Can Conventional Macroeconomic Policies Prevent Persistent Stagnation in the European Union?

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INTRODUCTION

In November 2014 there is general alarm that the Eurozone could be on the verge of slipping into its third recession in six years. The EC has already downgraded its projected growth rate for 2015 to close to 1%. The zone's overall inflation rate is perilously close to zero and could easily turn negative.

The resultant combination of deflation with recession would be difficult indeed to combat. Economic stagnation would likely spread throughout the European Union, dragging down even countries—such as the United Kingdom—that have appeared to revive economic growth.

The repercussions would also be global, likely hampering growth rates in both developed countries such as the United States and emerging economies such as China.

This Policy Brief is the first of a series of three that explore progressive policies that could address the current economic dilemma of the European Union.

The three Briefs will focus, in particular, on economic imbalances (manifested, for example, in large current-account surpluses or deficits and in yawning gaps between saving and investment). These imbalances will be highlighted within both the EU and a global context.

THE POLICY SCENARIO

This first Policy Brief assumes a continuation of conventional macroeconomic policies together with a significant rise in capital investment. The Cambridge-Alphametrics global macro model (the CAM) is used to project the impact of such a policy mix through 2020 and 2030.

We give particular attention to the announcement of the new EC President, Jean Claude Juncker, of an ambitious new Jobs, Growth and Investment Package, advertised to be financed by €300 billion over three years.

The details of such a plan, especially its form of financing and its allocation (geographically and sectorally), have yet to be elaborated. It is also not clear whether all of the €300 billion will be new financing.

Nevertheless, in our programming for the policy scenario that constitutes the focus of this first Policy Brief, we assume such a significant jump in investment—though we spread its implementation over 8-9 years.

We assume that 80% of the total financing will go to the Eurozone Periphery and France (60% to the Eurozone periphery and 20% to France) and the remaining 20% will be split equally between the Core Eurozone and the United Kingdom, where investment continues to be too low.

We also assume that the European Central Bank will implement continuously expansive monetary policies (such as quantitative easing), which could help thwart the threat of deflation. This would have to involve, for example, the ECB's continuous defence of the solvency of sovereign governments.

However, such an overall monetary stance does not eliminate the possibility that in the near future there could be significant jumps in bond yields in some peripheral countries such as Greece nor a sudden descent into deflation by some countries.

In addition, we assume that governments will still be obliged, for the sake of deficit reduction, to maintain a trajectory of at least moderate cuts in government expenditures along with the containment of increases in government revenue. This trajectory is intended to move countries progressively towards the deficit target of -3% of GDP and slow the rise of their debt burden.

In our discussion of the outcomes from this policy scenario, we confine our attention to four EU blocs: the Core Eurozone (led by Germany), France, the Eurozone Periphery (e.g., Italy and Spain) and the United Kingdom.

In this first scenario, we assume little or no change in economic policies among major economies outside the European Union—in particular, in the United States, China and Japan.

But we will briefly review the general outcomes for these countries' economic imbalances. This will help set the stage for discussing any changes in policies that we could assume that they would implement in an alternative scenario for our second Policy Brief.

Let us now review the general results of our initial policy scenario.

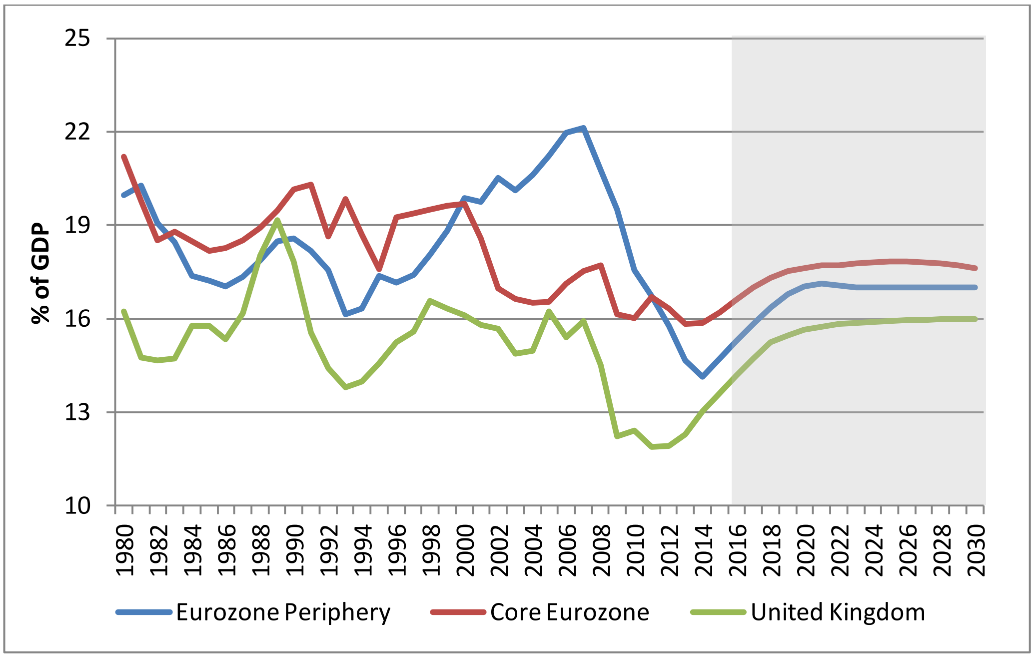
GROWTH AND INFLATION

This more expansionary policy package does succeed, for a while, in warding off recession and deflation across the EU. As hoped, private investment would indeed pick up across the four EU blocs.

The most modest results would be in the Core Eurozone and France. But in the Eurozone Periphery and the UK they would be more pronounced.

In the Eurozone Periphery private investment would rise from 14.7% of GDP in 2015 to about 17% in 2020 and remain fairly stable thereafter. In the UK the rise would be from 13.6% of GDP in 2015 to a high of 15.6% in 2030 (Figure 1). In the Core Eurozone investment would increase from 16.2% in 2015 to 17.6% in 2020 and peak at 17.9% in 2026.

Figure 1. Private investment as % of GDP



As a result of increased investment, economic growth is projected to be positive across the four EU blocs at least through 2019. But the Periphery, France and the UK are all projected to slip into recession well before 2030.

The Periphery would manage to attain 1.8% growth during 2015-2018 before it declines thereafter (Table 1); while the Core Eurozone would manage positive but low growth throughout the whole period to 2030.[1]

Table 1. Average GDP growth

	Core Eurozone	Eurozone Periphery
1995-1998	2.0	2.8
1999-2002	1.9	3.0
2003-2006	1.6	2.3
2007-2010	0.8	-0.5
2011-2014	1.2	-0.8
2015-2018	1.7	1.8
2019-2022	1.5	0.9
2023-2030	1.0	-0.3

Based on an immediate expansion in investment starting in 2015, the CAM projects that price inflation would remain fairly flat and quite low throughout the whole period to 2030.

Both France and the United Kingdom are projected to flirt with deflation but would not dip into negative territory. The Core Eurozone and the Eurozone Periphery would have a consistently low but uniform trend of inflation of about 1-2%.

Meanwhile, the global context is not projected to be propitious. The US would slip into recession in 2023, Japan would maintain barely positive growth throughout the whole period and China's growth would progressively slow from its present level of about 7% to about 5% by 2030.

Thus, the risks to the EU would all remain on the downside. The dire threat of facing a combination of deflation with recession would not be eliminated.

DEFICIT AND DEBT

As programmed, all four EU blocs would achieve moderate but sustained cuts in their government expenditures. For example, government expenditures as a ratio to GDP would fall from about 27% to 26% in France, and from about 22% to 21% in the Eurozone Periphery.

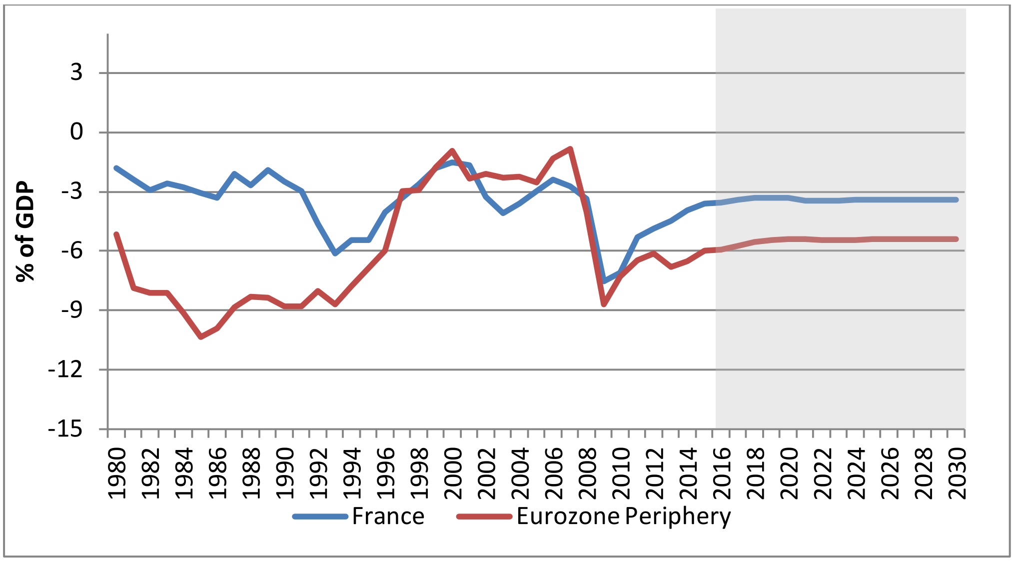
The trend in government revenue would also be restrained, falling, for example, in the Core Eurozone from about 21% of GDP to 20%. In the United Kingdom revenue would rise initially from about 18.1% to 18.4% and then decline eventually to just 18%. Thus, any resort to mobilizing additional tax revenue is being ruled out as a policy option.

As a result of these trends, the government deficit in the Core Eurozone would stay below -2% of GDP throughout the projected period while the deficits in both France and the United Kingdom would maintain fairly uniform trends, though both of them would reach only a deficit of about -3.4% of GDP in 2030.

The government deficit for the Eurozone Periphery would start out at about -6% of GDP in 2015 but, unfortunately, it would still exceed -5% in 2030 (Figure 2).

[1] In the next two Policy Briefs, we will draw out some of the employment implications of such growth trends.

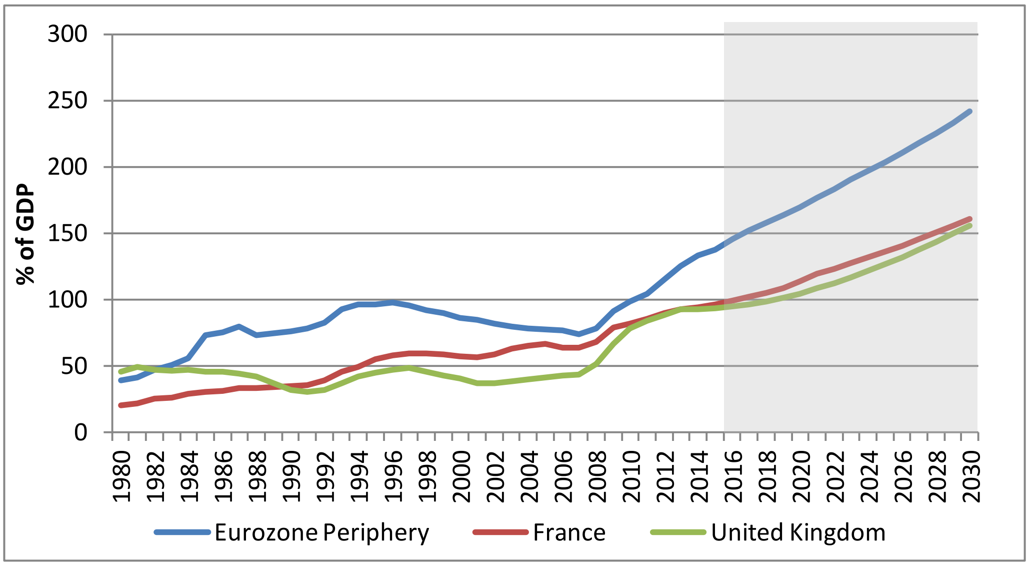
Figure 2. Government deficit as % of GDP



Combined with slow (and sometimes negative) growth in GDP, the deficit trends sketched out above would lead to progressively higher debt burdens across the four EU blocs. The Core Eurozone would fare the best, seeing its debt to GDP ratio rise only from about 80% in 2015 to about 90% in 2030.

However, both France and the UK would experience a hefty similar progressive increase in their debt ratios, from under 100% in 2015 to about 160% in 2030. The worst case would be the Eurozone Periphery, where the debt ratio would enlarge dramatically from about 140% of GDP in 2015 all the way up to about 240% in 2030 (Figure 3).

Figure 3. Government debt as % of GDP



Hence, while there would be at least modest improvements in government deficits throughout the projected period across the four EU blocs, debt burdens would continue to spiral out of control for all blocs except the Core Eurozone.

Economic growth would have to be significantly accelerated and some tax increases might have to be introduced in order to help balance government budgets. Such improvements could at least help rein in future runaway debt burdens though the national debt burdens in the Eurozone Periphery are already prohibitively heavy. We will return to this issue in the next Policy Brief.

ECONOMIC IMBALANCES

Saving and Investment

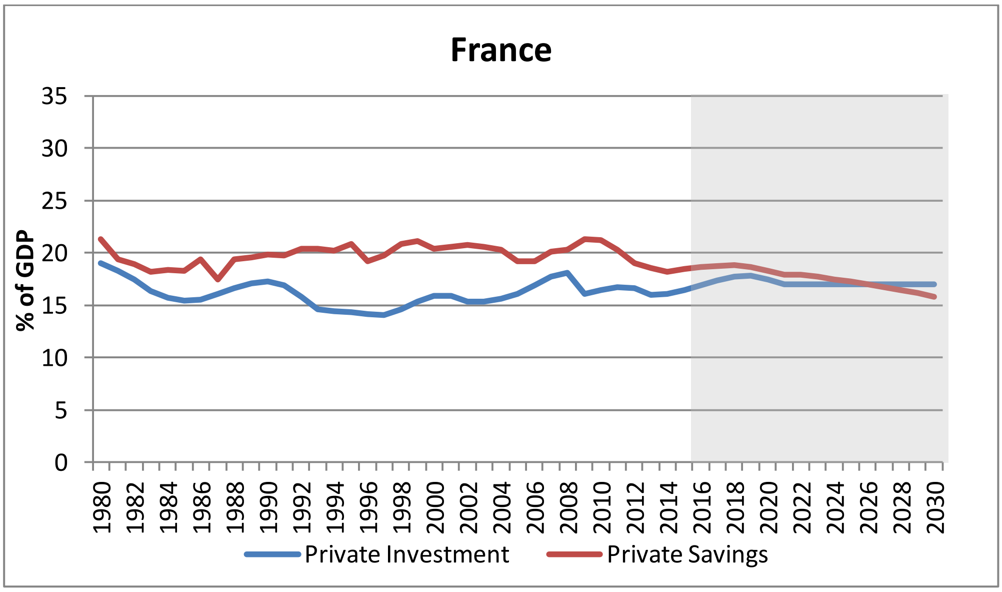
We now turn to the focus of our attention in this Policy Brief: economic imbalances both within the EU and across some of the key large economies in the world (USA, Japan and China).

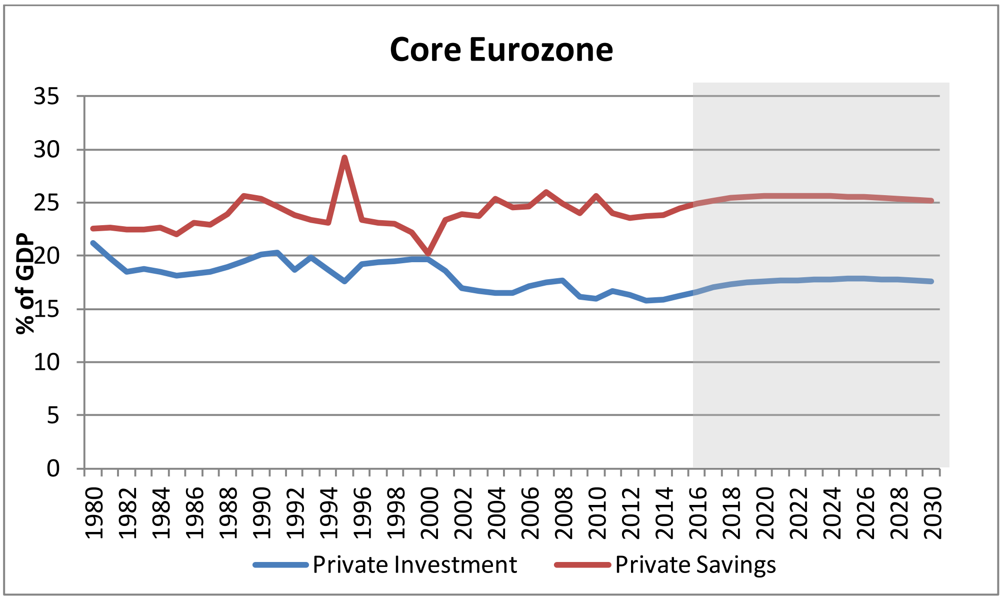
Having already examined the imbalances between government expenditures and revenue, we start here with an examination of the imbalances between private investment and saving within the EU.

Across the four EU blocs, it is evident that private investment would still remain too low under the current scenario. It would stay consistently below 20% of GDP, even after implementing the Juncker-proposed investment stimulus.

In the Core Eurozone, it is noteworthy that private saving (about 25% of GDP) would remain well above private investment between 2015 and 2030—as a result of continued chronic lack of internal demand and current account surpluses (Figure 4). However, in France private saving is projected to collapse to the low level of private investment—instead of being deployed as financing to boost it.

Figure 4. Private Saving-Investment gap





In the UK private saving would fall precipitously, from about 18% of GDP to a mere 10%, well below even low private investment—implying a badly worsening current-account position. In the Eurozone Periphery, however, private saving would remain just above 20%, consistently higher than private investment, but the latter, unfortunately, would not exceed 18%.

So the trends in saving and investment suggest that the four European blocs would face distinctly different kinds of imbalances in their economies. We now examine imbalances in the current account. They are also projected to be quite different across the four EU blocs.

The Current Account

In 2015 the Eurozone Periphery is projected to have a small current-account surplus of 0.7% of GDP (Table 2). This outcome would contrast sharply with the peak deficit of -7.6% of GDP that it had in 2008. Its current account has improved progressively, in fact, since 2008—primarily by slashing domestic aggregate demand.[2]

However, examining the trend further into the future suggests that the Periphery's current account balance would become negative again. By 2030 it is projected to have a deficit, as a ratio to GDP, of -1.7% of GDP—partly due to a real appreciation of its exchange rate of about 5%.

But it is important to point out that this shortfall would not be primarily due to a deficit on goods and services but to a deficit of -2.7% of GDP on income and transfers. While the balance on goods and services would remain positive throughout the whole period of 2015 to 2030, the outflow of income and transfers would become progressively worse (partly due to interest payments on public and private debts).

Current-account trends in the Core Eurozone (dominated by Germany) are projected to be quite different. However, they are inextricably part of the same Eurozone-wide process—an argument that we will elaborate in Policy Brief #2.

[2] The current projections of current accounts are aligned with the IMF estimates in the April 2014 *World Economic Outlook.*

Despite the significant compression of the deficits of the Eurozone Periphery, the Core Eurozone's current-account balance is projected to remain large, at about 6% of GDP between 2015 and 2020, and then to decline slightly to 5.5% of GDP by 2030, partly because of some appreciation of its real exchange rate.

This current-account outcome would be due primarily to large continuing surpluses on manufactures (equivalent to 6-7% of GDP) and moderation in deficits on energy (equivalent to negative 2-3% of GDP). This bloc would also benefit modestly from a continuing inflow of income and transfers (equivalent to about 1% of GDP).

Table 2. Current account balances as % of GDP

		2015	2020	2030
Core Eurozone	Goods and services	5.1	5.1	4.4
	Income and transfers	0.9	1.0	1.1
	Overall current account	6.0	6.1	5.5
France	Goods and services	-2.2	-2.3	-3.1
	Income and transfers	0.1	-0.3	-1.4
	Overall current account	-2.1	-2.6	-4.5
Eurozone Periphery	Goods and services	2.7	2.0	1.1
	Income and transfers	-2.0	-2.2	-2.7
	Overall current account	0.7	-0.2	-1.7
United Kingdom	Goods and services	-2.7	-4.9	-8.3
	Income and transfers	0.2	0.3	-0.5
	Overall current account	-2.5	-4.6	-8.9

In terms of its current account, France is projected to confront outcomes that would be worse than those for the Eurozone Periphery. Its current account deficit would basically double, from -2.2% to -4.5% of GDP, between 2015 and 2030 despite only a modest appreciation of its real exchange rate.

This growing deficit would be due overwhelmingly to a deficit on manufactures that is projected to widen from about -1.7% to -4.5% of GDP between 2015 and 2030. France is also expected to experience an outflow on income and transfers, which could reach -1.4% of GDP by 2030. This would be due, no doubt, to an increase in debt servicing.

The projected trends for the United Kingdom are far worse than even those for France. Its current account deficit, already -2.5% of GDP in 2015, would widen ominously to almost -9% of GDP by 2030—partly because of about a 10% real appreciation of Pound Sterling.

This widening current-account deficit would be due largely to a mammoth and widening deficit on manufactures along with a worsening deficit on energy. These two major negative trends would be mitigated to some extent by fairly buoyant surpluses on services (financial services in particular). These surpluses would remain fairly stable at 3.5%-4.0% of GDP throughout the projected period.

Global Imbalances: the USA, Japan and China

This scenario projects, almost across the board, that major economies and blocs throughout the world would experience a slowdown in economic growth. Hence, the global context for stimulating growth in the EU would not be promising. World GDP (at market rates) would decline from a projected 3.1% in 2015 to 2.3% in 2020 and to 1.3% in 2030.

In preparation for presenting the results of an alternative scenario, which will be highlighted in Policy Brief #2, we examine briefly the projected trends in current-account imbalances in the Eurozone as a whole and in three large globally important economies, the USA, Japan and China (Table 3).

The Eurozone is projected to generate current-account surpluses throughout 2015-2030 that range between 1% and 2% of GDP—despite running deficits on incomes and transfers. This trend signifies that in absolute terms the Eurozone would represent a major surplus bloc at the global level. In Policy Brief #2 we will explore the implications of this position in depth.

Table 3. Current account balances as % of bloc or country GDP

		2015	2020	2030
Eurozone	Goods and services	2.1	2.1	1.4
	Income and transfers	-0.2	-0.1	-0.2
	Current account	1.9	2.0	1.2
United States	Goods and services	-2.8	-3.5	-4.4
	Income and transfers	0.6	0.2	-0.6
	Current account	-2.2	-3.3	-5.0
China	Goods and services	1.4	2.1	2.3
	Income and transfers	-0.2	-0.1	0.1
	Current account	1.2	2.0	2.3
Japan	Goods and services	-1.6	0.4	1.3
	Income and transfers	3.4	2.9	2.8
	Current account	1.8	3.3	4.1

We have already mentioned above, in the section on Growth and Inflation, that growth rates in the United States, China and Japan are projected to worsen between 2015 and 2030. This trend would obviously represent a substantial problem since the performance of these economies will have had a pronounced impact on the rest of the global economy.

Despite some relative recent decline, especially compared to China, the USA is still the dominant economy in the world. Yet its future prospects are not projected to be promising in our current scenario. In particular, its current-account balance is expected to worsen between 2015 and 2030, from -2.2% to -5% of GDP.

This trend appears to be due to two main factors. Its deficit on manufactures is expected to worsen dramatically, from about -3% to -5% of GDP. Also, and unprecedentedly, its balance on income and transfers would turn from a positive 0.6% of GDP into a negative 0.6% of GDP.

During the projected period, Japan would succeed in improving its *overall* current-account balance (partly due, no doubt, to slow economic growth and demand). This balance would rise from a little under 2% of GDP in 2015 to about 4% in 2030. Behind this surplus will continue to be a significant surplus on manufactures.

What is noteworthy, however, about Japan's overall current-account surplus is that it would be due largely to a surplus on income and transfers, not—perhaps as popularly assumed—on goods and services.

During 2011-2015 Japan would run, in fact, a deficit on goods and services. By 2030, when Japan's balance on goods and services would have turned positive and reached 1.3% of GDP, its surplus on income and transfers would have reached 2.8%.

China's current-account surplus, which had approached almost 9% of GDP in 2008, is projected to decline all the way to 1.2% by 2015, and to increase again only to 2.3% by 2030. This would be a noteworthy development indeed for the global economy.

During this projected period, China's formidable surplus on manufactures would decline moderately, from about 8.5% to about 7% of GDP. Meanwhile, it would still suffer from significant deficits on primary commodities and on energy.

CONCLUDING REMARKS

Our macroeconomic modelling shows that the scale of the more expansive macroeconomic policies currently being contemplated by EU policymakers would not be sufficient to stave off secular stagnation throughout Europe.

Clearly, the scale of the Juncker-proposed investment stimulus would be far too modest, both in its currently advertised scale and duration. Recently, for example, the Polish Finance Minister has instead proposed a more ambitious investment package equivalent to 700 billion euros (about 5.5% of EU GDP).

Moreover, the stimulus effect of the Juncker-proposed investment plan would appear to be nullified, to some extent, by the continued depression of government expenditures as a whole in the EU.

In addition, even if the adoption of some kind of sustained quantitative easing (which is currently being signalled by Mario Draghi, the head of the ECB) would succeed in helping ward off—just barely—the daunting spectre of deflation, it would be highly unlikely to contribute significantly to stimulating higher economic growth.

It is also clear from this modelling exercise that pronounced economic imbalances *within* the European Union are projected to persist well into the future. These have been illustrated, for example, by the projected trends of the current accounts (and saving and investment balances) of the Core Eurozone, France, the Eurozone Periphery and the United Kingdom.

An important implication is that merely scaling up stimulus policies will not be sufficient to address the EU's problems of protracted secular stagnation. Unless its stark imbalances are directly confronted and reduced, there appears to be little hope of sustaining significant EU-wide economic growth (along with substantial debt reduction).

Lastly, the malaise within the European Union is projected to occur within a global context of slowing economic growth—and continuing, if not increasing, malaise within the world's leading economies, i.e., the USA, Japan and China.

Thus, the EU's success in overcoming economic stagnation will hinge, to some degree, on reviving growth throughout the global economy. What this current scenario has already illustrated is that relying primarily on the USA to run progressively higher current-account deficits as a stimulus to global growth is clearly not a viable solution.

Other more feasible and progressive alternatives will have to be formulated. We will address these issues more directly in the next Policy Brief.