Involving European citizens in the benefits of the rescue plan: The political paradoxes of bank socialism

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Are EU citizens ready to accept the crisis rescue plan that makes massive transfers of resources from taxpayers to the banking sector? This column proposes three ways to share the rescue's benefits with citizens: increased competition in the banking sector, tax reductions for low-wage earners, and temporary relief schemes for families with mortgage problems.

Leaders of the Eurozone finally agreed on a plan. It is a very ambitious rescue plan – as it should be – to stop the self-fulfilling prophecies that brought us to the brink of another Great Depression. But it should now be made acceptable to European citizens.

Making the rescue acceptable to European citizens

In the next couple of weeks we shall see how effective these extreme measures are in reducing the spread between Euribor and the ECB refinancing rate. If they are successful, there will be no need to implement these measures. If they are not, public debts in the Eurozone are bound to skyrocket. If they only partly succeed in reassuring markets, there will be sizeable outlays to the banking sector. The insurance on the interbank market is potentially very costly – before the crisis the overnight volumes in many Eurocountries were of the order of 1-2% of GDP – while the bank recapitalisation plans commit so far up to 20% of the Eurozone GDP and this share is bound to increase further as national plans are unveiled and countries are forced to raise capital to match the core tier one levels of UK banks (too bad that there was no cross-country co-ordination in this respect!).

Is the public in EU countries ready to accept such potentially massive transfers of resources from taxpayers to the banking sector?

True, it is mainly gross debt that will increase. If the banking equity is later sold for a profit, net public debts may actually go down when the crisis is over. It is also true that by saving the banking system, we ultimately save our economies and million of jobs. Nonetheless, there is a non-negligible risk that plans committing this size of resources will encounter strong opposition in national parliaments. Paradoxically, the opposition to "bank socialism" is likely to come mainly from the ranks of the former supporters of the socialisation of the means of production.

Wealth distribution effects of stock market price drops

So far, the crisis has served to reduce wealth inequalities in Europe. This is due to the relatively low participation of households in financial markets and the relatively low take-up of pension schemes. Micro data on wealth assembled in the Luxembourg Wealth Study project suggest that a reduction of 40% in stock prices significantly reduces wealth of about 6% of Italian families compared to almost 30% of families in the US. The average wealth loss for those hit by the fall in stock prices is also lower in Italy (roughly 5% compared to almost 10% in the US). No doubt, measures dealing with the stock market crash will be perceived as measures benefiting the top deciles – Wall Street against Main Street – and even more so in Europe than in the US.

Another reason why these measures will be hard for the public to swallow is that the Eurozone package postponed much-advertised measures "punishing the bankers". There is a clear sequencing in the international package:

- First, rescue financial systems in order to restore confidence in the markets;
- Next, work on avoiding that all this happens again.

This was the right thing to do.

Mixing up the two phases could backfire, as the current priority is to anchor expectations to rule out domino effects such as those following the failure of Lehman Bros. However, are European citizens ready to accept measures rescuing banks, giving public money to bankers while deferring the punishment of those who were before the crisis earning up to $50 million (Richard Fuld's compensation in 2007) and for banks that were making profits (before the crisis) amounting in some cases to almost 0.5% of GDP (e.g. Unicredit and Banca Intesa)? Are the people ready to accept all this after the last decade's huge increase in income inequalities, driven by the gains of the richest 1% of the population (whose share in total income more than doubled in countries like the US)?

In the last few weeks, economists have been rather successful in inducing governments to come to terms with the financial crisis. At times of extraordinary politics, they were taken extraordinarily seriously by policy-makers, forcing many of them (including George Bush and Angela Merkel) to do embarrassing U-turns. Economists should now be equally effective in addressing the rescue plans' political constraints and in devising ways to involve European citizens in the benefits of this plan. Here are three options to be considered.

Three options for sharing the rescue's benefits with European citizens

> *1) There is an alternative way to punish banks and bankers that can be implemented immediately – increasing competition in the banking sector.*

After experiencing a major liquidity crisis, banks will compete more to attract savings from the households. Removing barriers to competition in the retail sector would drive down profit margins and improve services for citizens. More contestability should also be allowed. Angela Merkel's initial reluctance to accept a European initiative was due to the fear that other countries could put their hands on German banks. The way out of the crisis will involve a fair amount of bank restructuring. National protections against mergers and acquisitions could severely hamper this process and hence should be removed as soon as possible.

> *2) Governments have not been at all active in Europe in providing support to low-income families with housing mortgages.*

True, the problems are not as acute as in the US, but the increase in Euribor rates (to which monthly mortgage rates are often indexed) is significantly increasing the number of poor families with problems in paying their mortgages. Temporary relief schemes for these families should be devised as long as the rates decline. They should be narrowly targeted to minimise costs and moral hazard problems applied to a large population, but they should be implemented.

> *3) There is also scope for implementing tax reductions for low-wage earners.*

These measures would kill two birds with one stone.

- They would increase the progressiveness of taxation, reducing opposition to the iniquities of bank socialism.
- They would help anchor expectations to a moderate output fall, as the current lack of confidence is also driven by the belief that the crisis will now spread to firms and households leading to a deflationary trap.

Tax deductions for low-income earners have the advantage of acting on both sides – demand and supply. They increase demand as they target the households with the highest propensity to consume and increase supply because induce more people to work without increasing firms' labour costs. As these measures could reduce the informal sector, they would also have a limited impact on the budget.

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