FOUNDATION FOR EUROPEAN PROGRESSIVE STUDIES
FONDATION EUROPÉENNE D'ÉTUDES PROGRESSISTES

Scenarios for the European economy

This contribution has been elaborated in the frame of the collaboration

between FEPS and ECLM

ECONOMIC COUNCIL OF THE LABOUR MOVEMENT **(www.eclm.dk)**

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International Growth Projections has gone worse

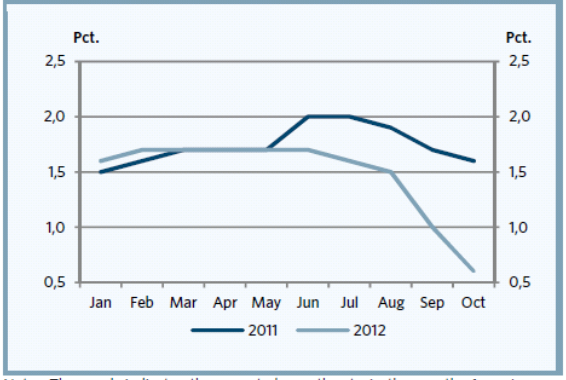
Over the summer, the outlook for the international economy has become far more uncertain. The signs of growth we saw in the first quarter from a number of European countries did not continue into the second quarter. Overall it has given rise to a larger downward revision of expected growth in both Europe and America.

The downward revision of expectations is larger for 2012 than for 2011. It should be seen in the light of recent financial turmoil and growing uncertainty about the European debt crisis and fiscal austerity. The U.S. as well has had major problems with public finances, and the growing skepticism in relation to handling this is not helping to improve the prospects for growth to seriously take off in 2012. The growing pessimism and downward revisions of growth forecasts have not come out of the blue. Since spring, there has been a tendency for a steady downward revision of growth prospects for the Euro zone and the U.S., see Figure 1.A and 1.B.

Figure 1.A. GDP growth estimates for the U.S.

Note.: The graph indicates the expected growth rate in the months from January 2011 to October 2011.
Source: ECLM and Consensus Forecasters.

Figure 1.B. GDP growth estimates for the Eurozone



Note.: The graph indicates the expected growth rate in the months from January 2011 to October 2011.
Source: ECLM and Consensus Forecasters.

The figures confirm that it is not an isolated event that has given rise to the darker outlook, but that it is the result of many smaller and larger events that have appeared during the spring and summer. All together these events have caused the blooming optimism from the turn of 2010/2011 to disappear and growth prospects to be downgraded. The development confirms that following a severe recession the road ahead is both long and winding.

Negative Scenario: lower growth in Europe and the U.S.

Despite the fact that the expected growth in Europe has already been downgraded, it is not unlikely that the growth will be even lower. There are substantial uncertainties associated with the international economy at the moment and most of the uncertainties are pointing in a negative direction.

In Europe, the uncertainties gather around the debt issue and the fiscal austerity. First and foremost the uncertainty surrounding Greece, and whether the Greeks can deliver and implement the actions required to get the next payment from the aid package from the EU and the IMF. We have in recent months seen how the contagion from political uncertainties quickly spreads to the financial markets, and creates negative confidence in the economy. If there is uncertainty about politicians' ability to act, or any further doubt about the southern European countries' ability to get their budgets on an even keel, it can create further financial turbulence and uncertainty among businesses and consumers.

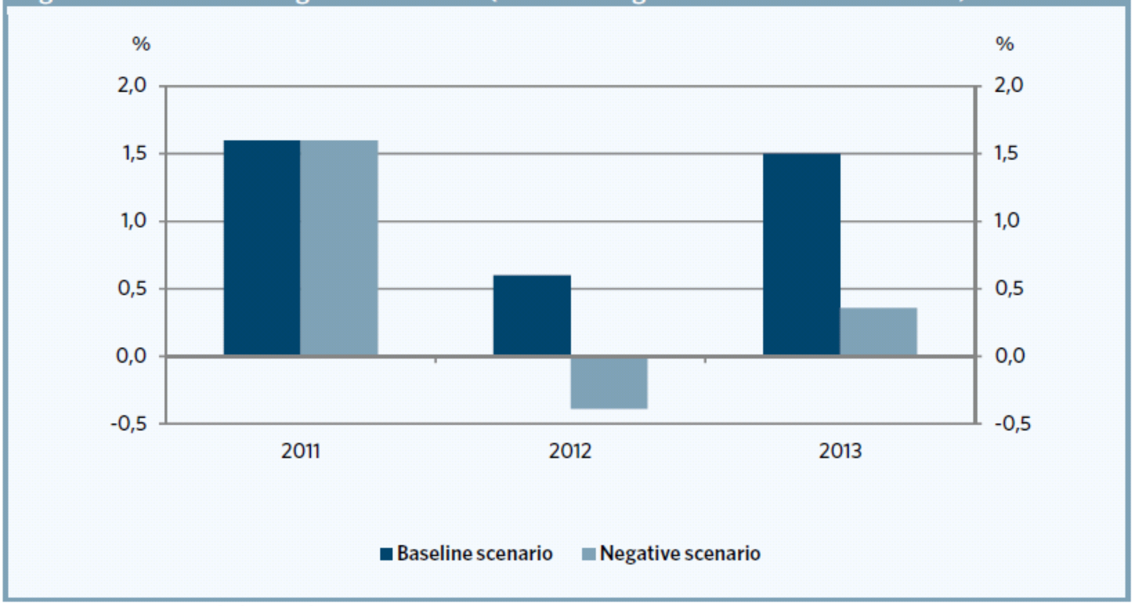
In America, the political turmoil during the negotiations over an increase of the debt ceiling has also contributed to nervousness, which has led the American consumers to be very careful with consumption. It is not unlikely that this caution takes a hold in the consumers.

A shock to the world economy in terms of increased negative trust in Europe and the U.S. will quickly spread like ripples in water. If firms and consumers choose to leave money in their pockets instead of invest and spend, it will lower the domestic demand even further.

Using ECLM's international macroeconomic model HEIMDAL we have calculated what such a negative shock to the economy with decreasing trust will mean for the European economy.

Figure 2 shows the development in GDP growth in the EU in the baseline scenario and in the negative scenario. If GDP growth in the U.S. and Europe is 1 percent lower in 2012 and in 2013, it would mean that the EU will be in recession next year, as GDP next year will fall 0.4 pct, instead of growing by 0.6 as predicted in the baseline scenario. In 2013 the European economy will grow again, but the lower demand in the world economy will pull down growth to 0.4 percent in 2013, instead of 1.5 percent in the baseline scenario.

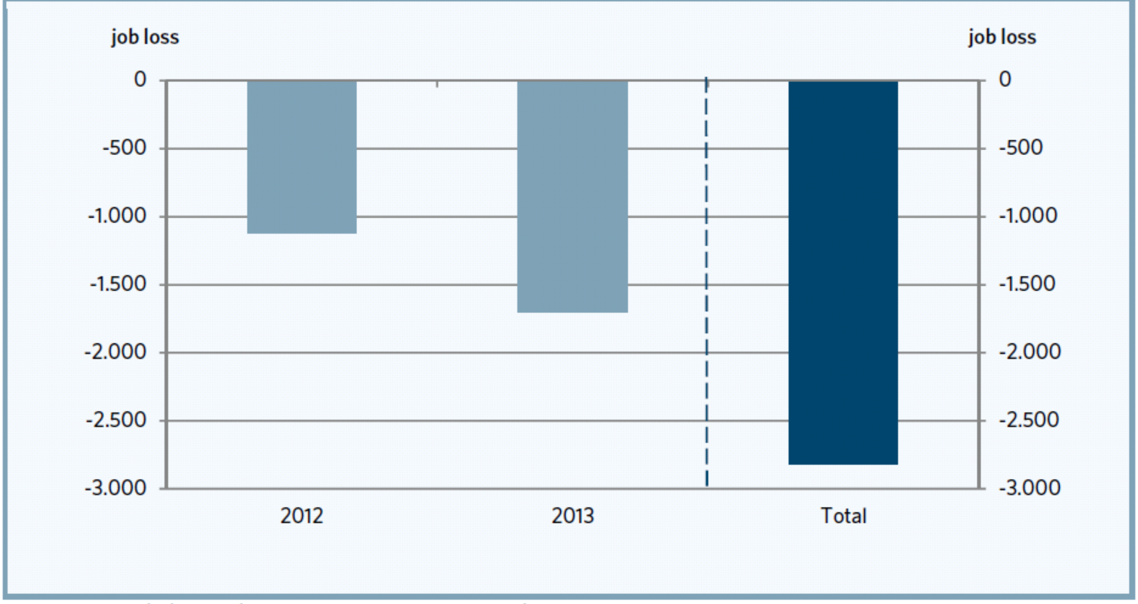
Figure 2. Effects on GDP growth in the EU (when lower growth in the EU and the U.S.)



Note. Baseline scenario on the basis of the European Commission Autumn 2011 forecast.
Source: ECLM on the basis of the international macroeconomic model HEIMDAL.

Figure 3 shows the development in employment in the risk scenario. Overall, the slower growth internationally will cost 2.8 million jobs in the EU in 2013.

Figure 3. Effects on employment in the EU (when lower growth in the EU and the U.S.)



Source: ECLM on the basis of the international macroeconomic model HEIMDAL.

Table 1 summarizes the effects of lower growth in Europe and the U.S., for a number of countries. It is seen how lower growth in the EU and in the U.S. pulls down employment all over Europe. In small countries like Belgium and the Nordic countries it will cost around 30.000 to 50.000 jobs. In medium size countries like Poland France, Spain and Italy it will cost in the area of 200.000 jobs. In the larger European countries, like Germany and the UK, it will cost close to ½ a million jobs.

Table 1. Effects on the EU, 2012-2013 (when lower growth in the EU and the U.S.)

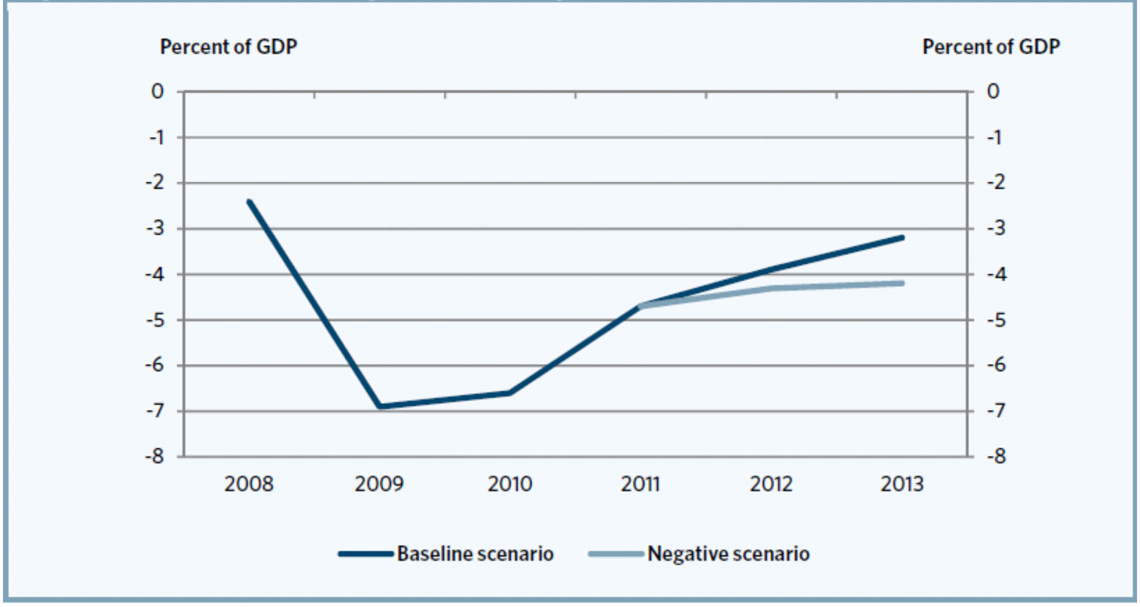
	Employment (1000 jobs)
Denmark	-49
Sweden	50
Finland	-32
Belgium	-37
Polen	-218
Czech Republic	-85
Germany	-542
France	-258
UK	-432
Spain	-266
Italy	-183
EU-27	-2.818

Note: The table shows the effects of the negative scenario relative to the baseline scenario.
Source: ECLM on the basis of the international macroeconomic model HEIMDAL.

The lower growth in the international economy also affects the government budgets negative. Fewer workers are employed, which means fewer tax-payments and higher costs for unemployment benefits.

This means that government balance in 2012 will be -4.3 percent of GDP in the negative scenario instead of 3.9 percent of GDP in the baseline scenario. Likewise the government budget will be 4.2 percent of GDP instead of 3.2 percent of GDP in 2013. This is shown in figure 4.

Figure 4. Effects on the EU budget (when lower growth in the EU and the U.S.)



Note. Baseline scenario on the basis of the European Commission Autumn 2011 forecast.
Source: ECLM on the basis of the international macroeconomic model HEIMDAL.

Positive Scenario: Coordinated European Financial- and Monetary Expansion

Despite the fact that most of the uncertainties associated with international economics suggest a negative direction, there remains the possibility that things will go better for the European economies.

However, improved prospects for the European economy require a policy response.

The European Commission has issued recommendations for countries to tighten fiscal policy and improve their budgets. Table 3 summarizes the national recommendations.

As the table shows, the countries are requested to tighten up fiscal policy this year and in the next two years. On average, EU countries must tighten fiscal policy by almost 3½ percent of GDP from 2011-2015. An average tightening of this size is intense and requires a robust domestic demand; otherwise it will take the breath away from the European economy.

There are European countries that have so unsound public finances that it requires immediate consolidation. These countries are not able to stimulate the economy at the moment but should focus on getting their deficits under control. On the other hand, one might question whether it is appropriate that so many European countries tighten fiscal policy simultaneously. As the table shows, the EU has requested fiscal austerity in 23 out of 27 EU countries. When nearly all European countries tightens the economy simultaneously, it hits the economies extra hard as they experience both domestic tightening and lower demand from their trading partners and therefore lower exports.

In light of the recent downgrades of the European growth, the International Monetary Fund (IMF) recommended European countries to reconsider the situation and if possible postpone some of the tightening and instead stimulate the economies. The head of the IMF, Christine Lagarde, said:

"When we look at the European situation, there has to be fiscal consolidation qualified by growth-intensive measures" and for some countries *"…some of the measures that have been taken are so strong, given the current deficit situation, that they can accommodate some relaxation - especially if the economy weakens further"* and she points to Germany as a country which could have the potential to stimulate growth *"… Given Germany's heavy reliance on exports, if demand weakens so much that it really changes the equilibrium, then it would need to be revisited (….) domestic demand is good for both the German economy and for the other economies surrounding Germany".*

Table 2: Country-specific recommendations 20011-2015 (percent of GDP)

	2011	2012	2013	2014	2015	2011-2015
Greece	1.67	1.67	1.67	1.67	-	6.7
Ireland	1.9	1.9	1.9	1.9	1.9	9.5
UK	1.75	1.75	1.75	1.75	1.75	8.8
Latvia	2.75	2.75	-	-	-	5.5
Lithuania	2.25	2.25	-	-	-	4.5
Spain	1.5	1.5	1.5	-	-	4.5
Rumania	1.75	1.75	-	-	-	3.5
Portugal	1.25	1.25	1.25	-	-	3.8
Czech Republic	1	1	1	-	-	3
France	1	1	1	-	-	3
Slovakia	1	1	1	-	-	3
Poland	1.25	1.25	-	-	-	2.5
Cyprus	1.5	1.5	-	-	-	3
Slovenia	0.75	0.75	0.75	-	-	2.3
Belgium	0.75	0.75	-	-	-	1.5
Holland	0.75	0.75	0.75	-	-	2.3
Austria	0.75	0.75	0.75	-	-	2.3
Germany	0.5	0.5	0.5	-	-	1.5
Denmark	0.5	0.5	0.5	-	-	1.5
Italy	0.5	0.5	-	-	-	1
Malta	0.75	-	-	-	-	0.8
Hungary	0.25	-	-	-	-	0.3
Finland	0.5	-	-	-	-	0.5
EU-27	**0.9**	**0.9**	**0.8**	**0.3**	**0.3**	**3.3**

Note. For countries where the European Commission has given a total tightening over a given time period, it is assumed that the tightening will be equally distributed over the period. The EU-27 tightening is calculated as a weighted average of the national recommendations to the 27 EU countries.

Source: ECLM on the basis of the European Commission Report "Public Finances in EMU - 2011".

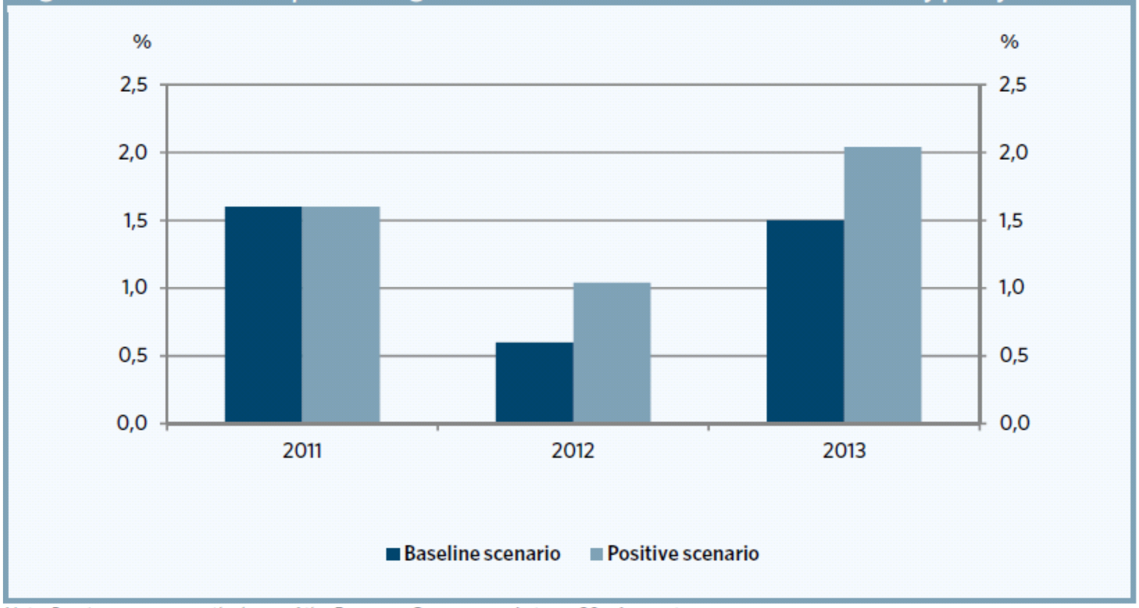
If an agreement is reached at the European level to make an effort to get the European economy back on the growth track by implementing a coordinated fiscal and monetary policy response consisting of increased investment and a more expansionary monetary policy, it will have significant positive effects on the economy.

Imagine that the European countries with the least unsound public finances put consolidation on hold and instead stimulate the European economy by increasing public investment equal to ½ percent of GDP in 2012 and ½ percent of GDP in 2013. Using ECLM's international macroeconomic model HEIMDAL we have calculated the consequences for the European economy, if a number of Central European (Holland, Belgium, France and Germany) and northern European (Denmark, Sweden and Finland) countries are stimulating the economy, while the ECB lowers interest rate.[1]

Significant increase in GDP and employment by coordinated European policy response

Figure 5 shows the consequences for the European economy of a coordinated European fiscal and monetary policy response.

Figure 5. Effects on European GDP growth from a coordinated fiscal and monetary policy action



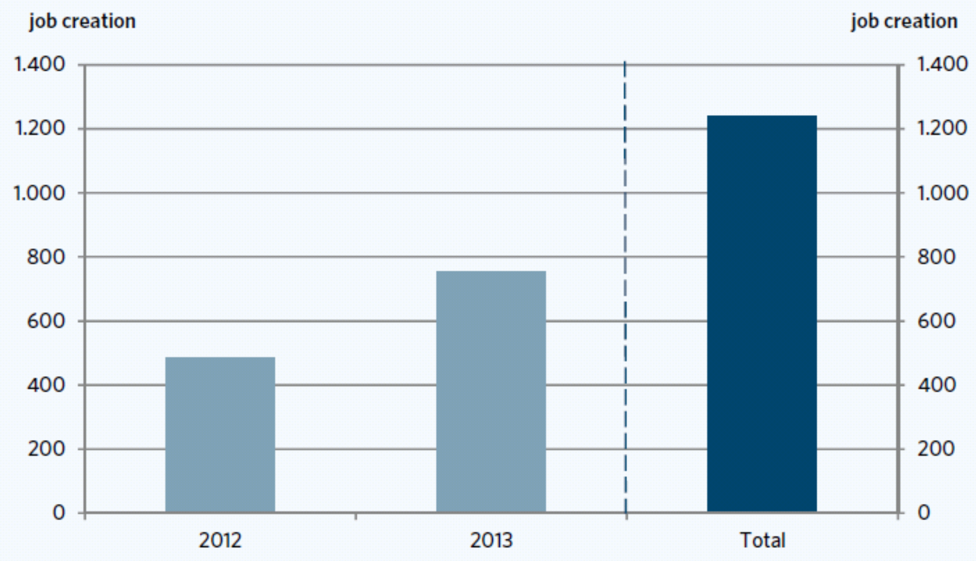
Note. Baseline scenario on the basis of the European Commission Autumn 2011 forecast.
Source: ECLM on the basis of the international macroeconomic model HEIMDAL.

The figure shows how a coordinated action can help the European economy back on track. With the coordinated action GDP in the EU will grow with 1 percent in 2012 instead of 0.6 percent as projected in the baseline scenario. Likewise growth will be higher in 2013 where the European economy will grow with 2 percent instead of 1.5. Despite the fact that only 7 of 27 EU member states are stimulating the economy, the EU will all in all be able to expect a growth that is 0.4 percentage points higher in 2012 and 0.5 percentage points higher in 2013 compared with the baseline scenario.

Likewise the coordinated action will create jobs all over Europe. In 2013 the coordinated action will have created more than 1.2 million jobs in Europe, cf. figure 6. This is coursed by the fact that fiscal stimulants, along with the more accommodative monetary policy, send positive waves throughout the EU.

[1] It is assumed that the European Central Bank (ECB) will cut the policy rate by 0.5 percentage points during the period 2012-2013.

Figure 6. Effects on European employment from a coordinated fiscal and monetary policy action



Source: ECLM on the basis of the international macroeconomic model HEIMDAL.

Table 3 shows the effects of a coordinated European fiscal and monetary policy response for a number of European countries. As shown, you will see the largest effects in countries that stimulate their economies directly, but the countries that are outside the effort will also, through the increased demand from their trade partners, achieve job creation and increased GDP growth of up to 0.3 percent.

Table 3. Effects on the EU and selected countries, 2012-2013 (fiscal and monetary policy action)

	GDP (percent)	Employment (1000 jobs)
Ex. of countries participating in the effort (domestic effects + interest rate effects and trade effects)		
Germany	1,6	390
France	1,5	221
Denmark	1,5	36
Sweden	1,4	32
Finland	1,3	21
Belgium	1,7	30
Ex. of countries not participating in the effort (interest rate effects and trade effects)		
Polen	0,3	29
Czech Republic	0,3	16
Spain	0,2	34
UK	0,1	40
EU-27	**1,0**	**1.238**

Source: ECLM on the basis of the international macroeconomic model HEIMDAL.

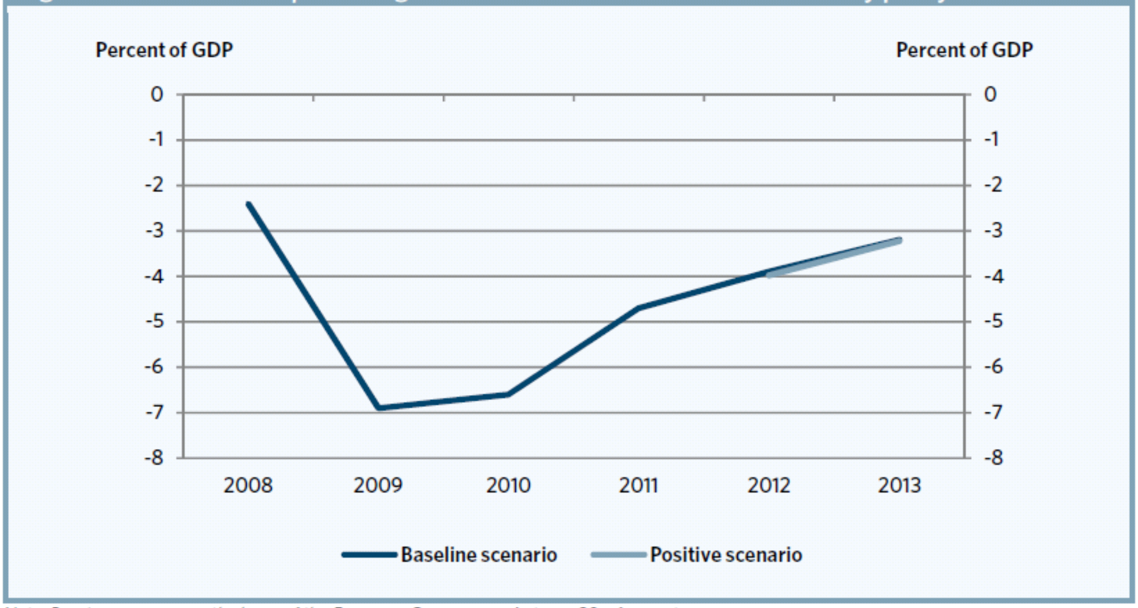
As the table shows, a coordinated fiscal and monetary policy effort mean that GDP in the EU will be 1 percent higher in 2013 compared to the baseline scenario. At the same time the coordinated efforts will create more than 1.2 million new jobs at the EU level. And this is the result of only 7 out of 27 EU countries stimulating the economy.

Despite the fact that a small European country like Denmark only stimulates the economy by ½ percent of GDP in the positive scenario, Danish GDP grows by 0.7 percentage points more than in the baseline scenario. This is because the economy is not only stimulated by the domestic increase in public investments, but also by the increased demand from the countries involved in the coordinated effort, the so-called spillover effects. As small countries are highly dependent on exports, the trade effects of the coordinated effort will be larger for small countries. In addition to the fiscal effects, the positive effects of the more accommodative monetary policy will also contribute to the positive effects.

There has been much focus on Greece in the debate on public finances and consolidation in Europe. Greece is not modeled directly in ECLM's international model HEIMDAL, but there will also be positive effects on Greece in a coordinated effort. It is likely that the effects of Greece will be close to the effects seen for Spain in Table 3. The size of the effects in each country depends on how much they trade with other European countries. Overall, there is no doubt that a coordinated effort will benefit the EU's overall economy.

Figure 7 shows the effect on the European budget from a coordinated action. Despite the fact that 7 European countries are stimulating the economy, the coordinated action is close to being neutral to the budget. This is due to the fact that the action creates jobs all over Europe, which removes people from unemployment benefits till jobs where they pay taxes.

Figure 7. Effects on European budget from a coordinated fiscal and monetary policy action



Note. Baseline scenario on the basis of the European Commission Autumn 2011 forecast.
Source: ECLM on the basis of the international macroeconomic model HEIMDAL.

A Common European Policy

When several EU countries are stimulating their economies at the same time, it creates so-called positive spillover effects. Spillover effects will overall benefit the European economy – and not only the countries participating in the common effort. Spillover effects on European countries are large, because the European countries are open economies that largely depend on exports to other EU countries.

The great uncertainty associated with the international economy, emphasizes the need for coordinated European action. The positive scenario clearly shows that the efforts should be targeted towards a coordinated fiscal and monetary policy. Such action would mean that the European economy is not only positively affected by a possible domestic stimulus to the economy, but also the positive effects from the countries we trade with. When activity increases in the countries trading with each other, it becomes easier for countries to sell their goods, which leads to increasing exports. It will increase output and employment even more compared to a situation where each country individually stimulates the economy.

One idea would be to divide the budget deficit in an operational part, including public consumption and transfers, and in an investment-related part. A breakdown of the budget, so the requirement for the budget deficit mainly relates to the operational part, would, in the current situation, make it possible for several countries, with relatively low dept deficits, to stimulate growth through investment, which they cannot do today because of EU recommendations on fiscal austerity.