Summary for non-specialists
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Evaluating the Macroeconomic Effects of Government Support Measures to Financial Institutions in the EU

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The recent financial crisis has led to an intense debate about the efficacy of fiscal stimulus. This debate centers on temporary increases in government purchases and social transfers, and on tax cuts. See, e.g., Drautzburg and Uhlig (2011), Forni and Pisani (2010), Leeper, Traum and Walker (2011) and Coenen et al. (2012) for model-based evaluations of these standard fiscal policy instruments.

However, a key aspect of fiscal policy in the crisis was massive government support for the banking system, e.g., in the form of purchases of bank assets, bank recapitalizations by governments, and loan guarantees. In several countries, these 'unconventional' fiscal interventions were larger than the changes in standard fiscal instruments, during the crisis. Surprisingly, the macroeconomic effects of these bank support measures have, so far, received little attention in the literature. Our paper seeks to fill this gap, by analyzing the effect of state-aid to banks, using the Commission's macroeconomic model QUEST III augmented by a financial sector. This paper assesses the cost and benefits of state aid to the financial system in an economy which is hit by a severe financial shock and is subject to financial market imperfections (balance sheet constraints, segmentation and panic).

Our analysis shows that state interventions to support banks are an efficient means of stabilising the real economy. Multipliers are lower than those for government consumption, but generally larger than those for transfers to households. State support to the banking sector has helped to stabilise corporate investment, which is the component of aggregate demand most severely affected from the financial shock when there are financial frictions (bearing in mind that the decline in residential investment has been largely due to the bursting of a housing bubble). This feature also distinguishes state aid from conventional fiscal interventions (like an increase in government spending or transfers), which primarily target non-investment demand categories and rather crowd out private capital formation.