

Could Employment-Focused Policies Spearhead Economic Recovery in Europe?

by Terry McKinley and Giovanni Cozzi, CDPR, SOAS

In Development Viewpoint #66, we assessed the performance of two contrasting strategies for debt reduction in the US: a 'fiscal-contraction' versus a 'fiscal-expansion' approach. In this Policy Brief we apply a similar 'fiscal-expansion' approach to economic recovery in Europe, focusing here on the need, first and foremost, to foster rapid growth in employment.

Employment generation should be a high priority for European policymakers, particularly because of secular declines in the size of the working-age population across the continent. Moreover, unemployment levels (especially among young workers) are unbearably high in many countries in the aftermath of the global financial crisis. So getting people back to work represents, indeed, one of the best strategies for debt reduction currently available.

As in past exercises, we use the *State of the World Economy* global macroeconomic model to gauge the impact of such a strategy. In this case, we construct a model scenario that programs changes in macroeconomic policies that are designed to stimulate an employment-focused economic recovery in Europe (as well as in the US). We then compare this scenario's results with those of a 'baseline' scenario (based on no change in policies).

We are not interested in gauging short-term impacts alone so we extend our assessment through 2030. We present our results for blocs of countries (except for the UK and the US) because data in the model are aggregated in this fashion.

We start with the policy lever that has the most immediate potential to stimulate Europe's economies—i.e., an increase in government expenditures. We also assume that these expenditures will help promote private investment. For example, they could be public investments in infrastructure, skills training or new cutting-edge technology. In order to reinforce the desired increase in private investment, we also assume a modest stimulus to bank lending.

Both public expenditures and private investment are marshalled to target an increase in employment, not economic growth alone. This target is based on the ratio of the number of employed to the number of people of working age. We calibrate the size of the stimulus in order to achieve a desirable, but also feasible, level of this ratio for each European bloc.

Employment Targets

In the case of North Europe (e.g., the Nordic countries), Central Europe (e.g., Germany and France) and the UK, the targets are 70-74%. For Eastern Europe (e.g., Poland and the Czech Republic), the target is much more modest, namely, 60%. For South Europe (e.g., Greece, Italy, Portugal and Spain) the target is also low, i.e., 62%.

With the exception of North Europe, these targets would represent a significant improvement in employment. But they are still certainly feasible in comparison to past historical performances, either just before the global crisis or over a longer period.

In order to support the recovery in Europe, we also assume that a similar set of policies will be implemented in the US. For example, its target for the ratio of the employed to the working-age population is 72%—a level that the country last achieved in 2000.

However, if the set of stimulus policies outlined above were implemented in isolation, they would not likely be feasible. They would probably not help reduce government deficits (because of the unilateral increase in government expenditures); neither would they likely help achieve sustainable growth in GDP and employment (because of potentially adverse impacts on the current account).

Thus, we need to implement a set of more comprehensive, but also mutually compatible, macroeconomic policies. For this purpose, we consider, in turn, increases in revenue and changes in real exchange rates.

Supportive Policies

If future government deficits are going to be contained, government revenue will have to be boosted in conjunction with the projected increases in expenditures. So, for Central Europe and the UK, we assume that net government income as a ratio to GDP rises to 25%. Our targets for South Europe and East Europe are more modest, namely, 23% and 21%, respectively. We also assume a modest target of 20% for the US—though this target is still well above the abysmally low level of revenue in 2010.

The last problem that we need to address is the potentially negative effects on European current accounts because of the projected employment-focused fiscal stimulus. To address this problem, we need to set targets for each bloc's real exchange rate.

As a global reference point, we set a ceiling ratio of 1 on the real exchange rate of the US dollar, the world's still dominant reserve currency. Setting a ceiling makes sense since our baseline projection (which assumes no policy changes) suggests that there will be continuous pressure on the US dollar to appreciate after 2011.

We now squarely confront the controversial topic of breaking up the eurozone, namely, abandoning the common nominal exchange rate for both Central and South Europe. Though the pros and cons of such a position remain hotly contested, we nevertheless allow the nominal exchange rates to diverge

between these two eurozone blocs in order to achieve targets for their real exchange rates that are desirable for Europe as a whole.

The target for the real exchange rate for Central Europe is set at 1.3 while that for South Europe is set at 0.75. These changes are also programed to happen quickly. These particular targets signify that relative to the US dollar, the real exchange rate of Central Europe will quickly appreciate while that of South Europe will quickly depreciate.

Such a reform is designed to remove the inherent relative exchange-rate advantage of Central Europe as well as the relative disadvantage of South Europe, both of which have resulted from adhering to a common currency.

Outside the eurozone, the targeted appreciation of the combined real exchange rate of North Europe is set at 1.7. In contrast, the combined real exchange rate of East Europe is set at 0.55. Also, British pound sterling is assumed, relative to the US dollar, to depreciate in real terms to 0.9. All of these rates have been selected after extensive testing of their feasibility and impact in combination with the rest of our assumed policy changes.

Scenario Results

What kind of results does our employment-focused scenario project? Compared to the results for the baseline scenario, economic growth is more rapid across the board (see Table 1). The most dramatic results are evident in South Europe and East Europe. Average growth of GDP jumps from 0.8% per year to 3.5% for South Europe, and from 2.1% to 5.5% for East Europe. There are more moderate increases for North Europe and the United Kingdom (as well as the US), and only a modest increase for Central Europe.

Table 1: Projected Average Growth Rate of GDP (%) Europe and the US, 2012-2030

	EMPLOYMENT SCENARIO	BASELINE SCENARIO
Central Europe	2.1	1.7
East Europe	5.5	2.1
North Europe	3.2	2.4
South Europe	3.5	0.8
UK	3.4	2.0
US	3.9	2.8

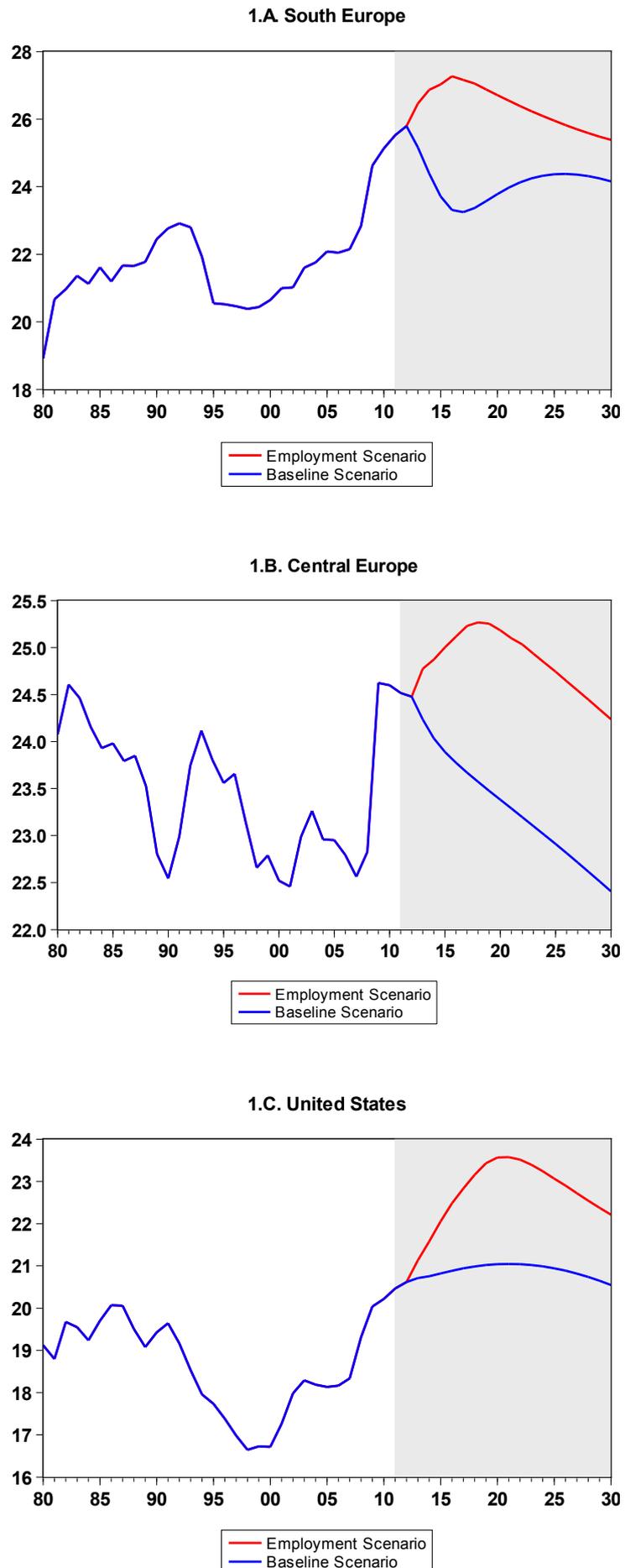
In some blocs, the increase in the employment ratio by 2030 exceeds our target. For example, in South Europe, the employed as a ratio to the working-age population slightly exceeds 64% even though our target was 62%. This overshooting also characterises East Europe’s resultant employment ratio: it surpasses our 60% target by over two percentage points.

Migration contributes to these increases in employment. This is evident in South Europe and the United Kingdom, which experience an upswing of migrant workers. There also appears to be a *return* of workers to East Europe, a region that had suffered from marked out-migration after the mid 1980s. However, where there is an increased net inflow of workers, such as into South Europe and the UK, the impact on the size of the working-age population is not dramatic.

Expenditures and Revenue

In the early years of our scenario, namely, 2012-2015, the growth of government expenditures is rapid, but it markedly slows down in most blocs after 2015 (see Figure 1). In the UK, for example, the growth of government expenditures is 2.6% after 2015, compared to

Figure 1: Government Expenditures as % of GDP South Europe, Central Europe and US 1980 – 2030



4.4% during 2012-2015. In Central Europe, government expenditures increase by 1.7% per year after 2015, a decline from the 3.1% rate of growth during 2012-2015.

Even though the ratio of government expenditures to GDP increases during the early years of our scenario in almost all blocs, it falls sharply thereafter. There are two reasons. In almost all cases, growth of government expenditures (the numerator) slows substantially after 2015 while growth of GDP (the denominator) is much improved.

In blocs such as Central Europe, East Europe and the UK, government net lending as a ratio to GDP converges towards zero. Although this ratio also dramatically improves in other blocs such as South Europe and the US, it remains negative, i.e., between -2% and -3%.

Government deficits are eliminated or significantly improved not only because government expenditures slow down after an initial spurt. Government net income as a ratio to GDP also appreciably improves in the majority of blocs. This trend is attributable, in part, to our assumption that governments would undertake explicit efforts to improve revenue generation. But the achievement of more rapid growth rates of employment and private incomes also indirectly helps boost government revenue.

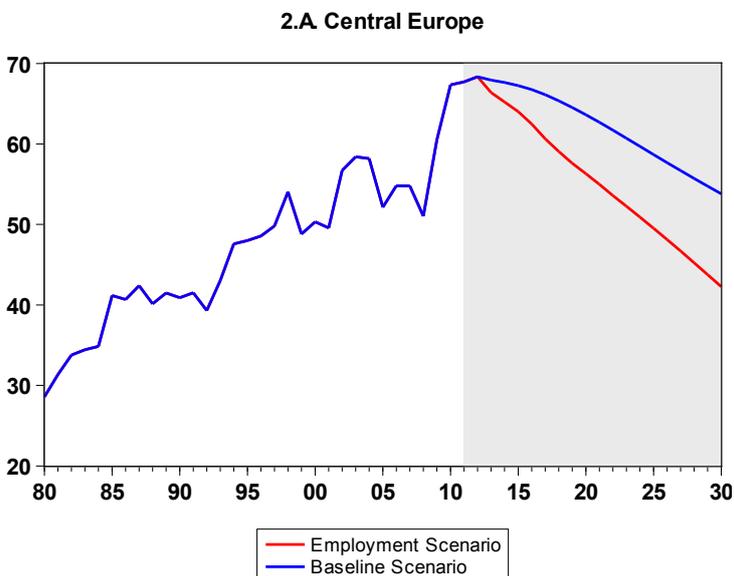
Falling Debt

Not surprisingly, government debt as a ratio to GDP falls dramatically in all blocs (see Figure 2). Though debt levels have been manageable in North Europe, Central Europe and even East Europe, their debt-to-GDP ratios still fall substantially. For example, Central Europe's debt/GDP falls from 67% in 2010 to 42% in 2030 and North Europe's from 48% to 9%.

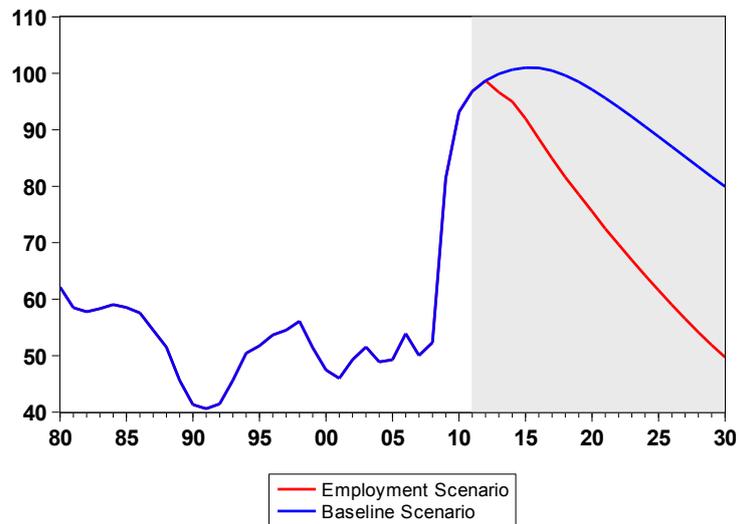
The other blocs with heavy initial debt burdens, such as South Europe, the UK and the US, also experience a significant lightening of their load. For example, the US's debt/GDP falls from 78% in 2010 to 62% in 2030. The latter is a more manageable level. The UK achieves almost a halving of its debt burden, from a level equivalent to 93% of GDP in 2010 to 50% in 2030.

South Europe's debt burden is also reduced but not as substantially as one would hope. Its debt/GDP declines from 102% in 2010 to 88% in 2030. In these circumstances, it should be obvious that some debt restructuring or relief is desirable, preferably sooner rather than later.

**Figure 2: Government Debt as % of GDP
Central Europe, UK and South Europe
1980 – 2030**



2.B. United Kingdom



2.C. South Europe



Exchange-Rate Impacts

What is the impact of our proposed changes of real exchange rates across the European blocs? First, we examine the impact on trends in the current account (see Figure 3 next page).

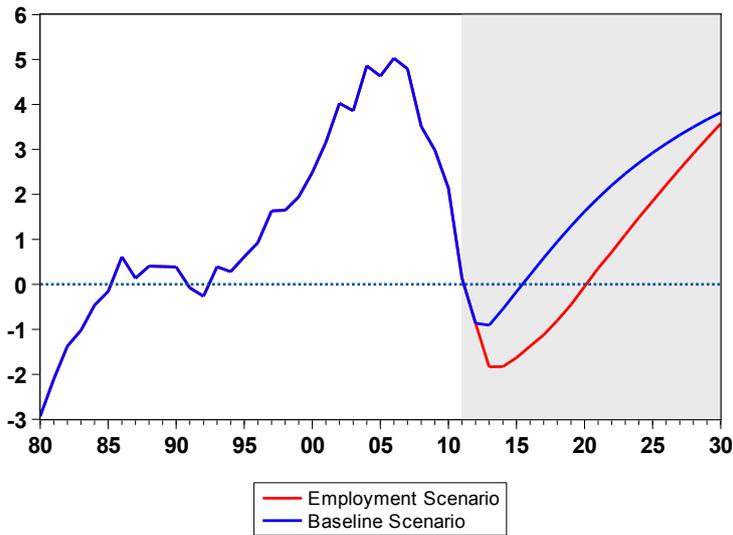
Already becoming negative in 2011, Central Europe's current account, as a ratio to GDP, becomes even more negative through 2013. Thereafter, however, it progressively improves, approaching a positive 3% by 2030. North Europe's large current account surplus declines markedly but still remains above 2% by 2030. Hence, the appreciation of the real exchange rates of these two blocs does not prevent them from running surpluses.

The current account deficits of South Europe, East Europe and the UK all progressively improve as a result of the depreciation of their real exchange rates. All of them approach or slightly exceed a zero balance by 2030.

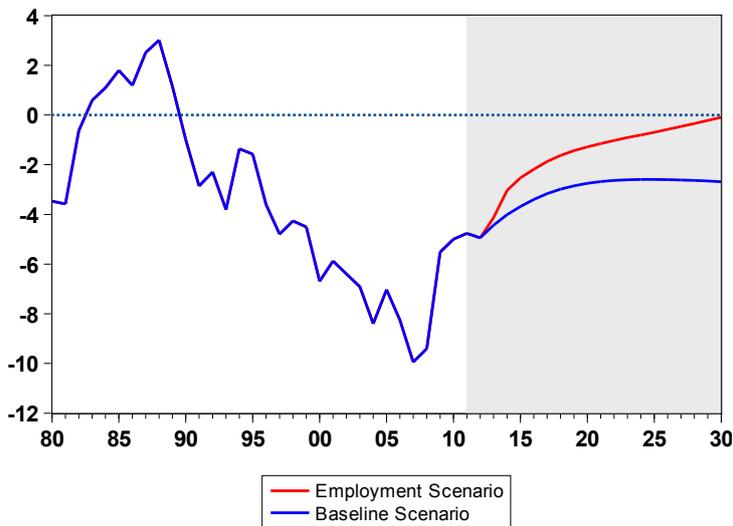
However, almost from the scenario's beginning, the US continues to slide into deeper current-account deficits, closing in on a -4% deficit by 2030. Hence, in order to correct this trend, the US dollar would need to be substantially depreciated, instead of being merely prevented from appreciating.

Figure 3: Current Account as % of GDP
Central Europe, East Europe and UK
1980 – 2030

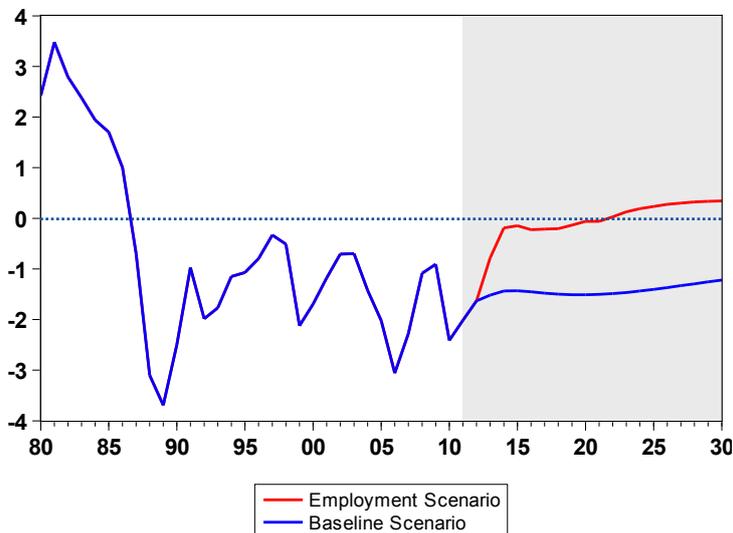
3.A. Central Europe



3.B. East Europe



3.C. United Kingdom



Domestic price inflation is not the driving force of the appreciation of the US real exchange rate since the rate of change of the price deflator for US domestic expenditures averages less than 2% during 2015-2030 (see Table 2).

Table 2: Domestic Prices, Average Change (%)
Europe and the US, 2015-2030

BLOC	2015 - 2030	BLOC	2015 - 2030
Central Europe	1.2	North Europe	0.6
East Europe	3.9	United Kingdom	2.8
South Europe	2.7	United States	1.7

Domestic price inflation also remains relatively subdued across the European blocs. For example, during 2015-2030, it averages a low 1.2% in Central Europe, and a lower 0.6% in North Europe. In East Europe, the UK and South Europe, average inflation is higher: 3.9%, 2.8% and 2.7%, respectively.

However, none of these inflation rates suggest that our proposed combination of an employment-focused fiscal stimulus and sharp depreciation of the real exchange rate would cause inflation to become unusually high.

Concluding Remarks

In this Policy Brief we have presented the results for various European blocs of a policy-oriented scenario generated by the *State of the World Economy* global macroeconomic model. The two defining features of this scenario are: 1) a proactive employment-focused fiscal stimulus and 2) management of the real exchange rate.

The first defining feature might appear counter-intuitive since the current focus on fiscal consolidation across Europe is generally interpreted to imply sharp reductions in government expenditures instead of systematic increases.

Another distinctive feature of our scenario is that fiscal expansions are not geared to achieve GDP growth *per se*, but rather employment growth. In addition, the character of government expenditures is designed explicitly to boost private investment, not dampen it.

Lastly, we also acknowledge the need to significantly increase government revenue in order to contain fiscal deficits, especially since revenue levels remain at historically low levels across Europe and the US in the wake of the global financial crisis.

The second defining feature of our scenario—which is no doubt as controversial as the first—is the active management of the real exchange rate of each European bloc. This implies dissolution of the eurozone in its present form, which is based on a common nominal exchange rate in both Central and South Europe.

Of course, if management of the real exchange rate is going to be successful, it will still depend on coordinated efforts across Europe. This coordination will not only involve a larger number of blocs but must also acknowledge the persistent differentials in their levels of productivity, or competitiveness.

Such an arrangement should help avoid the inevitable recourse to the depression of domestic living standards, which is now becoming pervasive, for example, across South Europe. The adjustment of each bloc's real exchange rate could replace the need for such drastic domestic price deflation.