

# Bailout or springboard for innovation?

A recent OECD report analyses the varying scope and composition of the stimulus packages introduced around the world in response to the current economic crisis.

Murdoch Mactaggart investigates

The current financial crisis may not have brought us to the depths of the Great Depression but it's had a devastating impact not just on world trade and productivity but on individual financial and social well being. The situation in the underdeveloped world is, however, significantly worse.

Nowadays global mining, oil extraction, logging and food production companies are having a dramatic and deleterious effect on indigenous populations, perhaps particularly in central and south America and in parts of Asia. The direct effects of climate change – storms and dramatic weather changes, increased heat, loss of watercourses, for example – disproportionately affect people in less developed countries. When money is short, as now, they miss out twice over: measures to reduce directly the continuing effects on climate change in the developing world – the US and China are the biggest polluters – tend to get shelved and supporting projects in the underdeveloped world are seen as less important.

There's a cutting back on direct financial support for development projects, a cutting back on relatively costly ethical trading initiatives and a reversion to the idea that underdeveloped countries are there to be exploited commercially irrespective of the impact on their immediate environment or the well being of their population. Humanitarian charities report significant reductions in income and people die in increasing numbers.

## The stimulus package response

It's against this background of an extraordinarily severe global financial crisis that countries have developed a range of so-called stimulus packages. These have, broadly, two aims: to underpin the virtually bankrupt financial services sector both to avoid runs on banks and to stimulate lending to minimise the impact on trade and commerce and, secondly, to provide both commercial and social support in a variety of ways and with both immediate short term and longer term aims.

The sums of money involved are enormous. Among OECD members the unweighted average is about 2.5% of GDP but ranges from 0.1% to over 5% of 2008 GDP. The US, for instance, is spending about 5.5% of 2008 GDP while Australia, Canada, South Korea and New Zealand are all 4% or greater. The figures for some non-OECD countries are even more extraordinary with China apparently spending around 15% of 2008 GDP, although this may not be entirely new expenditure.

"The OECD is naturally extremely interested in the responses to the economic crisis" explains Sacha Wunsch-Vincent, Economist, OECD Directorate for Science, Technology and

Industry "and as part of our strategic response we've made a systematic effort to identify the detail of the various countries' stimulus packages. We want to consider the effect of these both in terms of dealing with the immediate financial market issues – specifically finance, competition and governance – and as to how effective they might be in supporting a return to sustainable growth and employment."

Wunsch-Vincent is a co-author, with Dominique Guellec, of the OECD Report "Policy Responses to the Economic Crisis: Investing in Innovation for Long-Term Growth" published in June 2009. This gives a general analysis of the impact of the crisis and of the appropriate policy responses but also looks in detail at the various national responses made.

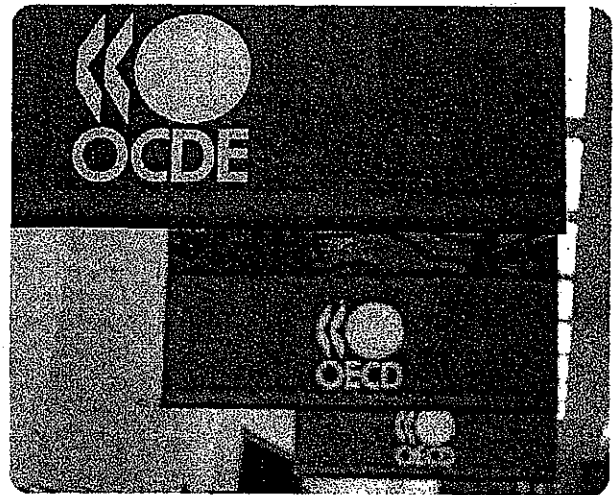


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The information comes mainly from detailed questionnaires circulated among the member countries as well as some non-member countries. 27 of the thirty member countries replied as did all five of the accession countries (Chile, Estonia, Israel, Russia and Slovenia) and the result is a fascinating analysis of the different approaches taken.

"The amounts of money in the stimulus packages are very significant" adds Wunsch-Vincent "and what we do in the paper is take stock of both the size and the composition. To put it into perspective, the total of the OECD members' stimulus packages is about \$1.4 trillion, or rather more than the entire GDP of Spain. It's a unique approach, because the information is taken not from press reports or hearsay but from questionnaires answered by the governments themselves."



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"It's also an important approach, partly on account of the need to take a proper account of some quite significant spending because of the regular economic analyses and forecasts which the OECD publishes. Perhaps more important even than that is to try to establish whether the money is being spent in the right way to foster innovation and bring about a return to long-term growth. Can the crisis be used as a sort of springboard to accelerate structural shifts and improve processes which aren't so good at the moment in order to benefit us in the future?"

#### Variations across packages

Most countries have given priority to tax cuts and other revenue measures although Japan, France, Australia, Denmark and Mexico are clear exceptions, focusing on boosting spending and developing infrastructure. The UK, following Belgium and the Netherlands, is somewhat below the OECD average spend but, with New Zealand, is unique among OECD countries in allocating very little to spending and investment measures.

"Our interest is around the long-term innovation elements of the stimulus packages," says Wunsch-Vincent. "We asked ourselves last November what areas we thought should be targeted to achieve long-term supply-side benefits and we came up with five categories: infrastructure, mostly ICT-related; R&D innovation; human capital; green technologies; and what we called entrepreneurship, something typically linked to supporting SMEs particularly."

South Korea plans significant investment in green issue although it's not entirely clear how much of this is new spending. Nevertheless, the South Korean approach is an important one and may stimulate other countries to follow. Finland's stimulus package also includes good support for green approaches whereas both Germany and Portugal

place considerable emphasis on education and retraining. As the report points out crisis-driven layoffs are rising, something particularly pronounced among skilled workers such as those in high-tech industries like ICT, aeronautics and pharmaceuticals. Education and retraining are therefore especially important but budget constraints – ranging from governments through businesses to individuals – tend to reduce expenditure on training while coinciding with rising demand, partly as a consequence of many people's enforced spare time.

"There's a balance, certainly, between using funds to support banks and using funds to support or improve schools" says Wunsch-Vincent "and people may disagree about the relative importance of each. But even within a given spending sector there are discussions to be had and decisions to be made. The German stimulus package has a significant spend going on education but when you look into it you see that most of that is for buildings and for making them energy efficient. And so the question arises as to whether that's the best use of funding for education or should more go on teaching staff, perhaps on taking on additional temporary teachers, say."

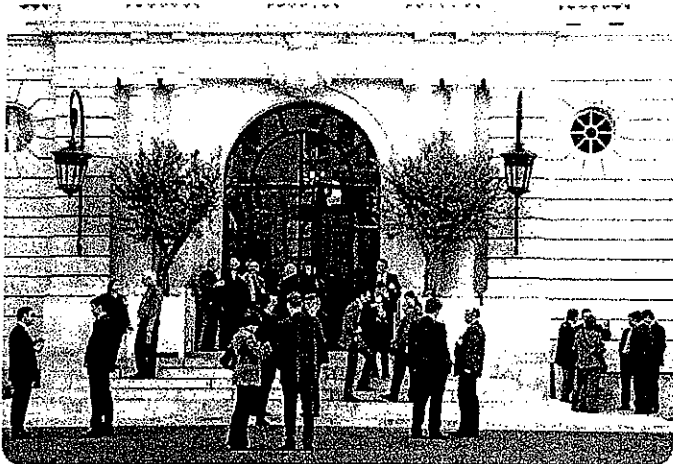
"So it's important to look in detail at the implementation of these plans but also to monitor what's happening and to learn from other countries. In the OECD we're always concerned about sharing information on good practice and having in place appropriate indicators to make proper comparisons between different efforts. Sometimes, unfortunately, implementation is not always as clear as it might be and may not even be well organised and there's some suggestion of this in some of the stimulus packages and more particularly in international coordination."

### Why bail out the banks?

The OECD report does not consider the question of banking support within or supplementary to the stimulus packages. However, many commentators have questioned why banks should receive favourable treatment when they were clearly culpable in provoking the crisis. There are two answers to this, one plausible and the other rather less so.

Banks operate using the system known as fractional reserve banking, which leverages the funds deposited by creditors to allow banks to loan regulated multiples of their liquid assets. Essentially banks print money, at virtually no cost to themselves, duly lending this out at interest to borrowers. If all creditors sought to withdraw their money simultaneously the bank would very quickly be unable to meet its obligations and a large proportion would get nothing. This risk of a 'run on the bank' and the bank's subsequent collapse is something governments have long been concerned to avoid.

The second justification made most notably in the UK and the US, with their strong focus on international financial services, is that it was essential to get banks functioning once more as rapidly as possible to ensure that lending to business would continue so that trade, business growth, employment, pensions income and so on would not suffer unduly. However, banks have long ago given up their traditional role as active lenders making considered judgements based on local community and business understanding in favour of risky get-rich-quick-schemes based on probabilities which, coupled with lax and inadequate regulation, was a direct stimulus to the crisis. Secondly, as various think tanks and individual economists have pointed out, it is entirely possible to provide essential traditional banking services to industry and to individuals in other ways.



If high street banks wish properly to do this then it's time for them to get staid and boring once more.

As Jørgen Elmeskov, Acting Chief Economist of the OECD, but writing a personal capacity, points out "... ill-designed regulation and misguided incentives in financial markets were main factors contributing to excessive leverage and risk taking. That inappropriate risk taking, the very antithesis of traditional banking, was a significant element of what came to be known as 'toxic loans' and 'subprime mortgages', advances made not against properly evaluated asset bases or realistic business plans but in order to benefit from short-term income in the form of handling commissions or the securitisation of what had become merely elements evaluated on the basis of overall statistical risk of default.

The authors of a recent New Economics Foundation (NEF) study titled "I.O.U.K. Banking failure and how to build a fit financial sector" point out that although the UK government has now spent over £37 billion in bailing out the largest banks this has failed in its stated aim of increasing lending, particularly to SMEs who face the double jeopardy of reduced turnover and enforced extended payment terms, citing the Financial Times as being of the same opinion.

Banks have both steadily closed branches and removed most of the traditional decision-making authority from manager. This, NEF argues, means that they have abandoned their traditional and important role and so it's essential that alternative means of providing such finance be supported, such as credit unions, community development finance institutions (CDFIs) and a basic banking structure based on the post office network, among others options. CDFIs, which play a significant role in both north American and continental European lending, were initially supported and financed by the government but the impetus there seems to have disappeared in favour of supporting the large banking conglomerates.

### Reforming the banking sector

It's a serious concern among observers and commentators that governments may not use the opportunity provided by the financial crisis to reform the banking and financial services sector. The seeds of the crisis lie in the attitudes fostered by the Reagan administration in the US and Thatcher government in Britain, each taking its cue from its immediate ideological predecessor, Augusto Pinochet of Chile, their ideas driven by the economic liberalism promoted by Milton Friedman and others in the Austrian and Chicago schools of economics. Free markets are important drivers of growth but the problem, as has long been obvious, is that markets are almost never free in the classical sense of that term, a limitation which Adam Smith actually understood well.

The evidence from the financial crisis and previous financial tremors has been clear and despite the objections of those in the financial services industry who want their licences to print money to continue without interference possibly the single most important lesson of the crisis is that regulation needs to be far better and far more carefully implemented.

The figures are stark in the UK, which has particularly been affected by the lax controls in place and the banking industry's greed for easy money. Total UK personal debt at the end of April 2009 was £1,459 billion, around £100 billion greater than the country's GDP and nearly twice the national debt of £754 billion (on which the government pays £103 million interest daily). One in 33 people currently employed are expected to lose their jobs during 2009. Every ten minutes, 24 hours a day, another property is repossessed and during that same short period two people will be declared bankrupt or insolvent.

Over the past few years SMEs have often found it difficult to get bank loans. Many small businesses have therefore financed their cash flow or investment needs either through withdrawals against rising house prices or by using initial low interest offers on credit cards, both strategies now causing severe problems. There are more credit cards circulating in the UK than there are people and the total credit card debt at the end of April 2009 was £53.1 billion. In the six months since October 2008 the bank rate moved from 5% to its lowest ever figure of 0.5% but during that same period the average interest rate on credit cards moved from 14.9% to 17.75% with leaps to 25%, 30% or even 35% being reported in individual cases. 7,241 new debt problems are brought daily to the Citizens' Advice Bureaux.

Klaus Schmidt-Hebbel, former OECD Chief Economist, says that there were several clear lessons to be drawn including addressing regulatory weaknesses and poor governance of markets. He remarked that better contingency planning and crisis management were necessary, adding that the crisis was managed in a pretty haphazard way with governments moving in late with ad hoc and selective emergency bailouts. Importantly, he added that rethinking of our current international financial architecture was needed, demanding international cooperation in regulatory reform of financial and capital markets, accounting standards and the treatment of international financial transactions. These were things the OECD could play a major role in addressing.

### Crisis: threat or opportunity?

The issue of seeing the financial crisis as an opportunity rather than merely a threat is important and as the examples of both Finland and South Korea show (see sidebar), it's vitally important to invest in future need. The activity of the UK's Technology Strategy Board in supporting innovation and in working to open up government departments to small business suppliers is welcome as is the £250 million earmarked to support innovation and research in advanced manufacturing and low carbon technologies.

The US, in contrast, has allocated some \$11 billion for the construction of a new smart electricity grid which will use improved communication technology and advanced IT to deliver electricity more reliably and efficiently. Part of the intention is to better understand and manage supply and demand and, as part of that, to enable the use of new technologies including plug-in hybrid electric cars and energy storage solutions for vehicles.

"It's important that new infrastructure should be smart and not dumb," says Wunsch-Vincent "This raises questions about communications strategies and broadband provision and here the differences between different country approaches can be significant. South Korea we know about but what surprised everybody was Australia's approach. Australia's a pretty big country and hard to wire but they've set aside \$40 billion and intend to lay fibre to 90% of the population."

What's opening up around the world is a potential digital divide, something which will have major consequences in the future just as earlier opening up the seas to particularly British and Spanish fleets brought enormous benefits in terms of trade and acquisitions. The two issues around broadband, complementary but partly also balanced one against the other in terms of affordable expenditure, are the goals of universal access and next generation services.

Several countries, the UK included, score well on the former but poorly on the latter; it aims to connect virtually every community by some near future date but to aim for only 2Mbps speed by 2012. Spain, in contrast, has a target of 30Mbps, Germany of 50Mbps and Australia of 100Mbps in approximately the same time scales. South Korea is largely already there with virtually universal access, broadband in the range of 10Mbps to 50Mbps and a target of 1Gbps, 500 times that of the UK, in the next few years.

Unlike South Korea where nearly everyone lives in massive apartment blocks with broadband provided as a standard service, the UK has the problem of many rural and remote communities where running fibre would be prohibitively expensive and where radio is the obvious solution.

The UK's preferred approach seems to be mobile broadband although technical commentators point out that this is a technology which is very unlikely to deliver the sorts of speeds which next generation networks will need to offer. The combination of some high bandwidth backhaul, as might be provided by a WIMAX network coupled with a metropolitan or similar area network seems more sensible.

Further, mobile broadband will need considerable investment in cellular infrastructure for expansion into remote areas and this can create legacy problems and perhaps an undesirable lock-in in the future, arising out of the need to make significant expenditure earlier.

### Promoting a Global Standard for business

Ángel Gurría, Secretary General of the OECD, is also clear about both the triggers of the crisis and about what needs to be done, stressing that there needs to be a return to integrity and ethics in financial transactions.

"Many people turned a blind eye to basic issues of business ethics and regulation" he says, pointing out in April 2009 that the OECD expected GDP in the OECD area to plummet by 4.3% in 2009 and calling in May for a "Global Standard", remarking "To build a stronger and cleaner global economy we need to think of the key elements of integrity and ethics ... [an] essential ingredient to restore confidence in globalisation." The dry figures of falls in GDP hide what he points out is the important social consequence of increasing global poverty.

"The way that the OECD operates" explains Wunsch-Vincent "is that on each topic member countries send their delegates to meet with others and discuss things in detail. So this paper is a platform for just such a discussion. And out of that, out of considering and discussing what others are doing, can come valuable conclusions about how to turn what's happened into ways to improve things in the future."

### Lessons from Finland and South Korea

Both Finland and South Korea earlier went through particularly severe economic crises and the lessons learned from that time are discussed in the report. During the first half of the 1990s, Finland's output dropped by 10% and its unemployment rate quadrupled to almost 17% in four years. A sharp downturn throughout the OECD, the collapse of Finland's trade with the Soviet Union and a domestic banking crisis led to a collapse of consumption and investment spending in the country, bringing about significant cuts in public expenditure and the raising of some taxes. However, R&D funding was increased and the government invested heavily in infrastructure and education and offered incentives for structural change. All of these worked to prepare the ground for future growth and eventually moved the Finnish economy to a stronger, more knowledge-intensive, base.

In South Korea, the Asian financial crisis of the late 1990s led to significant lay-offs from the larger companies and a considerable drop in corporate R&D spending. The government addressed this by increasing education spending and enlarging the public R&D budget as well as putting measures in place to support start-ups and small company growth. In particular, it used the crisis as an opportunity to develop a technology-based SME sector. These measures fuelled rapid expansion of corporate R&D facilities and pushed SME spending on R&D from 12% of the total in 1997 to 24% nine years later while in the field of communications South Korea rapidly became the most advanced country in the world, even overtaking Japan in certain areas.