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CPB Newsletter

2009 September 3

CPB Netherlands Bureau for Economic Policy Analysis

Bankruptcy legislation for banks inevitable

Coen Teulings

Last year's credit crisis has caused many victims. One of these was the German bank Hypo Real Estate. At the beginning of 2009, the bank was facing a bankruptcy. The German government was prepared to act as the ministering angel to bail out the bank. But there was a problem. Only one year earlier, the American investor JC Flowers had taken an interest — to the tune of one billion dollars — in the bank. At the beginning of 2009, the German government was prepared to pay Flowers only several tens of millions of dollars for his interest. That was not enough for him, and he refused to sell his shares. Flowers hoped that the bank would survive anyway. In that case, he could receive much more money for his shares. Eventually, separate legislation was passed that gave the German government the right to expropriate the bank, if deemed necessary. Only this threat made JC Flowers agree.

Flowers saw no good in the bid made by the German government. Obviously, he really wanted a higher bid, but why did he prefer to run the risk of bankruptcy rather than agree to a guaranteed rescue? This is why: tremendous social damage lays in the wake of the bankruptcy of a major bank. The fall of Lehman Brothers on September 15th, 2008 was a striking example of this damage. That bankruptcy started a chain reaction causing a total disruption of the world economy. Hence, governments must save banks— and creditors of banks know this. They will therefore expect the government to bail out troubled banks by using tax money (the exception being the Lehman case, of course). Such potential intervention offers exquisite opportunities to shareholders. By taking large risks in investing creditors' money, they make quite a risk-less bet: in the case of a profitable investment, they win the first prize; in the case of a loss, however, the taxpayer pays the bill. In normal times this is less important because a bank then has sufficient equity capital to cover its losses. But just before an impending collapse, these reserves have dried up. Then, the supervising authority has to ask for a supplement of the equity capital for covering the losses in case of setbacks, so that the taxpayer is protected. This supplement of equity capital, however, is not in the interest of the current shareholders. They prefer to gamble on the costs of taxpayers. Additional equity merely reduces their implicit claim on taxpayers. Only constraint can persuade current shareholders. That's why separate bankruptcy legislation for banks, accompanied by possibilities for nationalising them in case of failing, is so important. Which is it to be, the carrot or the stick? This is one of the most important lessons to be learnt from the credit crisis.

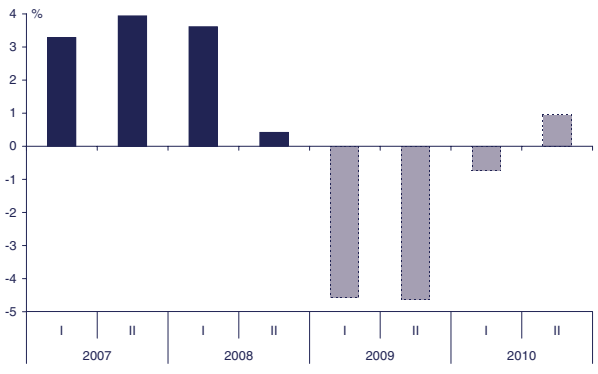
Coen Teulings, director

CPB's short-term forecasts September 2009

- The Dutch economy will decline by 4¾% in 2009, a postwar record. Economic activity is expected to remain stable in 2010.
- Last November, December and January world trade collapsed. This collapse will cause exports of goods to decrease by 13¾% in 2009.
- In two years' time the unemployment rate doubles, from 3.9% on average in 2008 up to 8% on average in the forecast for 2010.
- Inflation will drop to 1% this and next year. Contractual wage growth in the market sector will still be 3% in 2009, but is expected to slow down to 1½% on average in 2010.
- Government budget deficit will be 4.6% GDP this year. The deficit can increase to 6.2% GDP in 2010.

For the main economic indicators for the Dutch economy, see the back page or www.cpb.nl.

Economic growth in the Netherlands, 2007-2010 [a]



[a] GDP volume growth rate compared to corresponding period in the previous year.

Recent Publications

JUNE 2009 – SEPTEMBER 2009

The following list provides an overview of recent CPB publications that have appeared in English between June and September 2009. All publications can be downloaded at www.cpb.nl. An English press release on these publications is sometimes available at the website.

Special publications

The great recession — CPB about the credit crisis (only in Dutch)

September 2009
www.degroterecessie.nl

'The great recession' is a book for the general public in which CPB explains the causes and consequences of the fiercest crisis of our time. How could a relatively small shock on the American housing market cause the collapse of world trade? How long will the crisis last and what are the long-term economic consequences? A special website provides summaries of each individual chapter, plus background information, also in English. www.degroterecessie.nl.

Forecasts

Macro Economic Outlook 2010 (MEV, only in Dutch)

September 2009
johan.verbruggen@cpb.nl

The MEV 2010 describes the situation for the Dutch economy and the international economy, and presents forecasts for economic developments in 2009 and 2010. The accompanying English-language press release provides an overview of the forecasts.

CPB Documents

186. An analysis of individual accounts for the unemployment risk in the Netherlands

Egbert Jongen, June 2009
egbert.jongen@cpb.nl

See article on page 3.

190. Market performance and distributional effects on renewable energy markets

Paul Koutstaal, Michiel Bijlsma, Gijsbert Zwart, Xander van Tilburg (ECN) and Özge Özdemir (ECN), August 2009
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A renewable obligation (RO) combined with tradable renewable energy certificates is a market-based instrument used to promote the production of electricity from renewable energy sources and is an alternative for subsidies. This obligation will only function if certificate markets are efficient and requires that there is no market power and no anti-competitive behaviour on the certificate market. If current developments in Dutch renewable energy production continue, market power on a future renewable certificate market in the Netherlands will probably not be an issue, even if the RO should only rest on the retail market instead of on the whole electricity market.

CPB Discussion Papers

127. Varieties and the terms of trade

Frederik Huizinga and Sjak Smulders (UvT), July 2009
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This paper analyses the dynamic adjustment of the terms of trade in an intertemporal two-country model with endogenous product variety. In the base model, all workers are identical. In an extended version, the development of new varieties requires skilled labour while manufacturing uses skilled and unskilled labour. In the model without skills, a population increase in one of the countries has no effect on its terms of trade, not even in the short run. In the model with skills, the terms of trade initially worsen, but eventually return to their original level. The terms of trade immediately and permanently worsen in response to a productivity increase in manufacturing. However, they gradually improve if the productivity in variety research rises. If productivity in both activities rises equiproportionally, the terms of trade respond in the same manner as after a population shock.

128. An applied analysis of ACE and CBIT reform in the EU

Ruud de Mooij and Michael Devereux (Oxford university), July 2009
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The authors assess the quantitative impact of two alternative reforms to corporation tax, which would eliminate the differential treatment of debt and equity: the allowance for corporate equity (ACE) and the comprehensive business income tax (CBIT). They investigate the impact of these reforms on various decision margins, using an applied general equilibrium model for the EU calibrated with recent empirical elasticities. The results suggest that, if governments adjust statutory corporate tax rates to balance their budget, profit shifting and discrete location render CBIT more attractive for most individual European countries.

Colofon

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CPB Newsletter is also available at www.cpb.nl

Individual accounts for unemployment: miracle or myth?

A recurring reform option for unemployment insurance is a system of individual accounts in which mandatory savings replace the insurance premium. Benefits are paid out of the individual account during periods of unemployment. Individuals may have a negative balance — and negative balances at the end of working life are nullified. Proponents of individual accounts argue that such a system improves incentives with limited if any collateral damage in terms of reduced insurance. A recent CPB study considers whether individual accounts are indeed the miracle solution for unemployment insurance.

The study provides an overview of the theoretical and empirical literature on individual accounts and unemployment insurance. CPB researchers used this literature to construct and calibrate a lifecycle model with unemployment risk for the Netherlands. This model was then used to study the impact of individual accounts and to determine the optimal benefit level of unemployment insurance. Below are some key findings.

Improved incentives vs. reduced insurance

Under a system of individual accounts, workers who expect to end up with a positive final balance will have a stronger incentive to keep their job or find a new one. Individuals who expect to have a negative final balance will have weaker incentives. As most individuals end up with a positive balance, net incentives are improved and unemployment falls. However, the income shock from unemployment becomes more individual as well. Individuals who are unemployed often or for a long period of time will have a lower lifetime income.

The role of borrowing constraints

Individual accounts therefore do not escape the trade-off between incentives and insurance. However, these accounts may well improve this trade-off. When unemployed persons have no assets and cannot borrow, their consumption is determined solely by their unemployment benefits. Individual accounts force people to build up some precautionary savings for job loss and allow the unemployed person to borrow in the case of job loss. In this way, individuals can 'self-insure' against the risk of unemployment. This reduces the need for public insurance against unemployment, which improves incentives. It must be said, however, that individual accounts only have this advantage over a standard unemployment insurance system when individuals cannot implement the self-insurance themselves (i.e. when they run into borrowing constraints). Empirical studies suggest that most unemployed persons do not run into liquidity constraints, since most unemployment spells do not last that long, and most unemployed persons have sufficient assets or access to funds to cover the income shock. Indeed, empirical studies find that a change in the unemployment benefit level has only a minor effect on the consumption level of the unemployed.

Simulation results: only small welfare gains

Simulation results for the Netherlands suggest that the introduction of individual accounts will lead not only to a substantial drop in unemployment, but also to a considerable loss in insurance. The overall effect on welfare is small. Starting from an optimal unemployment benefit level, the overall welfare gains are less than 0.1% in consumption terms. Also in the model, most unemployed persons do not run into borrowing constraints. Individual accounts do not seem to be the miracle solution for unemployment insurance in the Netherlands.

Lessons for unemployment insurance

What is the optimal benefit level of unemployment insurance in the Netherlands? The study results indicate that the optimal benefit level in the preferred calibration is quite close to the actual level. The optimal benefit level is higher when workers are more risk averse, and is lower when the use of unemployment benefits is more responsive to the level of benefits. In the absence of liquidity constraints, the optimal benefit level is also lower.

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Main Economic Indicators for the Netherlands, 2007-2010

	2007	2008	2009	2010
	annual growth rates %			
International items				
Relevant world trade volume	6.2	1.1	– 14¾	2½
Import price goods	1.9	4.5	– 6½	– ¼
Export price competitors	1.9	4.3	– 1¾	– 1
Crude oil price (Brent, level in $ per barrel)	72.5	96.9	58	65
Exchange rate (dollar per euro)	1.37	1.47	1.37	1.40
Long-term interest rate (level in %)	4.3	4.3	3¾	4
Demand and foreign trade (volume)				
Gross domestic product (GDP)	3.6	2.0	– 4¾	0
Private consumption	1.7	1.3	– 2¾	– ¾
Public demand	3.8	2.5	2¼	½
Gross fixed investment, private non-residential	5.3	7.0	– 14	– 9½
Exports of goods (non-energy)	8.0	1.0	– 13¾	3
of which domestically produced	5.0	– 1.6	– 14¾	1½
re-exports	10.9	3.6	– 12½	4½
Imports of goods	6.4	3.7	– 11½	1¼
Wages, prices and purchasing power				
Export price goods (excluding energy)	1.8	2.0	– 2¾	– 1½
Price competitiveness a)	– 1.4	0.2	1¾	0
Consumer price index (CPI)	1.6	2.5	1	1
Contractual wages market sector	1.8	3.5	3	1½
Compensation per full-time employee market sector	3.3	3.6	2¾	2¾
Purchasing power	2.2	– 0.1	1¾	– ¼
Labour market				
Labour force (persons)	1.6	1.5	½	0
Employment (persons > 12 hours/week)	2.6	2.1	– ¾	– 2¾
Unemployment rate (level in % of labour force)	4.5	3.9	5¼	8
Unemployment (level in 1000 persons)	344	304	405	615
Market sector b)				
Production	4.7	2.1	– 6¼	– ¼
Labour productivity	1.9	0.9	– 3¾	5½
Employment (labour years)	2.7	1.2	– 2½	– 5¼
Price gross value added	0.3	1.4	4¼	1
Real labour costs	2.9	2.2	– 1¾	1¾
	level in %			
Labour share in enterprise income	78.4	79.0	81¼	78½
Profit share (of domestic production) c)	14.6	13.2	9¼	12
Public sector				
General government financial balance (% GDP)	0.2	0.7	– 4.6	– 6.2
Gross debt general government (% GDP)	45.5	58.2	59.9	65.8
Taxes and social security contributions (% GDP)	38.9	39.1	38.3	38.3

a) Export price competitors minus export price domestically produced goods.
b) Private sector excluding health care, mining and quarrying, and real estate.
c) Market sector excluding banking and insurance companies.