, 27 April 2009

29 Ibid.

30 A haircut, in the financial industry, is a percentage discount that's applied informally to the market value of a stock or the face value of a bond in an attempt to account for the risk of loss that the investment poses.

31 ECB Press Release, Measures to further expand the collateral framework and enhance the provision of liquidity, 15 October 2008

32 ECB Press Release, Longer-term refinancing operations, 7 May 2009

33 Jean-Claude Trichet, The financial crisis and our response so far, Keynote address by Jean-Claude Trichet, President of the ECB, at the Chatham House Global Financial Forum, New York, 27 April 2009

34 Federal Reserve, Monetary Policy Press Release, 16 March 2008; Federal Reserve, Monetary Policy Press Release, 2 May 2008; Federal Reserve, Monetary Policy Press Release, 14 September 2008; Federal Reserve, Monetary Policy Press Release, 19 December 2008

35 Reuters, ECB to buy covered bonds, 7 May 2009

36 *Financial Times*, The economic crisis has ECB policymakers boxing clever, 20 May 2009

as a response to the dollar liquidity crisis in mid-to-late 2008 when many investors simultaneously sought to invest in what is generally regarded as the world's safest currency. On 15 October 2008, the Bank of England, ECB and Swiss National Bank agreed to provide an unprecedented $250bn in dollar liquidity to European markets.[37] Most recently, the ECB announced an €80bn swap line with the Federal Reserve due to last until 30 October 2009.[38]

The consequence of the ECB's liquidity and currency swap measures was that by October 2008, European banks could effectively obtain unlimited liquidity across a wide range of term lengths, using an array of euro-denominated collateral and in any of the major global currencies. José Manuel González-Páramo, Member of the Executive Board of the ECB Universidad de Alcalá de Henares, explained that:

> Overall, the scope of the decisions taken in October 2008 should not be underestimated. As a result of such decisions, euro area banks can now borrow from the ECB as much euro and USD liquidity as they wish, also at some key term maturities, of course against eligible euro-denominated collateral. The new set of temporary measures provide an important contribution to mitigating the funding risks of solvent banks in the euro area, while also contributing to restore confidence among market participants in the current environment in which money markets remain under stress and the traditional channels of liquidity transmission are impaired. While it is too early to assess the impact of such measures, there is evidence that these operations have had a positive on the term spreads, which have now moderated from the peaks recorded right after the Lehman Brothers' bankruptcy (though they still remain at high levels by historical standards).[39]

2.3 Asset purchases

Although the ECB has recently considered "printing money" to purchase assets,[40] it has reiterated its belief that its large-scale short- and long-term liquidity facilities are more appropriate for the European financial model.[41] Unlike the central banks of Japan, the UK and US, the ECB has been reluctant to pursue a policy of expanding its balance sheet to purchase government (and other) securities. This approach is known as quantitative easing, although it has also been referred to as an aspect of "credit easing" by Federal Reserve Chairman Ben Bernanke.[42]

So far, the ECB has limited its asset purchases to the announcement on 7 May 2009 that the ECB intends to purchase €60bn of euro-denominated covered bonds (a particularly safe form of asset-backed security[43]) from primary and secondary markets.[44] The operational details of

---

37 *Financial Times*, European central banks pump $250bn liquidity, 15 October 2008

38 ECB Press Release, Central banks announce expanded swap arrangements, 6 April 2009

39 José Manuel González-Páramo, Liquidity, funding and solvency: Policy responses and lessons, Speech by José Manuel González-Páramo, Member of the Executive Board of the ECB Universidad de Alcalá de Henares, Madrid, 16 January 2009

40 *Financial Times*, The economic crisis has ECB policymakers boxing clever, 20 May 2009

41 Jean-Claude Trichet, The financial crisis and our response so far, Keynote address by Jean-Claude Trichet, President of the ECB, at the Chatham House Global Financial Forum, New York, 27 April 2009

42 Ben Bernanke, "The Crisis and the Policy Response", Speech at the Stamp Lecture, London School of Economics, London, 13 January 2009

43 An asset-backed security is a financial asset that pools together a large number of assets to create a security backed by a large number of interest-yielding assets as collateral. ABSs are often divided into homogeneous or heterogeneous portions (or tranches) for sale to a number of investors. The asset, or one of its tranches, may be bought and sold on the market, or purchased to pay periodic interest in exchange for a fee. The cost of purchasing an ABS reflects its risk profile. In theory, by pooling assets the security becomes more attractive because of the fall in the risk of a substantial default. However, the expected return to the asset will remain unchanged.

44 Reuters, ECB to buy covered bonds, 7 May 2009

the programme, which permits that ECB to purchase a wide variety of covered bonds, were published on 4 June.[45] Trichet, who denied that this policy amounted to quantitative easing, explained:

> The idea is to revive the market, which has been very heavily affected, and all that goes with this revival, including the spreads, the depth and the liquidity of the market. We are not at all embarking on quantitative easing.[46]

The *Financial Times* has suggested that the move may revitalise mortgage and public infrastructure markets:

> The ECB will buy €60bn ($81.6bn) in covered bonds, a 340-year-old asset class that, before the credit crisis, was widely used by banks to create bonds backed by mortgages or public sector loans.
>
> It is hoped the move will revive the €1,100bn market, which has been one of the biggest casualties of the financial crisis and in the process boost the European economy and housing market. The European covered bond market has shrunk by €200bn since August 2007, according to Dealogic.[47]

The purchase of these bonds is regarded as a further component of the ECB's wider policy of "enhanced credit support", which is designed to ensure that banks continue to supply businesses with the requisite funds.[48] The bond markets have generally responded well to the news: the *Financial Times* notes that the covered bond market has significantly increased trading since the announcement.[49]

The ECB's purchase has been criticised by some for being too cautious – it only represents 5% of the total covered bond market.[50] On the other hand, German Chancellor Angela Merkel attacked the policy for being too expansionary: Merkel argued that the combination of expansionary monetary and fiscal policies could sow the seeds of another crisis, and also questioned the capacity of the ECB to effectively unwind the expansion in a non-inflationary manner.[51] Furthermore, accusations of bias may arise depending on which countries benefit most from the purchase of the bonds – for example, the housing markets of Ireland and Spain could disproportionately benefit from the purchases.

Although the ECB has yet to purchase any covered bonds (purchases are due to start in July 2009 and continue until June 2010[52]), its balance sheet has nevertheless significantly expanded in response to the dramatic increase in the ECB's lending functions.[53]

Unlike the Bank of England, which required government authorisation to create money, asset purchases have always been an option available to the ECB. Given that it is expected that

45 ECB Press Release, Purchase programme for covered bonds, 4 June 2009

46 *Financial Times*, ECB opts for low risk, 11 May 2009

47 Ibid.

48 Lucas Papademos, Monetary policy and the 'Great Crisis': Lessons and challenges, Speech by Lucas Papademos, Vice President of the ECB at the 37th Economics Conference "Beyond the Crisis: Economic Policy in a New Macroeconomic Environment" organised by the Österreichische Nationalbank, Vienna, 14 May 2009

49 *Financial Times*, Covered bonds revived by ECB buying spree, 19 May 2009

50 *Financial Times*, ECB opts for low risk, 11 May 2009

51 *Financial Times*, Berlin breaks the unwritten rule, 3June 2009

52 ECB Press Release, Purchase programme for covered bonds, 4 June 2009

53 OECD, Interim Economic Outlook, March 2009, p41

Eurozone inflation will become negative over the summer of 2009,[54] there may be additional pressure and expectation for the ECB to pursue asset purchase schemes further.

2.4 Overview

The ECB has employed a number of policy tools in its attempts to resist the financial crisis. Many of its actions have mirrored those taken by the Bank of England, Bank of Japan and the US Federal Reserve; however, the ECB has generally acted in a more conventional fashion and has implemented most measures after other foreign central banks. The most significant action undertaken by the ECB has been its decision to provide unlimited long-term liquidity to a wide array of financial institutions.

Looking at central banks across Europe more broadly, the IMF finds that:

> Central banks are providing liquidity at longer maturities and are accepting a wide range of collateral in repurchase operations, including assets for which markets have essentially ceased to operate. In addition, most countries have adopted measures to guarantee wholesale funding and provide support for recapitalizing banks deemed viable. However, U.S.-originated toxic assets still must be cleaned off bank balance sheets, which is key to rebuilding confidence in banking systems. To achieve this, countries will need to devise and coordinate pricing mechanisms, and the European Commission and the ECB have offered guidance on how to achieve this. However, coordination has been far from optimal. Policymakers were repeatedly surprised by the virulence of the crisis and succumbed to national reflexes to "go it alone" in cobbling together responses that undermined rather than enhanced other countries' interventions, failing to live up to the May 2008 Economic and Financial Affairs Council (ECOFIN) commitments for crisis prevention, management, and resolution.[55]

Some commentators have criticised the ECB for being "behind the curve" and excessively cautious in its response to the financial crisis, when compared with the central banks of Japan, the UK and US.[56] However, the ECB counter-claims that its policies have been relatively successful in stabilising the European financial system:

> How effective have the ECB polices been in mitigating the impact of the crisis on the financial system and the economy? We can assess this by first examining the effects of the measures taken on the money and credit markets. The provision of unlimited amounts of liquidity (against adequate collateral) in the interbank money market and the sharp reduction in the ECB's key policy rates to exceptionally low levels have resulted in a significant improvement in money market conditions. This has contributed to the financing of the economy and has helped to contain the impact of the crisis on economic activity and price developments. The spread between the three-month unsecured money market rate, Euribor, and the three-month overnight index swap rate (Eonia swap rate), a widely-used measure of interbank market tensions, declined by almost 130 basis points over the past seven months, from the highs of above 180 basis points recorded in October 2008 to just below 60 basis points in mid-May 2009. Moreover, the levels of money market rates have declined even more from the peaks reached last October. For example, the three-month Euribor rate was 1.26% at the beginning of this week (26 May), more than 400 basis points lower that its peak value (5.39%) last October. Moreover, the increasing transaction volumes in the

[54] *Financial Times*, Negative German inflation adds to ECB fears, 28 May 2009

[55] OECD, Interim Economic Outlook, March 2009, p83

[56] *Wall Street Journal*, ECB's Work Isn't Yet Done, 6 May 2009; Paul Krugman, *New York Times*, A Continent Adrift, 16 March 2009

unsecured interbank market and the lower utilisation of the ECB's deposit facility indicate that market liquidity has improved significantly.

It is sometimes claimed that money market conditions in the euro area are considerably tighter than in other major money markets. The facts disprove such assertions. The current levels of interest rates in the euro money market compare very favourably with the levels of the corresponding interest rates in the dollar and pound sterling money markets, where interest rate spreads and levels have also declined sharply over the past few months. For example, the level of the six-month Euribor rate at the beginning of this week (1.46%) was only somewhat higher than the corresponding Libor rate (1.22%) in the US dollar money market. Therefore, effectively, over the past seven months, conditions in the euro area money market have improved substantially and they are broadly comparable to those in other major money markets, despite the higher level of the key policy rate of the ECB (the interest rate on the main refinancing operations (MRO) of the ECB). This outcome reflects the extremely low level (0.25%) of the ECB's deposit rate and the Bank's management of liquidity in the interbank money market.[57]

3 Domestic government financial responses

As in the UK and US, European governments have acted to support to the financial sector. This support has included recapitalisation, asset purchases, credit guarantees and enhanced deposit insurance, although responses have varied considerably across countries.

3.1 Bank recapitalisation

Fortis: the first European bailout

Large capital injections began in Europe when, on 28 September 2008, Belgium, Luxembourg and the Netherlands jointly announced an €11.2bn investment in the Benelux bank Fortis. Fortis had suffered from the purchase of Dutch bank ABN-AMRO's retail activities in the Benelux region, which subsequently required significant write-downs. By September, the market was seriously questioning Fortis's solvency as rumours of insolvency led depositors to redeem their funds; accordingly, Fortis suffered an acute liquidity crisis. The initial terms of the capital injections were such that the Belgian and Dutch government would receive 49% stakes in the Belgian and Dutch arms of the banks; Luxembourg's government offered a loan that could be converted into a 49% equity stake if necessary.[58]

On 3 October, the Dutch government instead announced the full purchase of the Dutch banking and insurance components of Fortis for €16.8bn.[59] The Luxembourg government also increased its purchase to obtain 52% of Fortis's Luxembourg branch. However, as complications in the deals made with the Belgian and Luxembourg authorities emerged, it was instead decided that French bank BNP Paribas would take a majority stake in the remaining retail operations, leaving the Belgian and Luxembourg governments with minority stakes in Fortis and BNP Paribas through a complex web of asset transactions.[60] After a complicated set of legal disputes, Fortis now remains only as a Belgian insurance firm.

---

57 Lucas Papademos, Monetary policy and the 'Great Crisis': Lessons and challenges, Speech by Lucas Papademos, Vice President of the ECB at the 37th Economics Conference "Beyond the Crisis: Economic Policy in a New Macroeconomic Environment" organised by the Österreichische Nationalbank, Vienna, 14 May 2009

58 Fortis Press Release, Governments of Belgium, Luxembourg and the Netherlands invest EUR 11.2 billion in Fortis, 29 September 2008

59 Fortis Press Release, Fortis statement on transaction with Government of the Netherlands, 3 October 2008

60 Fortis Press Release, Fortis confirms sale of Banking and Belgian Insurance activities, 6 October 2008

Subsequent bailouts

Since Fortis, many European governments – including France, Germany, Ireland, Italy, Sweden, Switzerland and the UK – have recapitalised their financial institutions. On 12 October, the 15 Eurozone countries unveiled a coordinated plan, akin to that employed by the UK, to provide banks with additional capital.[61] Recapitalisation has taken place under systematic government schemes but also on an *ad hoc* basis. Most notable among the institutions to receive firm-specific government capital injections were:

- Belgian bank KBC has received two bailouts totalling €5.5bn;
- Dexia obtained €6.4bn from the Belgian, French and Luxembourg governments;
- Dutch savings bank ING received €10bn;
- Dutch insurance firm Aegon got €3bn;
- Ireland's Bank of Ireland accepted €3.5bn; and
- Switzerland's investment bank UBS received SFr6bn.

Germany's €80bn recapitalisation fund, authorised by the Financial Market Stabilisation Law,[62] has so far dispensed €23bn in capital. Germany, in particular, favoured combining capital injections with significant credit guarantees – BayernLB, for example, received €10bn in capital, credit guarantees worth €15bn and a risk shield costing €4.8bn in addition to capital.

As of 8 April 2009, the European Commission calculated that Member States have spent a combined total of €312bn on recapitalisation measures; of this, the Commission has approved recapitalisation schemes in 11 Member States amounting to a total of nearly €274bn – the rest comprises firm-specific government guarantees and recapitalisations.[63] More detailed tables containing country-specific recapitalisation measures are available in the Commission's report.[64]

Some national governments have been forced to fully or partially nationalise some of their financial institutions. As was the case with American International Group, Fannie Mae and Freddie Mac in the US and Bradford and Bingley and the Royal Bank of Scotland in the UK, there are also European examples. In the Netherlands, Fortis's Dutch branch was taken under full government control; Ireland has taken 75% ownership of the Anglo Irish Bank; and Iceland took at 75% stake in Glitnir (before it entered receivership) and later fully nationalised Landsbanki. There is Library Standard Note available which details the banking problems, and responses, in Iceland – a nation that was hit particularly hard by the financial crisis.[65]

---

[61] European Commission, Summit of the Euro Area Countries: Declaration on a Concerted European Action Plan of the Euro Area Countries, 12 October 2008

[62] German Federal Government, German government agrees to set up financial market stabilisation fund, 17 October 2009

[63] European Commission, Special edition on State aid interventions in the current financial and economic crisis, COM(2009) 164, 8 April 2009, pp.19-21

[64] Ibid., pp18-21

[65] House of Commons Library, Iceland's Financial Crisis, SN/IA-5032, 27 March 2009

3.2 Toxic assets

Although devising strategies to address toxic assets has been entrusted to individual governments in the EU, the European Commission has suggested a number of methods by which Member States may combat the problem: "state purchase, state guarantees, swapping or a hybrid arrangement."[66]

So far, no Eurozone country except Germany has implemented an asset insurance (or guarantee) scheme, akin to the ones employed in the UK and US. In both the UK and the US, participating banks have been able to ring-fence a pool of toxic assets in exchange for an insurance fee; although participation conditions have varied on a case-by-case basis, it is generally agreed in advance that the state will be liable to fully or partially insure participants against losses on the ring-fenced assets beyond a given loss threshold.

The regional government of North Rhine-Westphalia provided stated-owned commercial bank WestLB with a €23bn guarantee on a portfolio of toxic assets in exchange for a €5bn fee in February 2008.[67] On 17 October 2009, the German government announced a formal scheme worth €80bn as part of its Financial Market Stabilisation Law; the Federal and regional Governments would either purchase, or assume liability for losses on, assets facing write-downs in exchange for a fee.[68] On 21 October 2008, BayernLB paid the German government €4.8bn to receive €20bn protection against further write-downs on a portfolio of asset-backed securities. A number of institutions since partook in the scheme; HSH Nordbank, for example, received capital of €3bn and insurance against €10bn of losses on a broad asset portfolio (after an initial €3.2bn was covered by the bank itself) in exchange for equity.[69]

Germany has also recently drafted legislation proposing the creation of a "bad bank" to hold toxic assets. On 12 May 2009, Peer Steinbrück, Germany's finance minister, proposed a system whereby banks could exchange bad assets for government bonds at 90% of their book value; furthermore, the bad assets would then be ring-fenced in a special purpose vehicle for an insurance fee, although participating banks also face compensation charges to be determined by auditors where the assets make losses. The *Financial Times* strongly criticises the voluntary scheme, suggesting that it lacks the incentives for bank participation:

> There are three problems with his arrangement. First, there is no advantage for a bank to push its bad loans out the door if it still has to cough up the difference if their value then falls. Shareholders suffer the same whether the bad loans are on or off balance sheet. Second, why should a bank pay extra for this? There is no point. Third, as the scheme is voluntary, no private sector bank in its right mind would join. There is no incentive to do so.[70]

However, the scheme does have the advantage that firms can remove these assets, which attract significant capital charges, from their balance sheets and thus free up additional space for lending.

66 European Commission, Driving European Recovery, COM(2009) 114, 4 March 2009, p4
67 *Wall Street Journal*, EU orders WestLB overhaul, opens probe into BayernLB, 13 May 2009
68 German Federal Government, German government agrees to set up financial market stabilisation fund, 17 October 2009
69 EU Europa website, State aid: Commission endorses rescue aid for German HSH Nordbank, 29 May 2009
70 *Financial Times*, German bad banks, 12 May 2009

3.3 Guarantees

Another popular tool has been the use of policies to guarantee wholesale and interbank lending. A number of governments implemented such policies in October 2008. The French scheme will issue up to €320bn in five-year guarantees for collateralised interbank lending before 31 December 2009. The German government has also promised to provide up to €400bn in interbank lending guarantees, including €42bn for Hypo Real Estate[71] and €15bn for BayernLB;[72] a further €100bn was extended in loan guarantees to small firms struggling to gain credit as part of January 2009's fiscal stimulus.[73] In the UK, the Treasury announced the £250bn Credit Guarantee Scheme which offers to guarantee the debt issuance of large banks seeking to replenish their Tier 1 capital;[74] the Government later offered a guarantee to the lender covering 75% of a loan made to a small business or social enterprise.[75]

A number of other European countries – including Sweden, who had experienced their own banking crisis in the early 1990s – pursued similar forward-looking strategies. However, Denmark and Ireland also chose to guarantee some retrospective wholesale lending. As the OECD identifies, very few European countries have not decided to pursue this line of action.[76]

Ireland, Greece, and Germany have dramatically increased their guarantees to depositors in an effort to improve liquidity in the financial system. Ireland's Irish Government Bank Guarantee Scheme was particularly notable as it provided unlimited deposit insurance across a range of deposits types until 29 September 2010.[77] Subsequently, on 7 October 2008, the EU as a whole adopted a minimum level of insurance at €50,000 in order to curtail regulatory competition for depositors (an EU Directive, coming into force from December 2010, has since raised the minimum level to €100,000).

3.4 Short-selling

Short-selling – a method of betting that a stock price would decline in value – was widely believed to have accentuated the problems facing the financial institutions such as Lehman Brothers by allowing hysteria about such institutions to translate into dramatic falls in stock prices. Many countries responded by issuing temporary bans on the short-selling of financial institutions.

3.5 Overview

The Table below provides a summary of the responses of European countries across a number of key policy areas.

Financial policy matrix

▲ denotes a plan to implement such a policy

	Capital injections	Purchase toxic assets	Insure/ guarantee toxic	Increase bank deposit	Lending guarantees	Restrict short-selling

[71] Bloomberg, Hypo Real Estate Gets EU12 Billion as Capital Talks Continue, 21 January 2009
[72] *Financial Times*, Top bankers fall as state steps in, 14 October 2008
[73] BBC, Germany agrees 50bn euro stimulus, 13 January 2009
[74] HM Treasury, Financial support to the banking industry, 8 October; HC Deb 8 October 2008 c277-80
[75] Business Link, Enterprise Finance Guarantee, retrieved 15 June 2009
[76] OECD, Interim Economic Outlook, March 2009, p34
[77] SI 411 of 2008 - Credit Institutions (Financial Support) Scheme 2008

			assets	insurance		
Major non-Eurozone						
Japan	▲				▲	▲
UK	▲		▲	▲	▲	▲
USA	▲	▲	▲	▲	▲	▲
Selected Eurozone						
Austria	▲			▲	▲	▲
Belgium	▲			▲	▲	▲
Finland	▲			▲	▲	▲
France	▲			(already high)	▲	▲
Germany	▲	▲	▲	▲	▲	▲
Greece	▲			▲	▲	
Ireland	▲			▲	▲	
Italy	▲			▲	▲	▲
Netherlands	▲			▲	▲	▲
Portugal				▲	▲	
Spain		▲		▲	▲	▲
Selected others						
Czech Rep						
Denmark	▲			▲	▲	▲
Iceland	▲			▲		▲
Norway	▲	▲		(already high)	▲	
Spain		▲		▲	▲	▲
Sweden	▲			▲	▲	
Switzerland	▲	▲		▲		

Sources: Table is adapted from a number of sources including: Ingo Fender and Jacob Gyntelberg, Overview: global financial crisis spurs unprecedented policy actions, BIS Quarterly Review, December 2008, p11; OECD, Interim Economic Outlook, March 2009, Table 1.4; European Commission, Special edition on State aid interventions in the current financial and economic crisis, 8 April 2009, pp15-16

The European Commission has reported that crisis spending in the EU amounts to approximately €3tr:

> The total maximum volume of crisis measures so far approved by the Commission, schemes and *ad hoc* measures taken together, entails amounts of around € 3,000 billion. This corresponds to around 24% of the EU GDP. This figure represents the overall maximum amount of guarantee umbrellas, rescue and restructuring packages and other measures set up by Member States.[78]

Furthermore, the maximum value of the guarantee schemes reviewed by the Commission is estimated at €2.3tr. A table listing these guarantees in more detail is available in the Commission's report.[79]

78 Ibid., p15
79 Ibid., pp17-18

4 Stimulus packages

While mainland Europe generally operates more potent automatic stabilisers – the tax and benefits systems that stabilise the output gap by increasing (decreasing) disposable income and thus consumption during the bust (boom) period of an economic cycle – than Anglo-Saxon economies, some European governments have decided that a discretionary fiscal stimulus is necessary to support their domestic economies. Fiscal policy becomes all the more important given that economies in the Eurozone cannot operate an independent monetary or exchange rate policy able to cater to the specific needs of their domestic economy. The European Commission estimated in March 2009 that the total fiscal effort (including automatic stabilisers *and* discretionary spending) would amount to more than €400bn, or 3.3% of EU GDP.[80]

Fiscal spending in response to the crisis has largely been lead by national governments, given that the EU's discretionary budget is relatively small compared to that of national governments. However, on 26 November 2008, the European Commission proposed the European Economic Recovery Plan where Member States would contribute 1.5% of GDP (of national government and EU monies) to fund cross-border projects including significant investment in clean energy and telecommunication infrastructure. The plan aimed to provide a fiscal boost at a time when monetary policy was looking relatively impotent, while simultaneously investing in the long-term future of the European economy.[81] On 12 December, the Council of the European Union (or the Council of Ministers) approved the strategy designed to stimulate consumer and investment spending. The Plan, worth around €200bn, would be coupled with continuing interest rate reductions, increases in benefits and a temporary suspension of the Stability and Growth Pact (which requires governments to restrict their budget deficits). In accordance with the Plan, many European countries subsequently passed significant fiscal stimulus packages.

4.1 Germany

Although German Chancellor Angela Merkel was initially dismissive of the need for fiscal stimulus (bearing in mind Germany's troubles with balancing its budget), Germany has passed two stimulus packages. The first, in November 2008, set aside €32bn for public infrastructural investment. The plan reportedly included a pledge by Germany's largest companies to avoid mass job cuts in return for an increase in government subsidies for employees placed temporarily on short work weeks or on lower wages.[82] The second package – a response to the seeming paucity of the first stimulus measure – was passed in January 2009 and allocated €50bn to public investment in railways, roads and schools, as well as tax relief measures.[83]

4.2 Spain

On 27 November, the Spanish government set out details of an €11bn stimulus package, which aimed to create 300,000 jobs. The plan aimed to boost local public works – especially construction and infrastructure – and support the ailing automobile industry.[84] Combined with a stimulus package earlier in 2008, Spain has spent approximately €40bn on stimulating its economy, which had been particularly dependent on a now-extinct construction boom.

---

[80] European Commission, Communication of 4 March 2009 "Driving European recovery", COM(2009) 114, 4 March 2009

[81] European Commission, Driving European Recovery, COM(2009) 114, 4 March 2009, p8

[82] *Financial Times*, German Stimulus Offers Job Promise, 16 December 2008

[83] BBC, Germany agrees 50bn euro stimulus, 13 January 2009

[84] *The Times*, Spain injects €11bn into struggling economy, 27 November 2008

4.3 France

On December 4, 2008, French President Nicolas Sarkozy announced a €26bn package of stimulus measures to accelerate planned public investments. The package is focused primarily on infrastructure projects and investments by state-controlled firms – including a canal north of Paris, renovation of university buildings, new metro cars, and the construction of 70,000 new homes – in addition to 30,000 unfinished homes the government committed to buy in 2009. The plan also included a €200 payment to low-income households and €10bn in measures to increase firm liquidity.

4.4 Elsewhere in Europe

Other European nations including Belgium, Italy, the Netherlands, Norway, Portugal, Sweden and Switzerland have launched smaller fiscal stimulus plans – primarily, these have intended to bolster public investment. A Library of Congress article, entitled *Fiscal Stimulus Plans: Recent Developments in Selected Countries*, provides useful links to more detailed outlines of stimulus measures in major global economies.[85]

US economist Paul Krugman has suggested that Europe's fiscal response has been too small – particularly when set alongside the US's $787bn American Recovery and Reinvestment Act that was signed into law by President Barack Obama on 17 February 2009.[86] However, Lorenzo Bini Smaghi of the ECB has responded by highlighting that Europe's fiscal stimulus is in fact of comparable magnitude:

> …the fiscal stimulus in European countries is wholly comparable to that seen in the United States, particularly when taking into account measures to cushion the effect of automatic stabilisers, which, by contrast with the United States, are a major factor in Europe. For instance, for the period 2009-10, discretionary measures adopted in Germany total 3.5% of GDP, compared with 3.8%in the United States. In some European countries, such as Italy, the size of such stimulus measures is relatively limited owing to the high levels of debt, but in other countries the total fiscal stimulus is larger than in the United States.[87]

5 An early policy assessment

Using NiGEM, an econometric model of the macroeconomy, a group of academics have attempted to assess the impact of policy responses to the financial crisis on economic growth. Stripping out the individual impact of each of the key policy decisions made in 2008, we see that Europe's relative inaction had little tangible effect upon growth rates:

> Policy actions in the Euro Area had little impact in 2008 in part because there was little fiscal or monetary response until the end of the year. Figure 3 plots the potential path for output with no responses. The coordinated interest rate response at the end of 2008 probably added almost half a point to Euro Area growth in 2009, offsetting the negative competitiveness effects of the cut in US rates a year earlier. The fiscal policies described above have probably added just above another half a point to growth in 2009; growth will also be stronger in 2010 as a result of these policies. The collapse in trade as a result of the US recession plus the domestic problems facing the European economies would have left the Euro Area with a contraction as large as 3 per cent if there had been no reaction. Although some of this may be a change in the trend level of output, most will reflect the opening of a gap between sustainable and

85 Library of Congress, Financial Stimulus Plans: Recent Developments in Selected Countries

86 Paul Krugman, *New York Times*, A Continent Adrift, 16 March 2009

87 *La Repubblica*, Letter from Lorenzo Bini Smaghi, 19 March 2009

> trend output, and as we argue in Barrell *et al*. (2009), a credit crisis is just the time when fiscal policy is most effective and the gains now exceed the reversals when debts are paid back. There is clearly scope for a further coordinated fiscal expansion.[88]

However, it is important to recognise that such macroeconomic models are difficult to calibrate to accurately reflect true economic interactions. Furthermore, financial variables have not traditionally been recognised as important determinants of wider economic phenomena in such models.

88 Ray Barrell, Tatiana Fic and Dawn Holland, “Evaluating Policy Reactions to the Financial Crisis”, *National Institute Economic Review 207*, January 2009, pp39-42