How can the EU Federal Government spearhead an employment-led recovery?

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INTRODUCTION

This Policy Brief explores a policy scenario for Europe of combining fiscal expansion at the country level with enhanced financial support from the EU Federal Government in order to spearhead an employment-led economic recovery. The outcomes generated by this scenario are contrasted with the stagnation in employment produced by a scenario that continues current austerity measures.

Our scenario for Employment-Led Economic Recovery assumes increases in government investment, government income and private investment as the strategic basis to generate substantial increases in GDP and employment. This scenario also assumes that the budget of the EU Federal Government will be gradually scaled up and directed to spur public and private investment across Europe, particularly in the South Eurozone (e.g., Italy, Spain, Portugal and Greece), and that the European Investment Bank will also provide sizeable loans to increase private investment. In order to provide the South Eurozone countries with a viable initial basis for economic recovery, the EU Federal Government also offers them immediate substantial debt relief.

The authors of this Policy Brief have used the CAM (Cambridge-Alphametrics Model) to compare and contrast the results from these two scenarios through 2020 and 2030 (see www.augurproject.eu for further description of the model). Both scenarios are placed within the global context of a moderately negative future economic trend in developed countries. The CAM is a global macroeconomic model that uses a comprehensive data set, stretching from 1970 to 2012, to project future outcomes based on scenarios that assume major differences in policies.

The 'baseline' scenario for our projections assumes that the current basic direction of austerity policies is maintained through 2030. Thus, this scenario assumes, for instance, that governments will continue to cut their expenditures in a concerted effort to reduce budget deficits and bring down debt-to-GDP ratios to below 60% (in line with the requirements of the Growth and Stability pact). Not surprisingly, such an effort is likely to be quixotic when the denominator of this ratio, GDP, is not growing.

In contrast, our scenario of an Employment-Led Economic Recovery assumes that governments will maintain their expenditures in order to help generate the economic momentum necessary to substantially raise employment levels. However, maintaining expenditures does *not* translate into higher debt/GDP ratios for two reasons: 1) complementary increases in government revenues from initially low levels are implemented and 2) the resultant growth rates are high enough to reduce the debt ratio over time because of the increase in GDP.

Because the CAM is a global model, it relies mainly on aggregating countries into meaningful blocs. This structure is maintained for the current exercise. For European scenarios, for example, it works with four blocs (the North Eurozone, the South Eurozone, Scandinavia and East Europe) and one major country (the United Kingdom). The North Eurozone includes, for instance, France and Germany; the South Eurozone includes Italy and Spain; Scandinavia includes Denmark and Sweden; and East Europe the Czech Republic and Poland.

The principal employment indicator that this exercise uses is the ratio of the total employed to the total working-age population. The Austerity Scenario projects that this ratio will basically stagnate in all blocs through both 2020 and 2030. One obvious reason is that economic growth is also projected to essentially stagnate during these time periods.

In contrast, our scenario for Employment-Led Economic Recovery deliberately targets historically significant increases in the ratio of the employed to the working-age population. For instance, it targets a ratio of 75% for Scandinavia, the North Eurozone and the United Kingdom. Since historical

employment levels have been much lower in the South Eurozone and East Europe, the scenario targets a ratio of 65% for these two blocs—a rate that is still relatively ambitious.

POLICIES FOR ECONOMY RECOVERY: THE FEDERAL LEVEL

What policy package and EU reforms does the scenario for Employment-Led Economic Recovery recommend? Extensive previous work with such scenarios suggests that policy initiatives solely at the bloc and country level will confront great difficulties in generating the desired outcomes. Hence, this scenario assumes that additional resources will made available and policy initiatives will be strengthened at the Federal level of the European Union in order to reach the targeted employment levels.

The core recommendation is that the EU budget be increased gradually from the present level of a mere 1% of EU GDP to a more effective level of 4% by 2021. For the CAM programming, this budget expansion is financed by increases in progressive taxes on income and wealth across Europe.

In addition, there is a provision for running a modest fiscal deficit at the Federal level. This deficit rises to no more than 0.3% of EU GDP. Both expanding the EU budget and running a deficit would necessitate setting up a Ministry of Finance at the Federal level. But this Policy Brief is not designed to address such institutional issues, which would require a much longer discussion.

The primary immediate intent of such an EU budget expansion is to allocate substantially more investment funds to the South Eurozone on the basis of fiscal transfers from surplus countries, primarily those of the North Eurozone. This allocation provides a mechanism to counteract the underlying structural asymmetry of this currency union. This asymmetry is reflected in an undervalued real exchange rate for the North Eurozone and a correspondingly overvalued real exchange rate for the South Eurozone, without the possibility of either bloc being able to revalue its nominal exchange rate.

The scenarios' mobilization of additional investment funds is carried out on the basis of two criteria: 1) a bloc's employment shortfall relative to an 85% ratio of the employed to the working-age population and 2) a bloc's total population.

These criteria imply that the South Eurozone will receive significant net fiscal transfers from the expanded resources at the Federal level (reaching a maximum of about +4.6% of its own GDP by 2030). East Europe will also be a net recipient of EU funding (receiving a maximum of 1.7% of its GDP). The net contributors to the EU budget will be the North Eurozone (providing, at most, 1.3% of its own GDP), Scandinavia (also 1.3%) and the United Kingdom (0.6%).

In addition, this scenario assumes an increase in private investment through enhanced lending from the European Investment Bank (EIB). One of the major constraints holding back economic recovery is the historically low levels of private investment across Europe as a whole. The EIB can raise funds for such critically important lending by issuing bonds at reasonable rates on the international capital market. Moreover, borrowing from the EIB does not count as part of the national debt of any EU member country.

Lastly, this scenario assumes that the EU will provide debt relief to the heavily indebted countries of the South Eurozone by expanding the powers of the European Stability Mechanism (the ESM) to shoulder their debt burden that exceeds 60% of GDP. At the EU level, such debt would represent about 7% of collective GDP. The ESM and its precursor, the European Financial Stability Facility, already have the mandate to help debt-distressed countries by buying their debt. But the proposal in this scenario would represent a significant expansion of the ESM's function. Previous work on the

CAM has underlined the importance of early debt relief in providing the South Eurozone with the basis for any significant economic recovery.

POLICIES FOR ECONOMY RECOVERY: THE BLOC LEVEL

At the bloc level, the Employment-Led Economic Recovery assumes two major policy initiatives: 1) maintaining government expenditures at levels close to those achieved prior to the 2008 global crisis, instead of substantially slashing them, and 2) stimulating private investment in order to raise it from the woefully low levels to which it has plummeted in the wake of the financial crisis.

These two policies are linked by prioritizing public investment, which can have a significant stimulus effect on private investment. Lending by the EIB at the Federal level is also assumed to enhance private investment. As a result, the scenario targets a level of private investment as a ratio to GDP of 18% across most blocs. However, since the United Kingdom has a particularly low level of private investment, the target for it is 15%.

For the North Eurozone, the South Eurozone, East Europe and the United Kingdom, the scenario targets levels of government expenditure to GDP of 24-26%. The one exception is Scandinavia: its level of government expenditure to GDP is targeted at 32% since it starts from a comparatively higher level. These expenditure figures include only current and capital expenditures on goods and services (not transfers).

But, in order to avoid a substantial increase in fiscal deficits across Europe, the Employment-Led scenario also assumes a rise in government revenue which, together with the fiscal transfers from the Federal level mentioned above, will help close any problematic financing gap. This rise in government revenue will occur partly through increases in taxable incomes as a result of enhanced growth.

For four of the five European blocs, the scenario adopts a target for government revenue as a ratio to GDP of 22-24%. For Scandinavia, which already has a high level of revenue, the target is 33% of GDP.

In addition to the measures for government expenditures and revenue and boosts to private investment, the scenario also assumes some degree of reflation in the North Eurozone. This effect results from a 0.7% yearly boost to the ratio of consumption to private income, based on an assumed rise in the share of wages in national income.

This assumption is designed to counteract the past wage repression in this bloc and stimulate domestic sources of growth. Such a policy should also help augment exports to the North Eurozone from the other four European blocs.

In order to address any problems with the trade balances, the scenario also assumes changes in the real exchange rate for the three blocs which are not part of the Eurozone: the United Kingdom, Scandinavia and East Europe. It is assumed that East Europe does not join the Eurozone since the Austerity Scenario shows that immediately in 2015, when it is projected to join the currency union, its current account immediately starts to markedly deteriorate.

For the United Kingdom, the scenario assumes a 26% depreciation of the real exchange rate, from 1.08 to 0.80. For each bloc, the real exchange rate is measured relative to the real exchange rate of the US dollar. The depreciation by the UK is necessary in order to help close its projected current account deficit. For East Europe a depreciation of about 15% in its real exchange rate is assumed in order to contain an eventual deterioration in its current account after about 2020. For Scandinavia, there is a projected long-term trend of appreciation of its real exchange rate above its starting-point

of about 1.5 in 2012. This appreciation is contained at 1.7 in order to enable it to continue generating current-account surpluses.

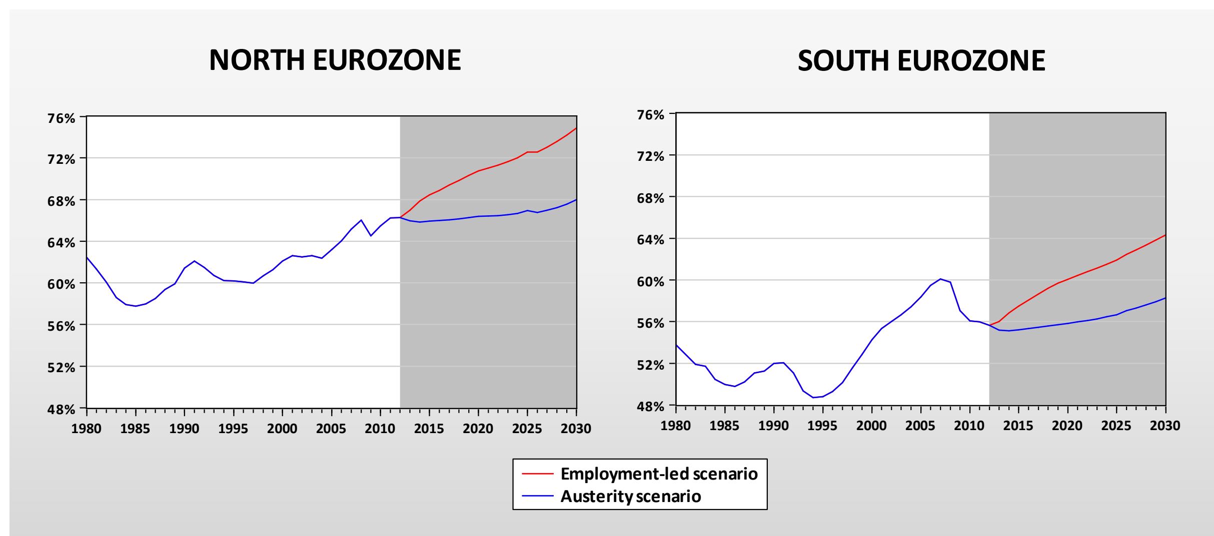
SCENARIO PROJECTIONS

Employment

What are the results from the policies assumed in the scenario for Employment-Led Economic Recovery? The most important result is the gains in employment, namely, the ratio of the employed to the working-age population. For this key variable, the scenario's targets are basically met.

Figure 1 shows the results for the North Eurozone and the South Eurozone as an illustration of the general results. In the North Eurozone, employment is projected to rise from about 66% in 2012 to 71% in 2020, and then to about 75% in 2030. In the South Eurozone, employment rises from 55.6% in 2012 to 60% in 2020, and then to over 64% in 2030.

Figure 1. Employment as % of Working-Age Population



These projected employment rates are impressive in comparison to past trends. This is especially the case in the South Eurozone, where employment has fallen sharply since 2008. In the North Eurozone, employment has essentially stagnated since 2008 but it is projected to resume its earlier trend rate of increase after 2013.

The results for the United Kingdom, East Europe and Scandinavia are also basically in line with the intended results. Scandinavia's employment was already at a fairly high level (namely, 71%) in 2012 so the projected increase to over 75% in 2030 is modest. However, the results for the other two blocs are more significant. The UK's employment is projected to rise from 67.6% in 2012 to almost 76% in 2030. East Europe's employment starts in 2012 at a low level, i.e., only 53.5%, but is projected to expand impressively to 66.4% by 2030.

It is important to note that such employment gains are not achieved at the cost of lowered labour productivity. In two of the five European blocs, the projected trend in labour productivity is similar to that maintained before the financial crisis. In the other three blocs, the future trend in labour productivity is higher than in the past.

Economic Growth and Inflation

Table 1 shows that all of the European blocs experience significantly more positive rates during 2013-2020 and 2021-2030 than they do under the Austerity Scenario. The economic growth rates for the Austerity Scenario are listed in the parentheses for each bloc. In the Employment-Led Scenario, economic growth is projected to slow down during 2021-2030 in some of the core European blocs as the impact of the initial fiscal stimulus begins to subside.

However, Scandinavia's performance is projected to be only modestly better than it would achieve under the Austerity Scenario. In contrast, East Europe is projected to achieve high rates of growth: 6% during 2013-2020 and 5.1% during 2021-2030. These represent a much better prospect than that projected for continued austerity, i.e. less than 2% growth.

The projected growth rates for the North Eurozone, the South Eurozone and the United Kingdom are roughly in the same range over these two periods, i.e., 2% to 4%. Though not high, these rates are certainly much better than the roughly zero growth rates produced by the Austerity Scenario. The United Kingdom has the most impressive growth rate, rising, for example, to an average of 3.1% during 2021-2030.

Table 1. Average GDP Growth (%)

	2008 - 2012	2013 - 2020	2021 - 2030
North Eurozone	0.4	2.7 (0.4)	1.7 (-0.3)
South Eurozone	-1.4	2.8 (-0.3)	2.0 (-0.1)
East Europe	1.5	6.0 (1.7)	5.1 (1.8)
United Kingdom	-0.5	2.2 (-0.3)	3.1 (-0.1)
Scandinavia	0.2	2.1 (1.7)	1.7 (1.1)

The economic growth rates mentioned above are not associated with high inflation rates. Only in Scandinavia during the initial period of the Employment-Led scenario (i.e., 2013-2020) is price inflation projected to significantly exceed 3%. During the same early period, inflation only slightly exceeds 3% in the North Eurozone. And in the later period of 2021-2030, price inflation in the United Kingdom approaches 3% as its economic growth accelerates towards 4% by 2030. Later in this Policy Brief there is a related discussion of each bloc's real exchange rate and its relationship to its trade balance.

Private Investment

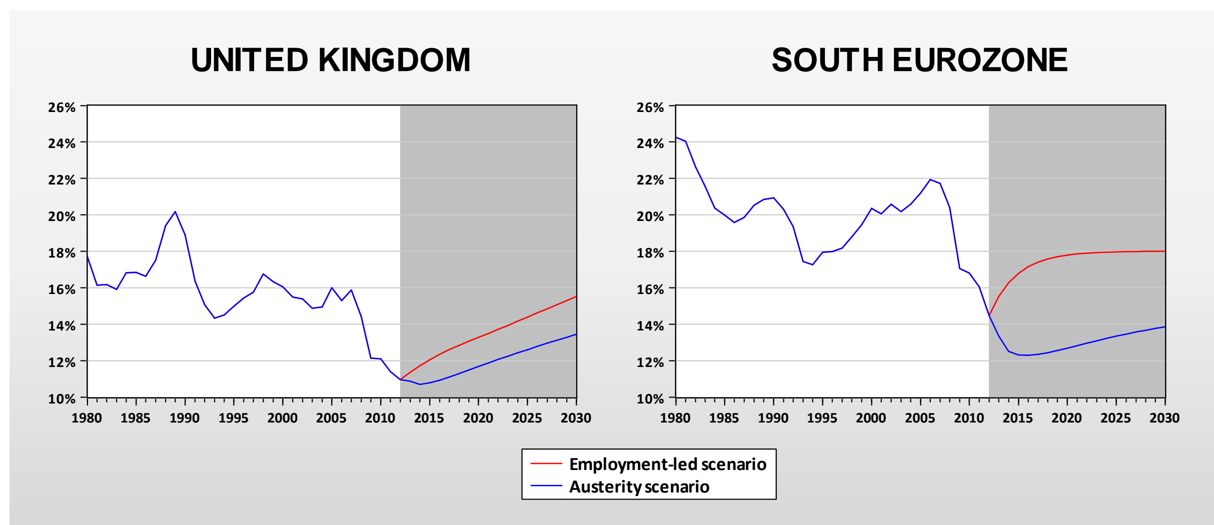
One of the key constraints on growth in all of the European blocs is the long-term decline in private investment, which results in historically very low levels by 2012. The scenario for Employment-Led Economic Recovery assumes important but fairly moderate increases in private investment through 2020 and 2030.

In four of the five European blocs, private investment as a ratio to GDP is projected to come close to the scenario target of 18%. **Figure 2** shows the trajectory of private investment for the South Eurozone, where there is a significant boost of such investment to about 18% as early as 2020. This

result contrasts with that for the Austerity Scenario, in which private investment recovers to about 14% of GDP only by 2030.

Figure 2 also highlights the results for the United Kingdom. Its private investment starts in 2012 at an abysmally low level of 11.4% in 2012 and reaches only 13.3% by 2020 and 15.5% by 2030. Although private investment is not a direct policy variable in the way that government expenditure is, the modest results across the five European blocs suggest, nevertheless, that increasing the economic growth of these blocs in the future will have to rely on mobilizing more concerted policy initiatives, such as bolstering public investment, enhancing bank lending and implementing strategic structural policies, in order to boost private investment to adequate levels.

Figure 2. Investment as % of GDP



Fiscal Balance: Expenditures and Revenue

What are the projected fiscal balances of the five European blocs? The scenario for Employment-Led Economic Recovery assumes that government expenditures are maintained at levels achieved just before the onset of the global crisis and that government revenues are increased to levels commensurate with expenditures. This configuration is in stark contrast to the Austerity Scenario, which projects dramatically reduced government expenditures while government revenues are held close to the relatively low levels experienced in the wake of the financial crisis.

Figure 3 illustrates these trends with the examples of government expenditures in the North Eurozone and East Europe. In the former, the ratio of government expenditures to GDP is maintained throughout 2013-2020 and 2021-2030 at about 24.5%, a level that is only slightly below its peak of about 25% before the 2008 crisis. Similarly, in East Europe during these two periods government expenditures as a ratio to GDP are maintained at just under 25%, slightly below the peak of over 25% attained before 2008.

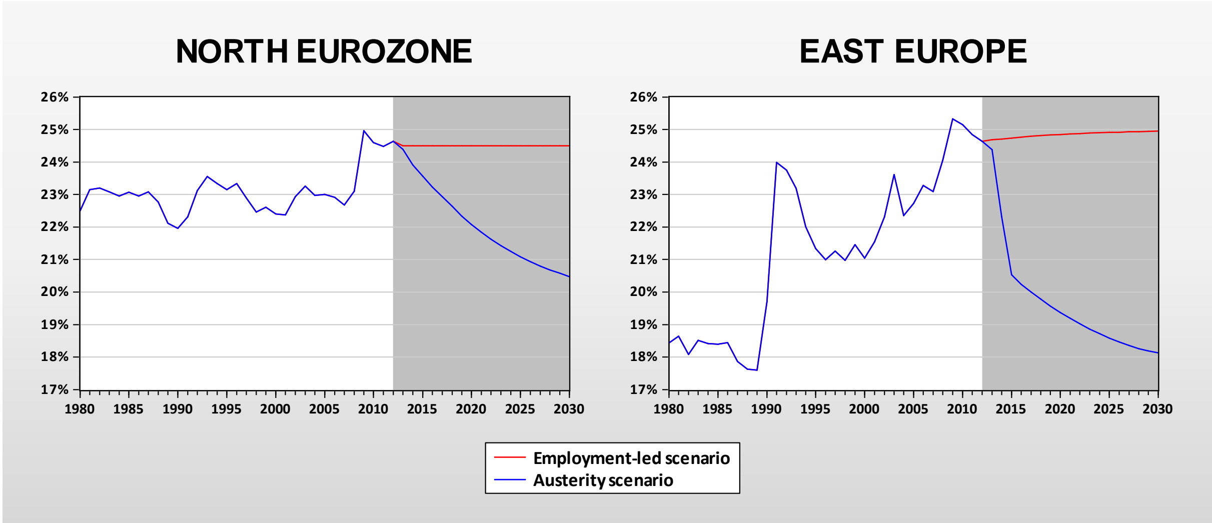
Under the assumptions of the Austerity Scenario, government expenditures as a ratio to GDP falls sharply in the North Eurozone to about 20.5% by 2030 and in East Europe to 18% by the same year.

One of the possible drawbacks often cited of implementing expansionary fiscal policies is the widening of fiscal deficits. But just the opposite is the case in this scenario. One major reason is its targeting of significant increases in government revenue. Another is the Federal policy of directing

fiscal transfers to the South Eurozone and East Europe, the two blocs that have been running the largest fiscal deficits.

In the South Eurozone, government revenue is projected to reach about 25% of GDP in 2020 and about 26.5% of GDP in 2030, both of which are well above its bloc-level target of 22% because of the inflow of Federal fiscal transfers. Both East Europe and the United Kingdom come close to their revenue targets of 24% of GDP only by 2030. However, government revenue in the North Eurozone only reaches a peak of 23.7% of GDP, instead of its targeted level of 25%, because of its net contribution of revenue to the Federal budget.

Figure 3. Government Expenditure as % of GDP



In general, fiscal deficits are projected to be reduced to levels below -1% of GDP by 2030 in the scenario for Employment-Led Economic Recovery. Thus, this scenario cannot be dismissed on the basis of promoting fiscal profligacy. **Table 2** shows the fiscal balances of each bloc plus its corresponding net fiscal transfers to/from the EU. Since there were no fiscal transfers in 2012, the table starts with 2013.

Table 2. Fiscal Balances and Net Fiscal Transfers as % of GDP

		2013	2020	2030
North Eurozone	Fiscal Balance (% GDP)	-4.9	-1.3	-0.8
	Net Fiscal Transfer (% GDP)	-0.4	-1.1	-1.3
South Eurozone	Fiscal Balance (% GDP)	-7.2	-1.2	0.6
	Net Fiscal Transfer (% GDP)	1.2	3.9	4.6
East Europe	Fiscal Balance (% GDP)	-5.6	-2.2	-1.0
	Net Fiscal Transfer (% GDP)	0.8	1.7	1.1
United Kingdom	Fiscal Balance (% GDP)	-8.5	-1.3	-0.6
	Net Fiscal Transfer (% GDP)	-0.2	-0.4	-0.6
Scandinavia	Fiscal Balance (% GDP)	2.3	-0.4	-0.2
	Net Fiscal Transfer (% GDP)	-0.4	-1.3	-1.2

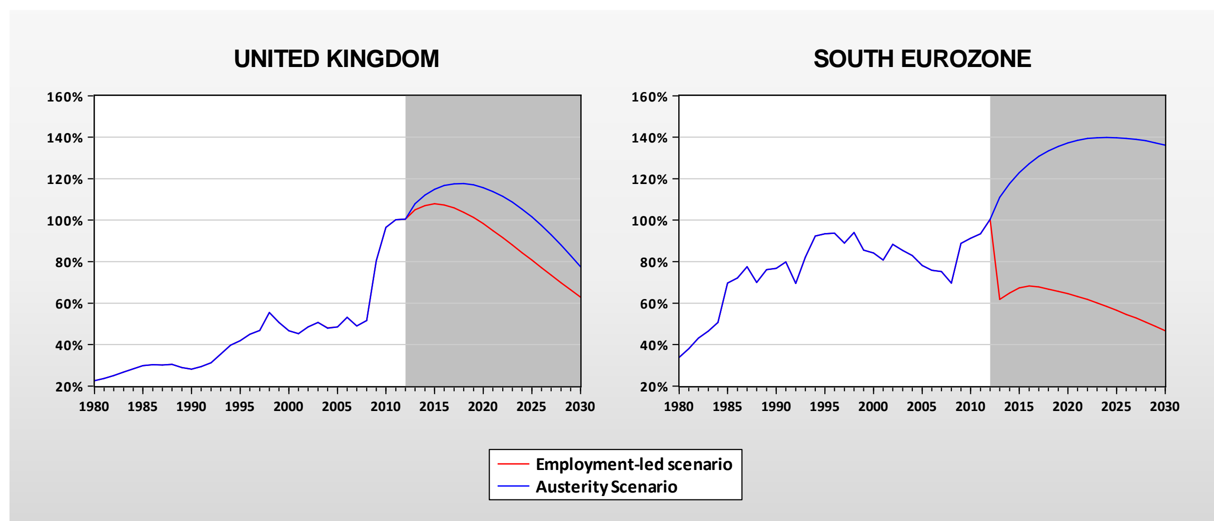
Since the South Eurozone is a major recipient of Federal fiscal transfers, its government net lending as a ratio to GDP becomes slightly positive after about 2025 and reaches a +0.6% by 2030. The fiscal deficit in East Europe, which is also a net recipient of fiscal transfers, closes more slowly, reaching a -1% of GDP by 2030.

In the North Eurozone, the largest net contributor to the Federal budget, the fiscal deficit closes to under -1% of GDP after about 2020. Scandinavia and the United Kingdom, which are also net contributors to the Federal budget, only run fiscal deficits between -0.2% and -0.6% of GDP after about 2020.

Government Debt

As a result of the above trends in government expenditures and revenue, as well as the acceleration in economic growth after 2012, government debt falls appreciably in all five European blocs, beginning roughly after 2015. In almost all cases, the Employment-Led Scenario generates *larger drops in debt* than the Austerity Scenario. **Figure 4** illustrates these results with the examples of the United Kingdom and the South Eurozone.

Figure 4. Government Debt as % of GDP



The United Kingdom starts in 2012 with a heavy burden of debt, that is, about 100% of GDP. In the CAM data base, debt is measured on a cash basis. After a projected initial rise to about 108%, this ratio is projected to fall dramatically, reaching about 63% by 2030. Though still high, this resultant level represents a marked improvement. This level of debt is also significantly lower than that projected in the Austerity Scenario, which would still be about 80% in 2030.

Figure 4 illustrates that the South Eurozone is the major beneficiary of debt relief from the European Stability Mechanism. This means that its initial burden of debt, which represents 100% of GDP in 2012, is reduced by 40 percentage points so that it starts 2013 with a debt-to-GDP ratio of 60%. Over time this bloc is able to further reduce this ratio, so that by 2030 it has dropped to about 47%.

In 2012 Scandinavia already had a debt that stood at about 42% of GDP. However, the Austerity Scenario produces a dramatic rise in its debt to well over 60% of GDP. In contrast, the Employment-Led Scenario succeeds in reducing its debt burden to just 18% of GDP by 2030. East Europe already had a debt-to-GDP ratio that was about 55% in 2012. Both the Austerity Scenario and the

Employment-Led Scenario dramatically reduce this burden. In the employment-focused scenario the debt ratio drops to about 38%.

The North Eurozone starts in 2012 with a debt that is about 63% of GDP but under the Employment-Led Scenario its debt progressively declines, reaching about 50% in 2030. In stark contrast, the Austerity Scenario prompts a pronounced rise in its debt to over 80% of GDP by 2030.

The Trade Balance

Since the five European blocs are projected to grow primarily on the basis of stimulating government expenditures and private investment, there exists a danger of deterioration in their trade balances as a result of increased import demand. Table 2 shows the trends in the trade balance and compares these to changes in the real exchange rate for each of the five blocs. The real exchange rate of each bloc is presented as a ratio to the real exchange rate of the United States, which remains comparatively flat throughout the projected period to 2030.

There is indeed a reduction in the substantial trade surpluses of both the North Eurozone and Scandinavia as the real exchange rates of both blocs appreciate. Although the appreciation of the real exchange rate of Scandinavia is contained in the Employment-Led Scenario, nevertheless, its rate still appreciates by 15% relative to its level in 2012. There is a slightly sharper appreciation of 19% in the real exchange rate of the North Eurozone. However, both blocs still continue to run modest trade surpluses throughout the period to 2030.

In contrast, the depreciation of the UK pound by 26%, which follows from the programming of the Employment-Led Scenario, helps this bloc to progressively reduce its trade deficit from about -2.2% of GDP in 2012 and eventually squeak out a +0.5% surplus in 2030.

Eastern Europe appears to have deeper structural problems that impede its ability to consistently run trade surpluses. The assumed delay in its joining the Eurozone and the assumed depreciation of its real exchange rate do produce trade surpluses for a few years until 2020. But thereafter these surpluses turn into worsening deficits that approach -2% of GDP by 2030. This trend coincides with an appreciation of about 16% of its real exchange rate between 2020 and 2030.

Table 3.The Trade Balance as % of GDP and the Real Exchange Rate

		2012	2015	2020	2030
North Eurozone	Trade Balance	2.27	3.16	2.27	1.27
	Real Exchange Rate	1.20	1.16	1.24	1.43
South Eurozone	Trade Balance	-0.32	0.59	-0.41	-1.43
	Real Exchange Rate	1.07	0.97	0.96	1.07
East Europe	Trade Balance	-1.66	-0.38	0.56	-1.94
	Real Exchange Rate	0.67	0.57	0.49	0.57
United Kingdom	Trade Balance	-2.24	-1.89	-1.61	0.05
	Real Exchange Rate	1.08	0.99	0.89	0.80
Scandinavia	Trade Balance	5.82	2.94	1.09	0.92
	Real Exchange Rate	1.48	1.49	1.63	1.70

The South Eurozone begins to experience worsening trade deficits after about 2015. This trend coincides with an appreciation of its real exchange of about 10% between 2015 and 2030. Nevertheless, this bloc's deficits only exceed -1% of GDP after about 2025. Meanwhile, this bloc's current account remains in surplus because of the inflow of fiscal transfers from the Federal budget.

Concluding Remarks

The purpose of our modelling of policy-relevant future scenarios for Europe has been to gauge the viability of a strategy of promoting employment-focused economic recovery and contrast its outcomes to those produced by the current alternative of persisting with austerity measures. The time horizons for our scenarios have been 2013-2020 and 2021-2030.

Our conclusion is that such a strategy is indeed feasible but it requires greater intervention by the EU Federal government. For our Employment-Led Scenario, this intervention implies substantially more EU funding of public investment, greater lending for private investment and significant debt relief for the heavily indebted countries in the South Eurozone.

At the bloc level, this strategy explicitly gears a range of policy measures to promoting employment as their overriding objective. These policies include maintaining government expenditures, especially public investment, at pre-crisis levels, and closing any ensuing fiscal deficits by raising government revenue above its low crisis-induced levels. The emphasis on public investment at the bloc level is designed to help stimulate private investment, which has languished at pitifully low levels across the continent.

The results generated by our Employment-Led Scenario are generally impressive, particularly in contrast to the bleak prospects being produced by the strategy of protracted austerity. Most importantly, employment reaches historically high levels, and economic growth rises well above the current rates that are hovering close to zero in most European blocs, as well as above the similarly low projected rates under the Austerity Scenario.

A rise in private investment is partially responsible for overcoming the stagnation in economic growth. However, more concerted policy initiatives will have to be undertaken over the medium term to lift private investment back up to its pre-crisis levels. Such an initiative could play an important part in raising economic growth rates consistently above 3% through 2030.

As a result of trends in both government expenditures and revenues, fiscal deficits are closed to manageable levels. Also, most importantly, debt-to-GDP levels plummet across the five blocs. Of course, the South Eurozone benefits immediately from being relieved of the portion of its debt that exceeds 60% of GDP. But accelerating economic growth also plays a major role in decreasing debt burdens across the continent.

The expansionary fiscal policies implied by this scenario do not lead to major trade deficits. But the blocs with historically sizeable trade surpluses, such as the North Eurozone and Scandinavia, do experience a secular decline in their surplus positions. In general, the blocs outside the Eurozone, including Scandinavia as well as East Europe and the United Kingdom, are obliged to undertake measures to depreciate their real exchange rate or contain, at least, its appreciation.

Thus, achieving significant increases in GDP and employment across Europe will not be easy, but it is certainly attainable. However, it will imply the implementation of a range of expansionary macroeconomic policies at both the country and the EU-wide level. These initiatives imply that the European Union will have to become a more coordinated and more progressive-minded economic bloc. The political realism of such policies has to be based, first of all, on their economic realism. It is the latter issue that has been the focus of this Policy Brief.