Ways out of the crisis

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

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EU recommends that 23 out of the 27 EU countries tighten fiscal policy, some countries already this year. Macroeconomic model calculations show that it will have large consequences for both GDP growth and the development on the labour market if all 23 countries tighten fiscal policy at the same time. If only the 5-9 countries with the largest budget deficit tighten fiscal policy the negative effects on the European economy will be much milder.

A second path is to reform our way out of the crisis. Tightening fiscal policy might improve the budgets in the short run, but in the medium run and long run, an economic upturn in Europe requires structural changes in the form of reforms that changes the underlining structures. Model calculations show that a strategy based on investments in green growth, increasing productivity and the education level and fighting social inequality can create 8.5 million new jobs over a 20 year period.

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The outlook for the European economy

Last year the European economy was hit by the worst crisis in the history of the European Union. It now seems that the worst part of the crisis is over when it comes to GDP. Even though the economy starts to grow again, it still takes a growth rate at or above the historical rate to turn around the negative development on the labour market. With that in mind, even though the worst part of the "growth-crisis" seems to be over, we have far from seen the full effect of the crisis on the labour market.

Table 1 below shows the key figures in the present forecast for EU-27. As it appears from the table the EU was hit hard by the economic crisis last year where GDP shrank with more than 4 percent. This year GDP is expected to grow again, but only with a little more than one percent, i.e. less than the historical rate. In 2011 and forward it is likely that GDP will grow with a rate close to the historical rate, but it will still not be enough to lower unemployment significantly.

Table 1. Key figures in the present forecast for EU-27

	2009	2010*	2011*	2012*	2013*	2014*	2015*	2016*-2020*
GDP (growth in percent)	-4.1	1.2	1.7	1.8	1.7	1.8	1.9	1.9
Employment (million people)	221.4	220.1	220.7	221.7	222.6	223.5	224.4	227.1
Unemployment (million people)	21.3	23.3	23.2	23.0	22.8	22.7	22.7	22.5
Unemployment rate (percent of labour force)	8.8	9.6	9.5	9.4	9.3	9.2	9.2	9.0
Public budget (percent of GDP)	-6.6	-7.2	-6.5	-5.8	-5.7	-5.5	-5.3	-4.7

Note: * indicates the forecast period.

Source: AE on the basis of the European Commission Spring forecast 2010 and Consensus forecasters April 2010, calculated with the international macroeconomic model HEIMDAL.

EU recommends that 23 out of the 27 EU countries tighten fiscal policy

Even though the European economy is growing again, the impact of the crisis on the member countries public budgets are now showing. According to the Stability and Growth pact, the member countries should seek to keep their public budgets below 3 pct. of GDP in the medium run. In the light of the fact that the majority of the European countries have implemented recovery packages and expenses to unemployment benefits have increased and taxes shrunk, most member countries now stand in a situation where the public budget is exceeding or are expected to exceed a public deficit 3 percent of GDP in the near future.

The European Commission has outlined deficit procedures that outline recommendations for the specific countries. Table 2 shows the recommendations from the European Commission measured in average annual fiscal effort in pct. of GDP. As it is shown in the table the European Commission recommends that 23 out of 27 countries should tighten their fiscal policy. On average it is recommended that the countries should tighten fiscal policy corresponding to a total fiscal effort of close to 4 percent of GDP from 2010-2014.

Table 2. Recommendations from EU (Ongoing Country-specific Excessive Deficit Procedures)						
	2010	2011	2012	2013	2014	2010-2014
Ireland	2	2	2	2	2	10
Greece*	2	2	2	2	2	10
United Kingdom	1.75	1.75	1.75	1.75	1.75	8.75
Latvia*	2.75	2.75	2.75	-	-	8.25
Lithuania*	2.25	2.25	2.25	-	-	6.75
Spain*	1.5	1.5	1.5	1.5	-	6
Cyprus	1.75	1.75	1.75	-	-	5.25
Romania*	1.75	1.75	1.75	-	-	5.25
Portugal	1.25	1.25	1.25	1.25	-	5
Czech Republic	1	1	1	1	-	4
France*	1	1	1	1	-	4
Slovakia	1	1	1	1	-	4
Poland*	1.25	1.25	1.25	-	-	3.75
Slovenia	0.75	0.75	0.75	0.75	-	3
Belgium	0.75	0.75	0.75	-	-	2.25
Netherlands	-	0.75	0.75	0.75	-	2.25
Austria	-	0.75	0.75	0.75	-	2.25
Denmark	-	0.5	0.5	0.5	-	1.5
Germany*	-	0.5	0.5	0.5	-	1.5
Italy*	0.5	0.5	0.5	-	-	1.5
Hungary*	0.5	0.5	-	-	-	1
Malta	-	0.75	-	-	-	0.75
Finland	-	0.5	-	-	-	0.5
EU-27 (weighted average)	**0.8**	**1.0**	**1.0**	**0.8**	**0.3**	**3.9**

Note: All recommendations are published in June 2010, February 2010, December 2009 or July 2009. For countries marked with * it is the case of minimum recommendations. For Greece, it is an enhanced recommendation.
Source: AE on the basis of the European Commission, Economic and Financial Affairs, Ongoing Country-specific Excessive Deficit Procedures

There is a significant risk connected to tightening fiscal policy this much. Although there is a light at the end of the tunnel, and many countries again are experiencing positive growth rates, we are not expecting growth rates close to the historical growth rates before earliest next year. In other words the economic upturn is still so fragile that tightening fiscal policy may very well mean that the recovery will be running out of steam.

Fiscal tightening in line with EU recommendations will jeopardize recovery

If all 23 EU-countries tighten fiscal policy at the same time in line with the recommendations outlined in table 2 above, it will have major consequences for the overall European economy.

Table 3 shows the alternative forecast scenario where the fiscal tightening is taken into account. Box 1 elaborates the assumptions underlying the model calculations.

Box 1. Assumptions behind the model calculation

In the scenario below it is assumed that the countries listed in table 2 on average over the period from 2010 till 2014 will follow the recommendations from the European Commission.

It is however not assumed that the countries will be able the reach the recommended fiscal effort of just under 1 percent of GDP this year. This assumption is both due to the fact that most of the effect from the fiscal tightening this year is already incorporated in the estimates for this year, as well as the fact that half of this year has already gone and there is a significant time lag between making the decision about tightening fiscal policy and until it is actually being done. On this basis it is assumed that the average annual fiscal effort will be ¼ of what is outlined in table 2 in 2010. From 2011-2014 the overall average tightening is similar to the figures pictured in table 2, corresponding to a total fiscal effort of well above 3 percent of GDP from 2010-2014.

It is assumed that the tightening is equally spread between less public spending and tax increases. It is also assumed that the interest rate will be ¼ percentage point lower each year from 2011-2014 in the scenario where fiscal policy is tightened compared to the baseline scenario.

It is assumed that the US will conduct a neutral fiscal policy.

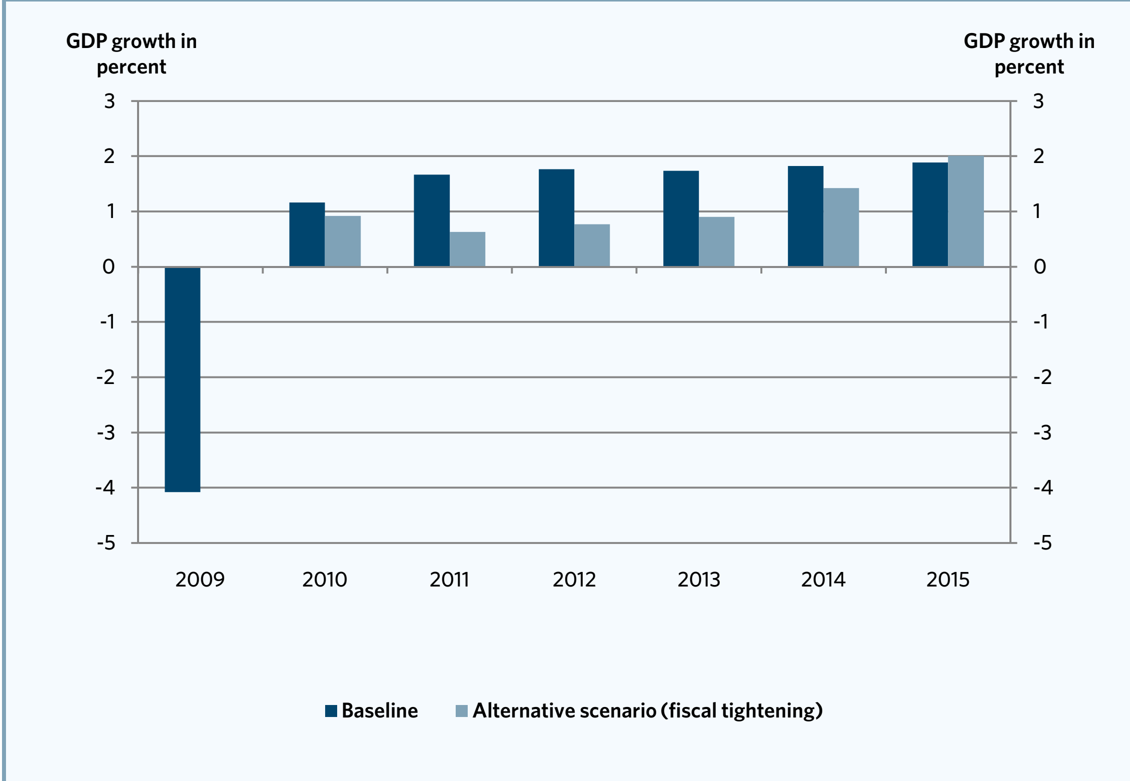
Table 3. Key figures for EU-27 when the recommendations from EU is taken into account

	2009	2010*	2011*	2012*	2013*	2014*	2015*
GDP (growth in percent)	-4.1	0.9	0.6	0.8	0.9	1.4	2.0
Employment (million people)	221.4	219.8	219.1	218.3	217.6	217.3	217.6
Unemployment (million people)	21.3	23.5	24.3	25.4	26.4	27.2	27.5
Unemployment rate (percent of labour force)	8.8	9.6	10.0	10.4	10.8	11.1	11.2
Public budget (percent of GDP)	-6.6	-7.1	-5.9	-4.8	-4.0	-3.5	-3.1

Note: * indicates the forecast period. In the calculations is assumed that the total average annual fiscal effort on average from 2010-2014 will be in line with the figures pictured in table 2. It is assumed that the tightening is equally spread between less public spending and tax increases. It is also assumed that the interest rate will be lowered as a reaction to the fiscal tightening.
Source: AE on the basis of the European Commission Spring forecast 2010 and Consensus Forecasters April 2010, calculated with the international macroeconomic model HEIMDAL.

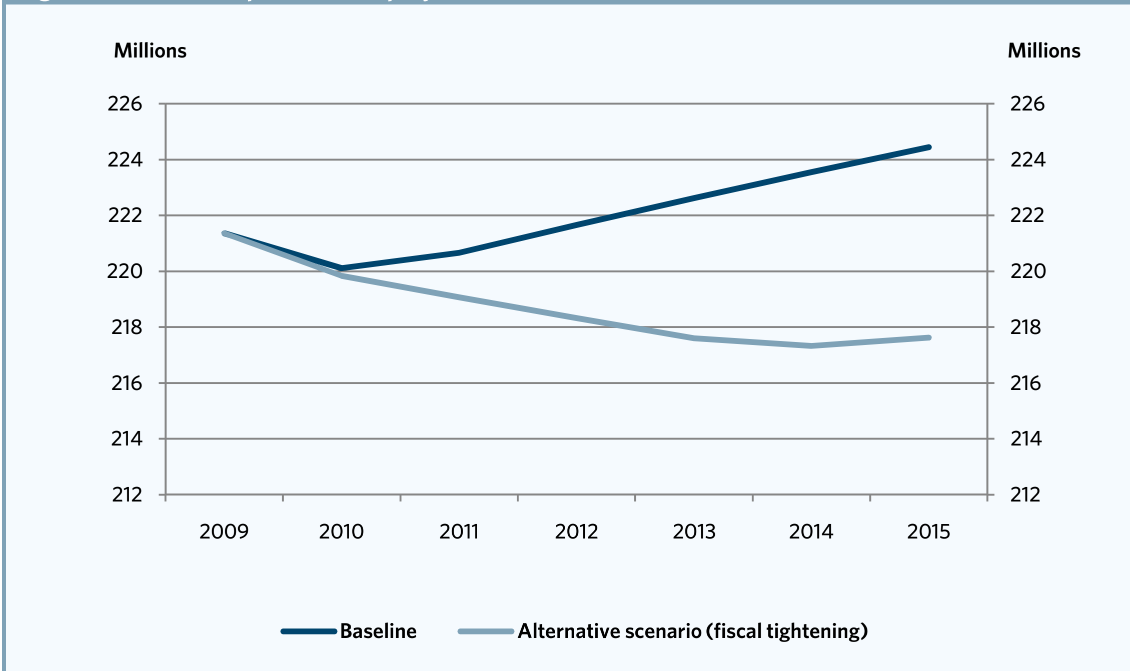
As shown in the table above a fiscal tightening will have large consequences for both GDP growth and the development on the labour market. Instead of having growth rates close to historical rates, GDP growth will be significantly lower if fiscal policy is tightened. The effect is especially pronounced from next year and forward where we see the full effects of the policy actions. From 2010-2014 the annual GDP growth is on average reduced by 0.7 percent a year compared to a situation without fiscal tightening. That influences the labour market. Instead of stagnating next year, the unemployment rate will continue to rise until 2015 where it will top at more than 11 percent of the labour force. Figure 1 to 4 shows a graphical presentation of the figure presented in table 1 and 3.

Figure 1. GDP growth in EU-27 in the two scenarios



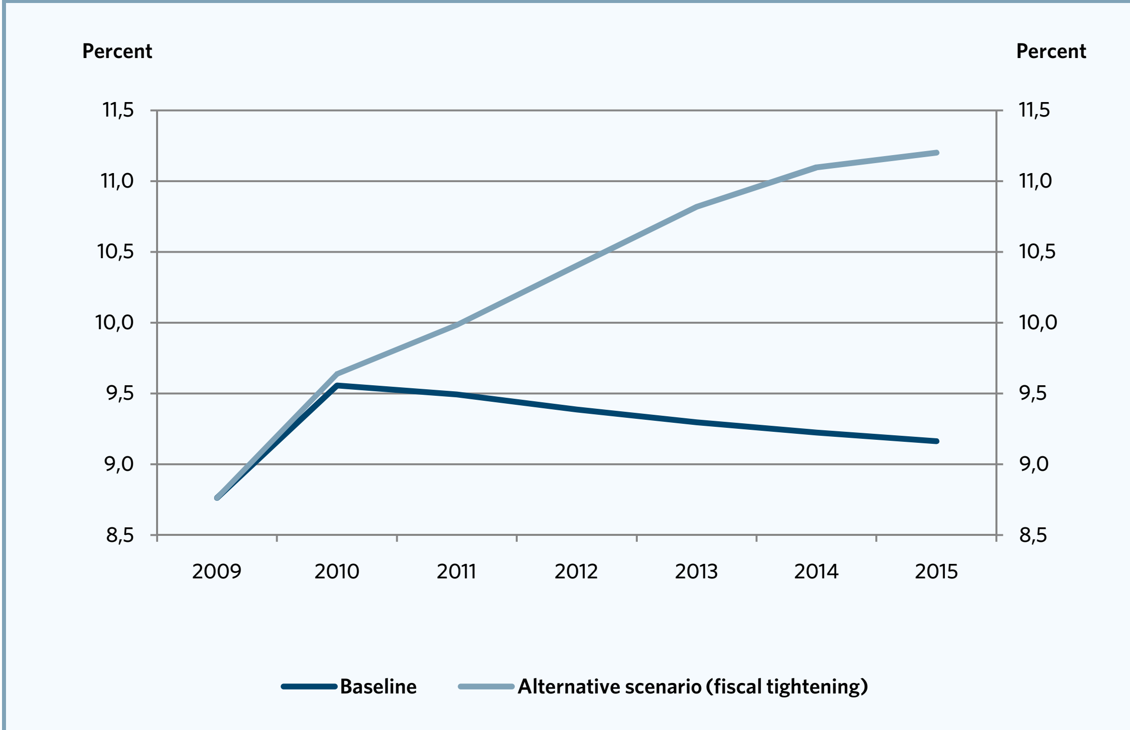
Note: In the calculations is assumed that the total average annual fiscal effort on average from 2010-2014 will be in line with the figures pictured in table 2. It is assumed that the tightening is equally spread between less public spending and tax increases. It is also assumed that the interest rate will be lowered as a reaction to the fiscal tightening.
Source: AE on the basis of the international macroeconomic model HEIMDAL.

Figure 2. The development in employment in EU-27 in the two scenarios



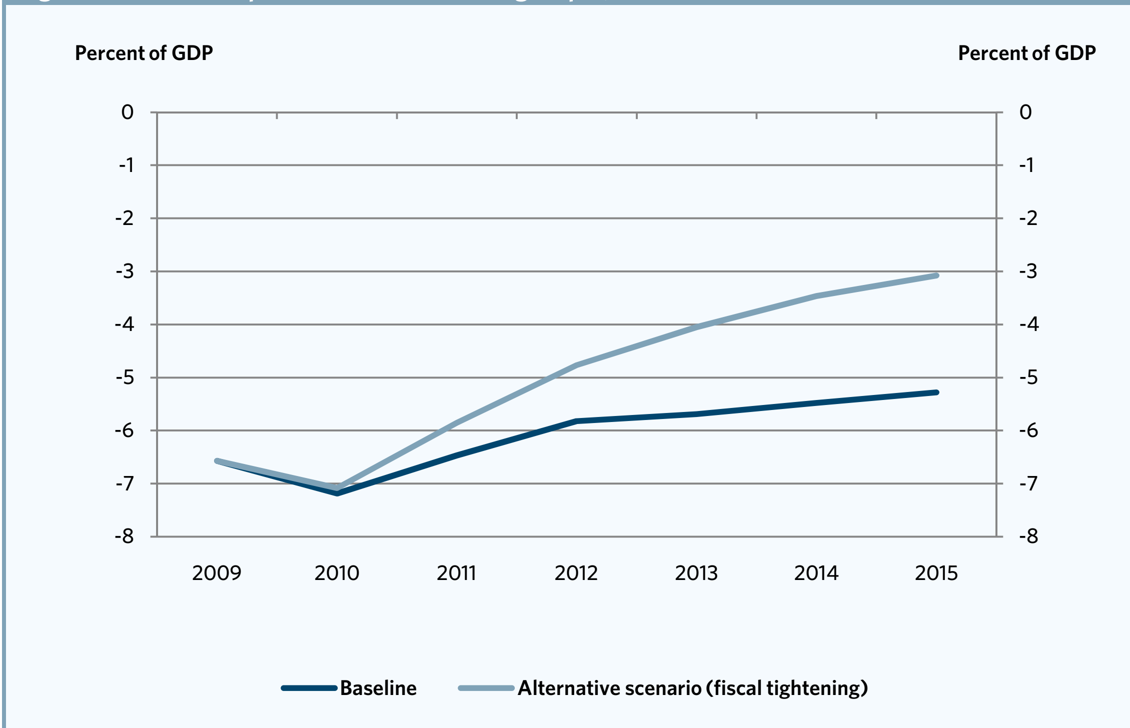
Note: In the calculations is assumed that the total average annual fiscal effort on average from 2010-2014 will be in line with the figures pictured in table 2. It is assumed that the tightening is equally spread between less public spending and tax increases. It is also assumed that the interest rate will be lowered as a reaction to the fiscal tightening.
Source: AE on the basis of the international macroeconomic model HEIMDAL.

Figure 3. The development in the unemployment rate in EU-27 in the two scenarios



Note: In the calculations is assumed that the total average annual fiscal effort on average from 2010-2014 will be in line with the figures pictured in table 2. It is assumed that the tightening is equally spread between less public spending and tax increases. It is also assumed that the interest rate will be lowered as a reaction to the fiscal tightening.
Source: AE on the basis of the international macroeconomic model HEIMDAL.

Figure 4. The development in the EU-27 budget (pct/GDP) in the two scenarios



Note: In the calculations is assumed that the total average annual fiscal effort on average from 2010-2014 will be in line with the figures pictured in table 2. It is assumed that the tightening is equally spread between less public spending and tax increases. It is also assumed that the interest rate will be lowered as a reaction to the fiscal tightening.
Source: AE on the basis of the international macroeconomic model HEIMDAL.

On top of that it is very likely that fiscal tightening will go hand in hand with falling consumer and investor confidence. If it is hard to sell and export goods businesses are less likely to expand and invest. At the same time consumers are experiencing a high risk of being unemployed coursing a tendency towards higher savings. Lack of confidence will also mean that there is a large risk that the unemployment rate will increase even more than pictured in table 3 and take hold at a historically high level. All in all if the lack of confidence among consumers and investors are taken into account it draws in the direction of even larger negative effects from the fiscal tightening than shown in table 3, and the lack of confidence will also to some extend offset part of the budget improvements.

In the calculations above it is assumed that the US will conduct a neutral fiscal policy. If the US instead tightens fiscal policy as well, then it will have negative spill-over effects on the European economy and the figures for the European economy will be worse than in the calculations above. Finally it is assumed that the ECB will react and that the interest rate will be lower in the scenario where fiscal policy is tightened compared to baseline scenario. If this is not the case it will also draw in the direction of larger negative effects on the European economy.

All in all the effects above can seem intense but they may very well be lower edge estimates, as the calculations build on very mild assumptions, and if lack of confidence, spill-over effects from the US and lack of reactions from ECB is taken into account the negative effects will be even larger.

In the calculations above, it is assumed that the fiscal tightening is equally spread between less public spending and tax increases. But it does make a difference how the tightening is implemented. As shown in more detail in box 2, it is possible to obtain a larger budget deficit reduction if the tightening is implemented as tax increases rather that less public spending.

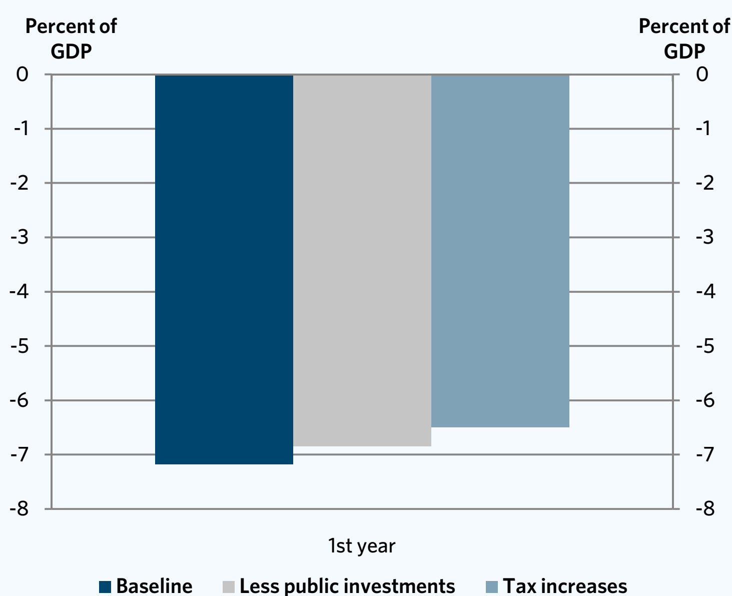
Box 2. Budget deficit reduction with different instruments

In the calculations above it is assumed that the tightening is equally spread between less public spending and tax increases. There is however a difference in the budget deficit reduction, if the tightening is implemented as tax increases or cutting public investments.

Figure A shows the effect on the EU-27 budget when all 27 EU countries increase their taxes with 1 percent of GDP or spend 1 percent of GDP less on public investments. As seen, it is possible to reduce the public deficit more, if the tightening is implemented as tax increases compared to the situation where the tightening is implemented as less public investments. As shown in the figure, fiscal tightening by increasing taxes corresponding to 1 percent of GDP will after one year have reduced the budget deficit by 0.7 percentage points (from 7.2 pct/GDP to 6.5 pct./GDP), whereas fiscal tightening implemented by spending less on public investments (corresponding to 1 percent of GDP) will after one year only have reduced the budget deficit by 0.4 percentage points. (from 7.2 pct/GDP to 6.8 pct./GDP). This shows, that when it comes to deficit reduction, tax increases are more effective that cutting public investments.

This is due to the fact that the effect on the labour market is larger if public investments are reduced compared to if taxes are increased. If taxes are increased consumers will not reduce consumption with the full amount, as they will try to equalise consumption over time and draw on their savings. The same effect is seen if taxes are cut, then the total tax cut will not be transferred into the economy as consumers will chose to spend part of the tax cut on consumption and part on saving. When public investments are increased or reduced there will not be this opposite effect.

Figure A: Budget deficit reduction with different instruments



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

Large variation in the effects between countries

The figures above show that the overall effects on EU-27 are large from tightening fiscal policy. But the individual country effects varies a lot as some countries are recommended to tighten fiscal policy with 10 percent of GDP from 2010-2014 whereas other countries can do with less.

Table 3 shows the consequences of the fiscal tightening in the five largest EU countries. As shown there is a large difference between how much the countries are recommended to tighten fiscal policy and therefore also large differences between the effects on growth and employment.

Table 4. Effects from fiscal tightening on growth and employment, 2010-2014							
	Fiscal tightening	**Growth in GDP 2010-2014 (percent)**			**Growth in employment 2010-2014 (mil.)**		
	Percent of GDP 2010-2014	Baseline Scenario (a)	Fiscal tightening (b)	**Difference in percentage points (b-a)**	Baseline Scenario (c)	Fiscal tightening (b)	**Difference in million (d-c)**
Germany	1.5	7.2	4.4	-2.9	0.5	-0.2	-0.7
United Kingdom	8.75	8.1	2.1	-6.0	0.6	-1.2	-1.8
France	4	7.4	4.2	-3.2	0.8	0.3	-0.5
Italy	1.5	4.9	3.8	-1.0	0.3	0.1	-0.2
Spain	6	5.6	2.1	-3.5	0.2	-0.4	-0.6
EU-27	3.9	7.2	3.8	-3.4	3.4	-2.5	-5.9

Note: In the calculations is assumed that the total average annual fiscal effort from 2010-2014 will be in line with the figures pictured in table 2. It is assumed that the tightening is equally spread between less public spending and tax increases. It is also assumed that the interest rate will be lowered as a reaction to the fiscal tightening.
Source: AE on the basis of the international macroeconomic model HEIMDAL.

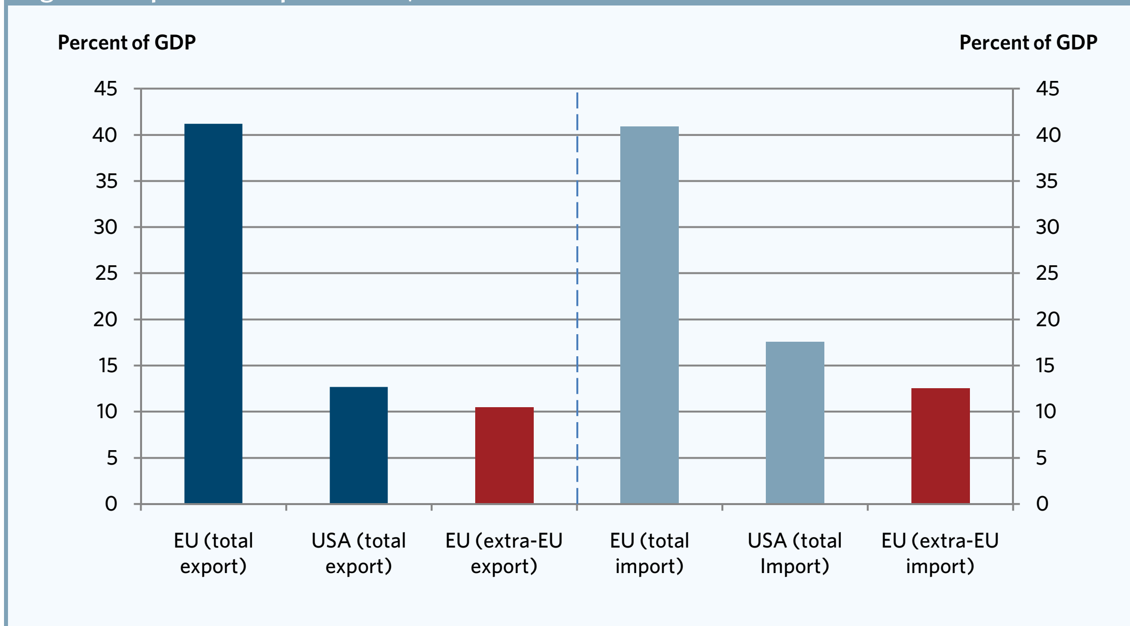
Out of the five largest EU countries United Kingdom and Spain are the two countries that are recommended to tighten fiscal policy the most, and are therefore also the two countries that suffers the largest declines in GDP compared to a situation without the tightening (column b-a). GDP in United Kingdom is expected to be 6 percent lower from 2010-2014 as a result of the European tightening, and 1.8 million jobs can be lost as a consequence of the tightening. Even though Germany is only recommended to tighten fiscal policy with 1½ percent of GDP from 2010-2014, GDP in Germany is still expected to be nearly 3 percent lower in 2014 compared to a situation without the tightening. The relatively large effect on GDP is due to the fact that all countries tighten fiscal policy at the same time. The effect on GDP and employment pictured in table 4 covers both the domestic negative effect and the negative spill-over effect. The spill-over effects are elaborate below.

The importance of coordination

As shown above there is a significant risk of slowing down growth and keeping unemployment historically high if fiscal policy is tightened. The effects on the European economy are big and this is partly due to the fact that nearly all European countries are tightening fiscal policy at the same time.

In the figure below it is shown why the European countries are so integrated and dependent on each other. Figure 5 shows import and export shares for the US and the EU both with regards to the total import and export in the EU and with regards to extra-EU imports and exports.

Figure 5. Export and import shares, 2008

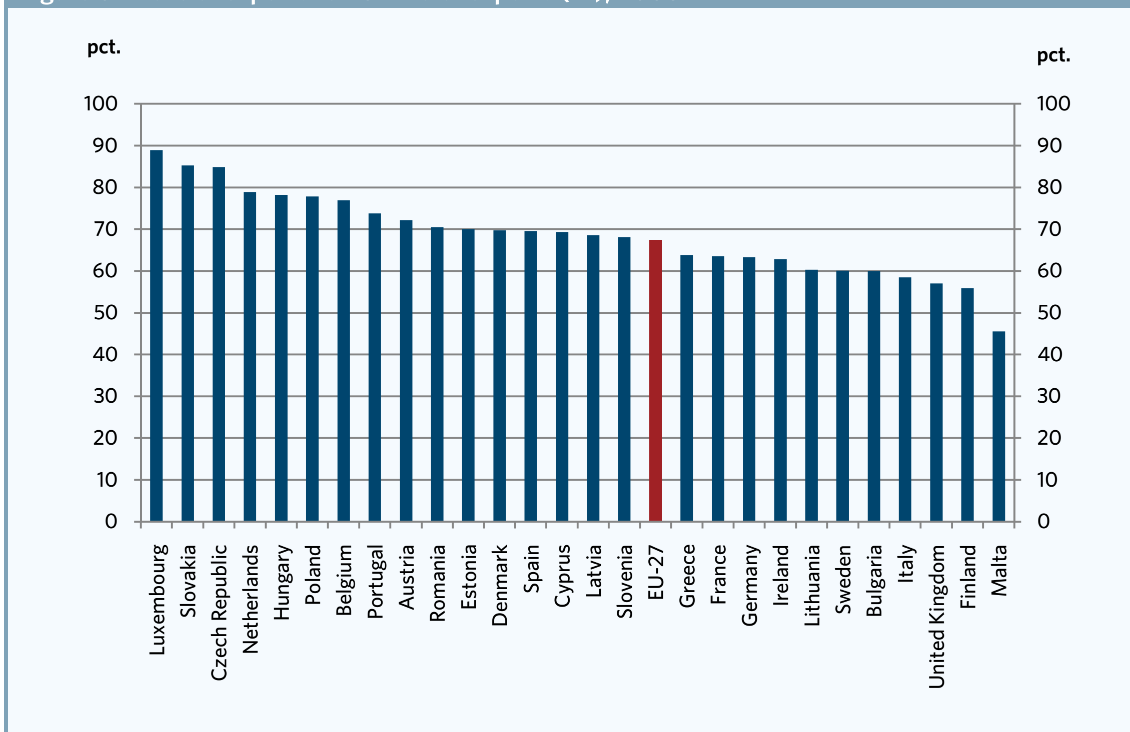


Source: AE on the basis of Eurostat.

On the surface the EU looks as a very open economy as both import and export make up more than 40 percent of GDP, but if the EU is looked at as one economy and all the intra-EU trade is left out, so that only the trade with non-EU countries are included (the so called extra-EU import and export) a totally different picture shows. The extra-EU export and import only make up 10 and 13 percent of GDP respectively. In the US export and import make up 13 and 18 percent of GDP respectively. Looking at extra-EU trade, the EU is actually a more closed economy than the US, which makes it even more important for the European countries to cooperate as the economies are highly integrated. This underlines why the European countries should be looked at as one economy and why a high level of policy coordination is crucial.

The same thing is shown in Figure 6 that shows the share of exports to EU in total export in European countries. The figure shows that on average 2/3 of all exports from European countries goes to other European countries. Especially some of the smaller European countries and some of the central- and eastern European countries depend highly on intra European trade.

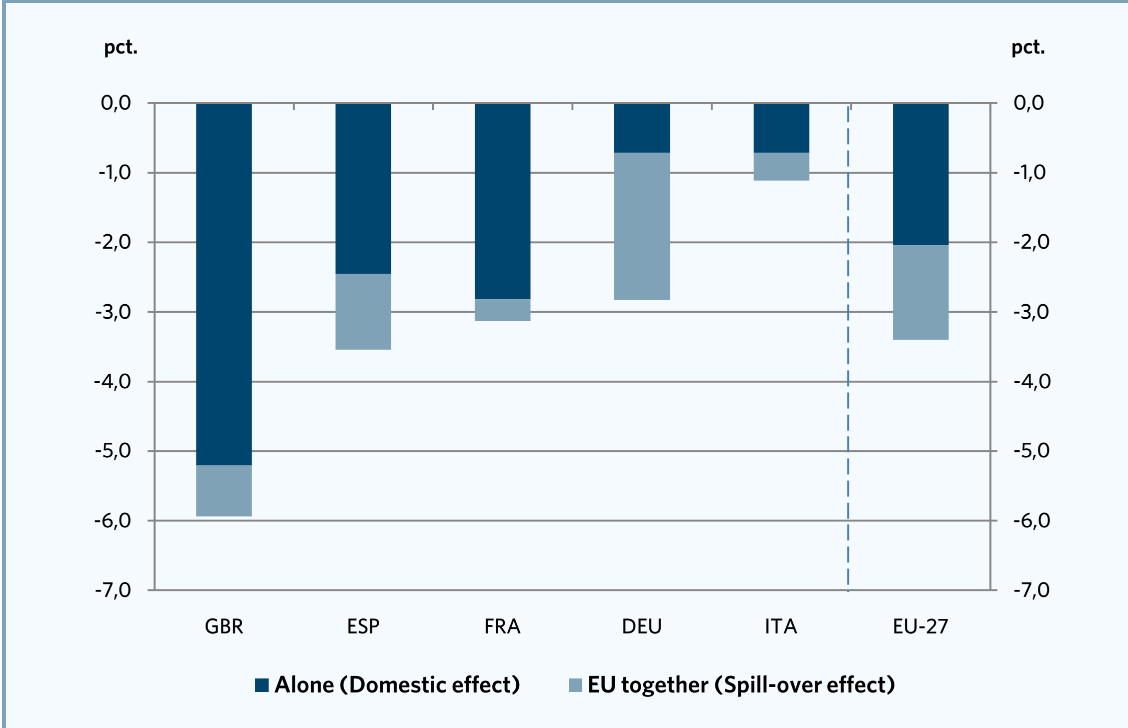
Figure 6. Share of exports to EU in total exports (%), 2008



Source: AE on the basis of Eurostat.

The large integration among European countries also shows in the spill-over effects between the countries. Figure 7, 8 and 9 shows the accumulated effect on GDP, employment and the public budget in 2014 in EU's five largest countries, when each country is tightening fiscal policy alone and together with all the other European countries.

Figure 7 shows how on average just below half of the negative effect on GDP is coursed by the negative spill-over effects, and consequently by the fact that all countries are tightening at the same time. It is also seen that the spill-over effects are larger for a country like Germany that depend highly on exports. In United Kingdom the situation is different. Here most of the effect on GDP is domestic, whereas the spill-over effects make up a smaller share.



Note: In the calculations is assumed that all countries tighten fiscal policy as recommended by the European Commission, cf. table 2. It is assumed that the tightening is equally spread between less public spending and tax increases. It is also assumed that the interest rate will be lowered as a reaction to the fiscal tightening. The "EU-27 alone" effect reflects a weighted average of the effects when the separate countries are stimulating alone.

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

Figure 8 shows the overall employment effect decomposed in the domestic effect and the spill-over effect for the five largest EU countries. Again the largest negative effect on employment is seen in United Kingdom as they are recommended to tighten fiscal policy the most, and due to the large share of exports the spill-over effects are largest in Germany.

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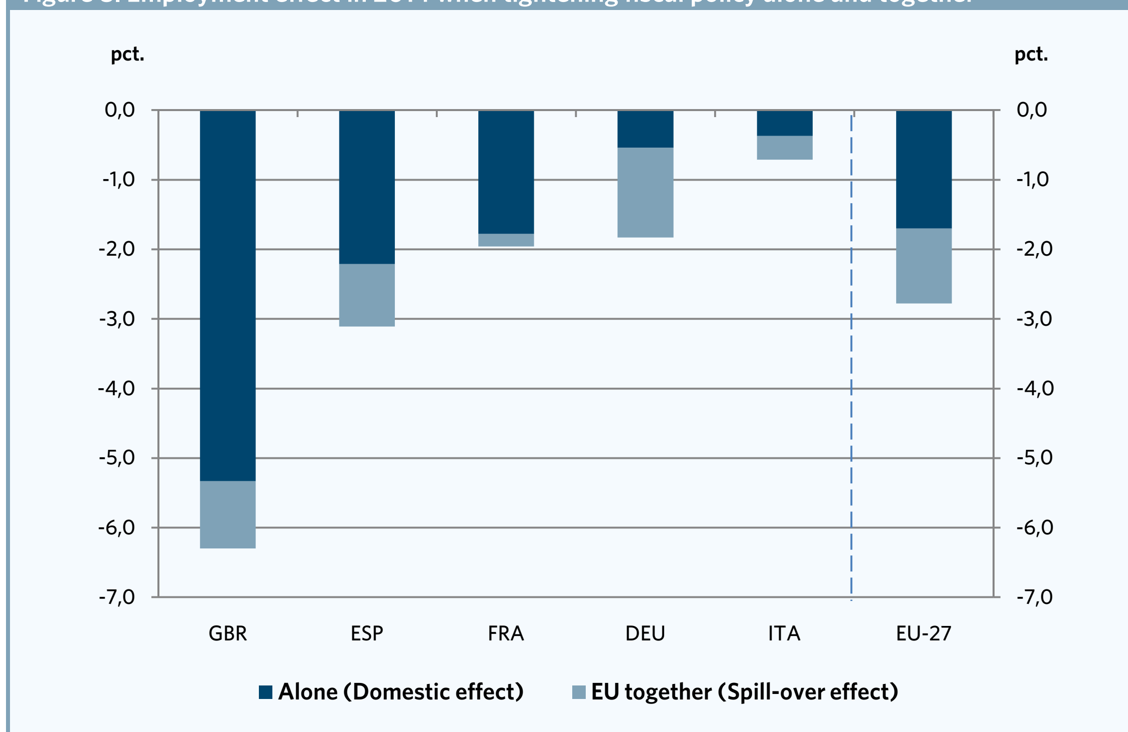
Figure 8. Employment effect in 2014 when tightening fiscal policy alone and together



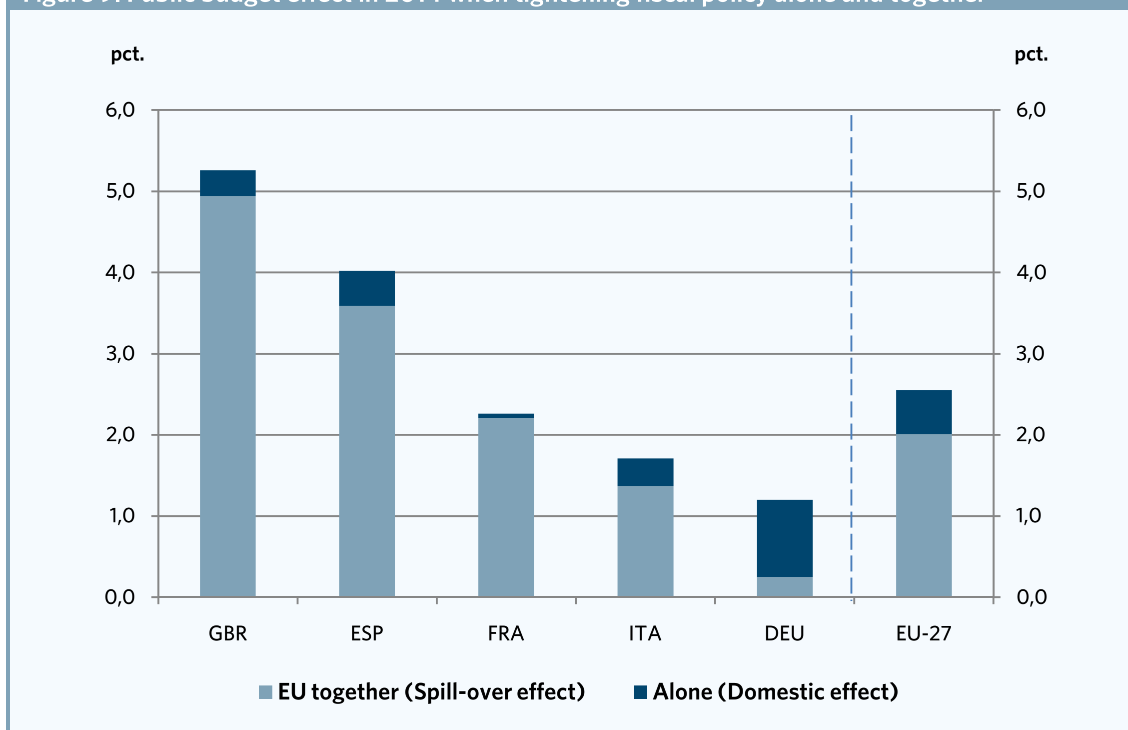
Note: In the calculations is assumed that all countries tighten fiscal policy as recommended by the European Commission, cf. table 2. It is assumed that the tightening is equally spread between less public spending and tax increases. It is also assumed that the interest rate will be lowered as a reaction to the fiscal tightening. The "EU-27 alone" effect reflects a weighted average of the effects when the separate countries are stimulating alone.
Source: AE on the basis of the international macroeconomic model HEIMDAL.

Figure 9 shows the overall effect on the budget decomposed in the domestic effect and the spill-over effect for the five largest EU countries. The figure shows how the budget improvements are larger when the countries tighten fiscal policy alone compared to the situation where all countries tighten together. For EU-27 this means that the weighted average effect on the budget is 2.6 percentage points when the 23 countries tighten fiscal policy alone. When the 23 countries tighten fiscal policy together, and the negative spill-over effects are taken into account, the effect on the budget is only 2 percentage points.

This is due to the fact that negative spill-over effects are created when all countries tighten fiscal policy at the same time. Let's for instance say that a country cut public expenses to improve the public budget, if the countries' trading partners do the same, it will lower exports, this will lead to job losses, and will worsen the public budget compared to a situation where there is no negative spill-over effects.

The figures stress the importance of European coordinating not only in the situation of fiscal expansion but just as important in the present situation of fiscal tightening. If the spill-over effects are not taken into account, then the negative effects from tightening fiscal policy are underestimated and the beginning upturn jeopardized.

Figure 9. Public budget effect in 2014 when tightening fiscal policy alone and together



Note: In the calculations is assumed that all countries tighten fiscal policy as recommended by the European Commission, cf. table 2. It is assumed that the tightening is equally spread between less public spending and tax increases. It is also assumed that the interest rate will be lowered as a reaction to the fiscal tightening. The "EU-27 alone" effect reflects a weighted average of the effects when the separate countries are stimulating alone.
Source: AE on the basis of the international macroeconomic model HEIMDAL.

The effects of only some countries tightening fiscal policy

In the calculations above it is assumed that all countries will follow the recommendations from EU and tighten fiscal policy in line with table 2. The calculations show that a simultaneous fiscal tightening of this size will lower GDP growth significantly and cause a higher unemployment rate than would have been the case without the fiscal tightening.

It is clear that some kind of fiscal tightening must take place, especially in the light of the latest turmoil on the financial markets in Southern Europe. But as the calculations above show, half of the negative effect on the European economy is caused by the so-called negative spill-over effects that are created when nearly all countries tighten fiscal policy at the same time. It would therefore be wise to let the countries with the largest budget deficits tighten fiscal policy.

In the following we will do the same calculation, but just assuming that only some of the countries will tighten their fiscal policy. The calculations are now divided into four scenarios – A baseline scenario and three alternative scenarios. The three alternative scenarios are:

- Scenario 1 where all countries tighten fiscal policy in line with the recommendations from EU, as outlined in table 2 and identical with the calculations in figure 1-4.

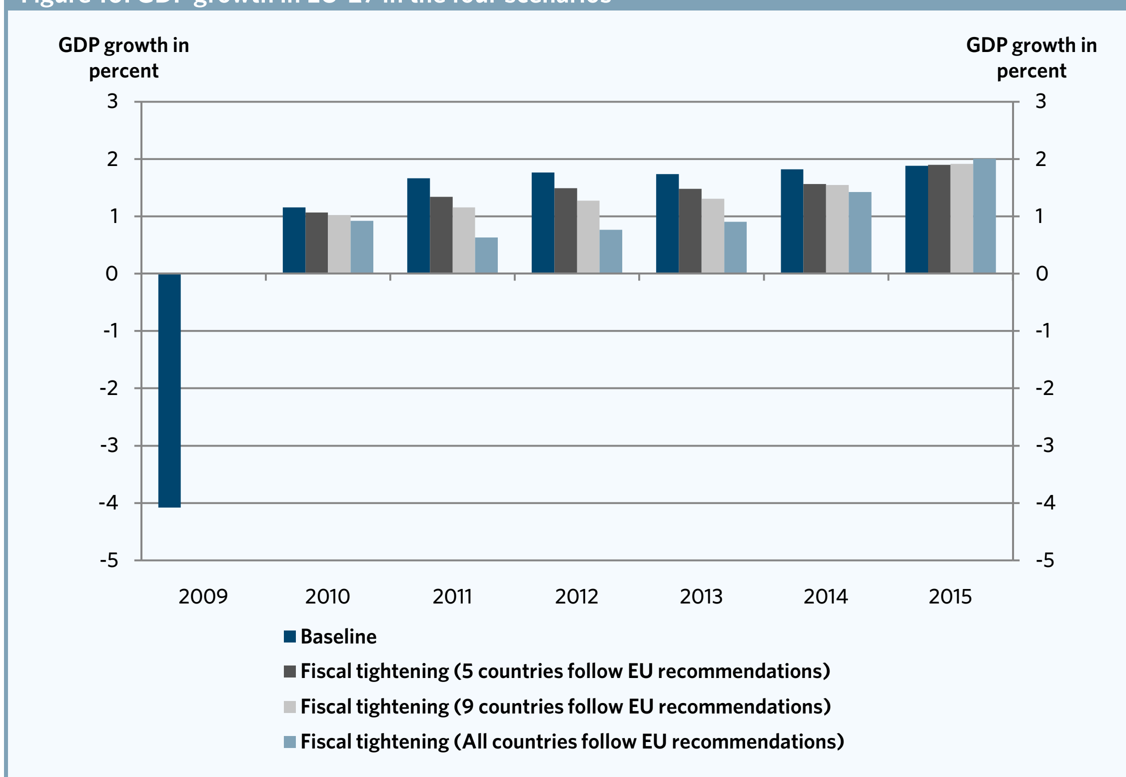
- Scenario 2 where only the five countries with the largest recommendations (recommendations of a total tightening of 6.75 percent of GDP or more from 2010-2014) will tighten fiscal policy. This corresponds to the case where only Ireland, Greece, United Kingdom, Latvia and Lithuania tightens fiscal policy in line with table 2.

- Scenario 3 where only countries with recommendations of 5 percent of GDP or more from 2010-2014 will tighten fiscal policy, corresponding to 9 countries. This corresponds to the case where Ireland, Greece, United Kingdom, Latvia, Lithuania, Spain, Cyprus, Romania and Portugal tighten fiscal policy in line with table 2.

Figure 10-13 compare the scenarios.

Figure 10 shows the GDP growth in the four scenarios. As shown the effect on GDP can be reduced significantly if only 5 or 9 countries tighten fiscal policy compared to all 23 countries as the EU recommend. If all 23 countries tighten fiscal policy at the same time, the average annual GDP growth from 2010-2014 will be reduced from 1.6 percent to 0.9 on average per year. If only 5 our 9 countries tighten fiscal policy then the average GDP growth rate will be 1.3-1.4. It is especially in 2011-1013 that the growth rate will be higher if only some countries tighten fiscal policy.

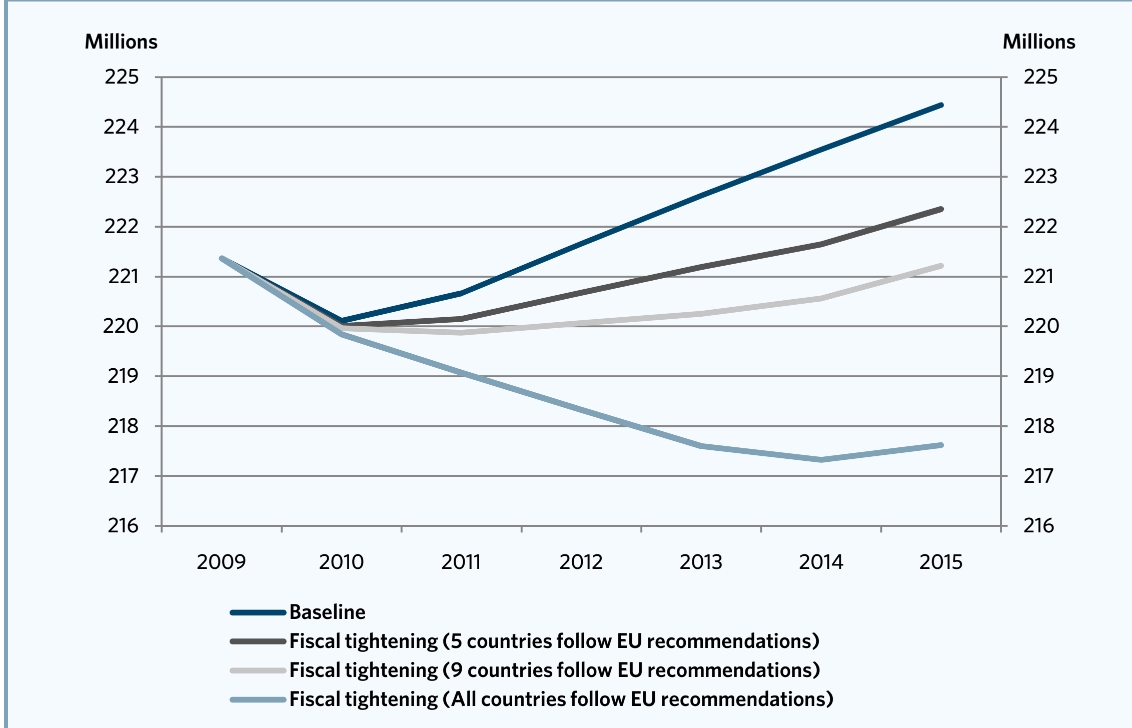
Figure 10. GDP growth in EU-27 in the four scenarios



Note: In the calculations is assumed that the total average annual fiscal effort on average from 2010-2014 will be in line with the figures pictured in table 2. It is assumed that the tightening is equally spread between less public spending and tax increases. It is also assumed that the interest rate will be lowered as a reaction to the fiscal tightening.
Source: AE on the basis of the international macroeconomic model HEIMDAL.

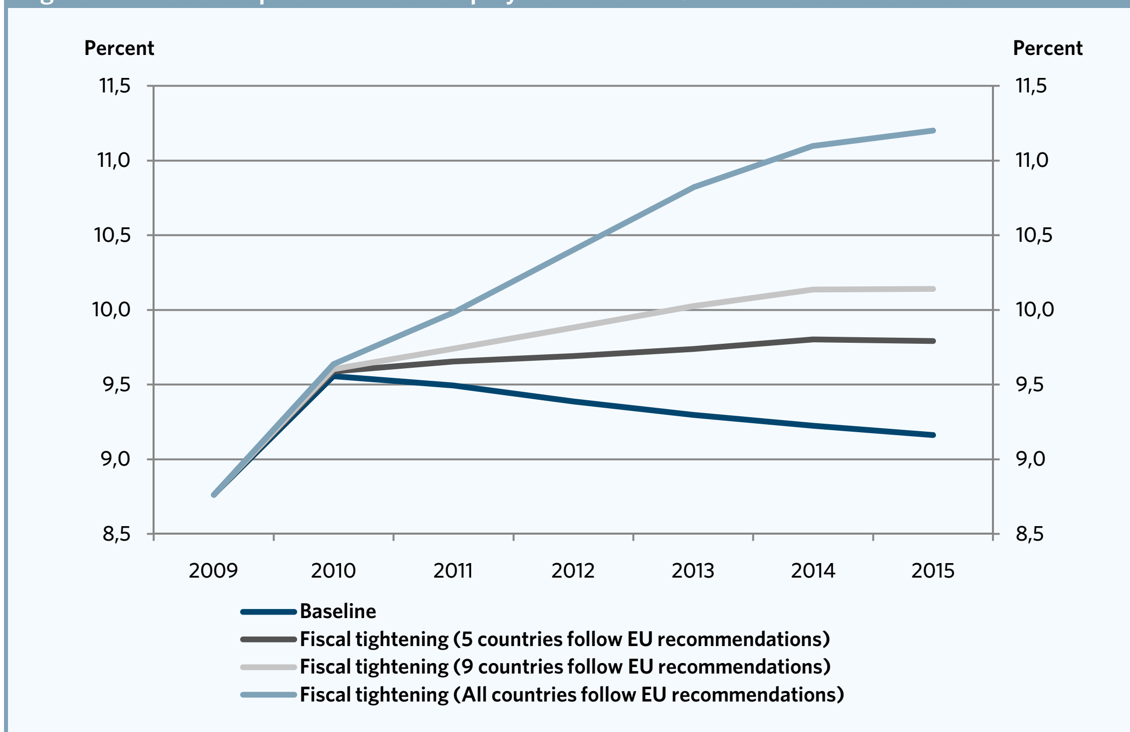
Figure 11 and 12 shows the effect on employment and unemployment in the four scenarios. Likewise will the negative effect on employment be less severe if only some countries tighten fiscal policy from 2010. Instead of nearly 7 million jobs being lost if all 23 countries tighten at the same time, only a little more than 2 million jobs will be lost if only the 5 countries with the largest budget deficits tighten fiscal policy. And instead of an increase in the unemployment rate of 2 percentage points, the increase will only be ½ a percentage point if only 5 countries tighten fiscal policy.

Figure 11. The development in employment in EU-27 in the four scenarios



Note: In the calculations is assumed that the total average annual fiscal effort on average from 2010-2014 will be in line with the figures pictured in table 2. It is assumed that the tightening is equally spread between less public spending and tax increases. It is also assumed that the interest rate will be lowered as a reaction to the fiscal tightening.
Source: AE on the basis of the international macroeconomic model HEIMDAL.

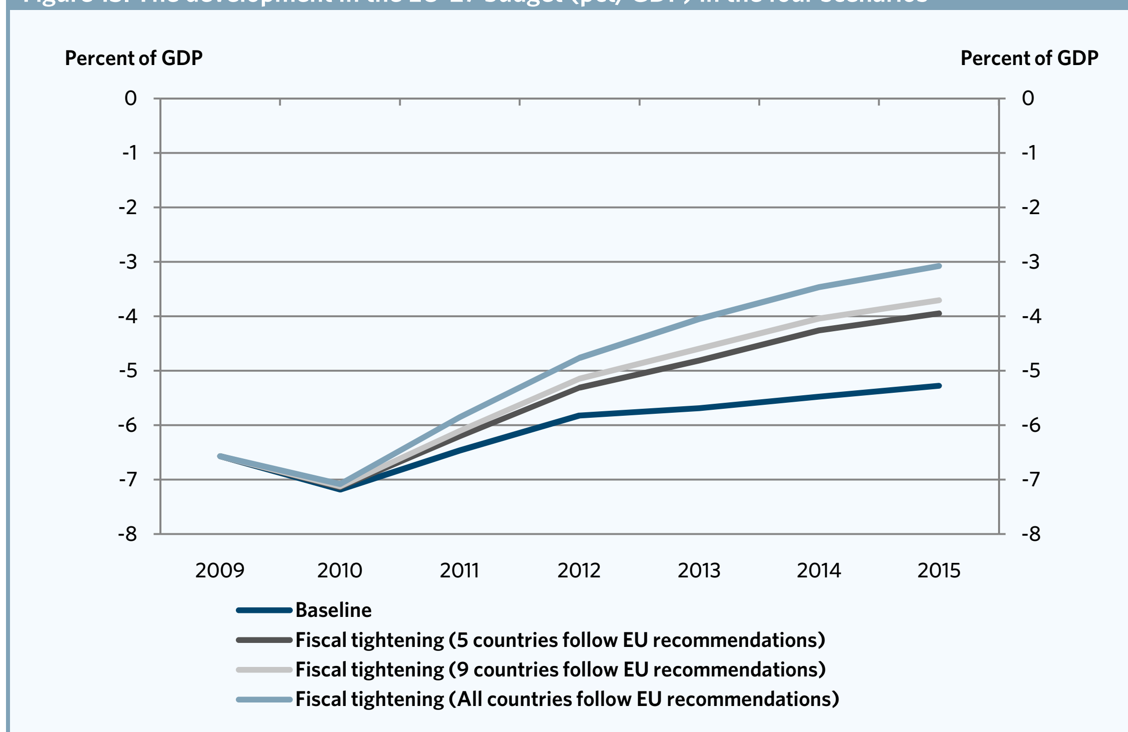
Figure 12. The development in the unemployment rate in EU-27 in the four scenarios



Note: In the calculations is assumed that the total average annual fiscal effort on average from 2010-2014 will be in line with the figures pictured in table 2. It is assumed that the tightening is equally spread between less public spending and tax increases. It is also assumed that the interest rate will be lowered as a reaction to the fiscal tightening.
Source: AE on the basis of the international macroeconomic model HEIMDAL.

Figure 13 shows the effect on the public budget in the four scenarios. The overall effect on the public budget is of course bigger if all 23 countries tighten fiscal policy. But more than half of the improvement can be achieved if only 5 countries tighten fiscal policy. This is because the negative spill-over effects are not to the same extent drawing in the opposite direction.

Figure 13. The development in the EU-27 budget (pct/GDP) in the four scenarios



Note: In the calculations is assumed that the total average annual fiscal effort on average from 2010-2014 will be in line with the figures pictured in table 2. It is assumed that the tightening is equally spread between less public spending and tax increases. It is also assumed that the interest rate will be lowered as a reaction to the fiscal tightening.
Source: AE on the basis of the international macroeconomic model HEIMDAL.

The calculations show that by letting the European countries tighten fiscal policy in different speeds, it is possible to reduce the negative spill-over effects and therefore also reduce the negative effects on the European economy from tightening fiscal policy.

A 2020 Strategy

Up until now the paper has focused on how to save our way out of the crisis. Savings plans are one way to address the growing public budgets. A second path is to reform our way out of the crisis. This chapter will focus on how to increase the European growth potential in the medium and long run in order for Europe to regain momentum in growth. Changes in business cycles in the short run can be responded to with fiscal policy. In the medium and long run, an economic upturn requires structural changes in the form of reforms that changes the underlining structures in society in a wide range of areas.

Tightening fiscal policy might improve the budgets in the short run, but it does not change the fact that many Europeans are unemployed and if the fiscal tightening creates lack of confidence in the economy for consumers and investors, then the upturn may very well be jeopardized. In the medium and long run, an economic upturn in Europe requires structural changes in the form of reforms that changes the underlining structures in society in a wide range of areas, so that Europe quickly returns to its historical growth pad as well as increases the

growth potential in the medium and long run. Such a development will create jobs, lower unemployment from its present historically high level and improve the budget.

The strategy suggested in this section shows an alternative way for the European economy, also called the 2020 strategy. The strategy is based on the underling ideas in the PES paper "A progressive Strategy for a Green, Smart and Inclusive Europe". The following elements are included in the strategy. Firstly, focus is on making a shift to low carbon activities by *implementing a smart green growth strategy*. Secondly, focus is on turning knowledge and creativity into the main resource of people, companies and regions by *implementing an ambiguous education strategy*. Thirdly, the focus is on renewing and strengthening the welfare system to fight social inequality. This could be done by creating *larger equality between men and women*, and by *increasing the education level for the weakest* and in this way lifting the incomes in the bottom. The strategy outlined in this paper is so to say focusing on the following three pillars:

- **A smart green growth strategy**
  By implementing a simultaneous investment strategy across the European Union we can obtain higher economic growth, productivity and prosperity. This could be investments in infrastructure such as road and public transportation, or environmental investments and energy renovations. But also investments in a greener energy system such as investments in wind mills etc.

- **Higher productivity and education level**
  By increasing the education level and making sure that the European labour force increase and hold the skills that are required by society, we do not only increase employment and cut unemployment we also improve productivity for greater future prosperity.

- **Fighting social inequality**
  By increasing the female participation we can increase employment and create more equal opportunities for men and women. One way to make it more likely for women to participate in the labour force is to develop and substitute the public childcare system. By increasing the education level for the weakest we can lift the incomes in the bottom and in this way reduce income spread and hereby inequality. This can be done through investments in better education for the weakest in society, and through active labour market policies and active social policies targeted at the weakest in society. In this way we can fight social inequality by getting weaker groups employed.

The effects of the 2020 Strategy

A strategy as the one described above, with simultaneous investments, improvement of the productivity, increasing employment, creating a sustainable development and changing the structure of public spending can and must be done differently in different countries as the different challenges must be taken into account – as well as different public budget situations. This analysis does not give a plan in detail for each country. Instead it sketches the effects of different initiatives and gives a scenario on how the effect could be.

The final effect will depend on the nature and pace of the initiatives. The following calculations will build on the three pillars: green investments, education and fighting social inequality. The scenario illustrates the effects of structural changes in the European economy in the coming ten years. Box 3 gives a detailed description of the scenario.

Box 3. Details behind the calculations

The medium term scenario illustrates the structural effects of implementing the strategy described above over the coming ten years from 2010 till 2020.

The initiatives are calculated as increasing the labour force by ½ percent point to the year 2020. This effect could come as a combination of effects of education, childcare, active labour market policies and research and development. Increased productivity and competition result in a lower inflation rate that otherwise have been.

The investment initiatives are assumed to be distributed equally between private and public investments so that the total investment level in the EU on average is 9 percent higher in 2020 compared to a situation without the investment plan.

The utilization of the extra resources in the labour market is subject to the condition that an active economic policy is implemented to increase demand on labour. The demand generating equilibrium is equally distributed between private and public internal demand. The inflation rate is assumed to be 0.2 percent point lower each year than otherwise.

Table 5 shows the forecast for the next ten years if structural changes are implemented within green investments, higher productivity and education level and lower social inequality.

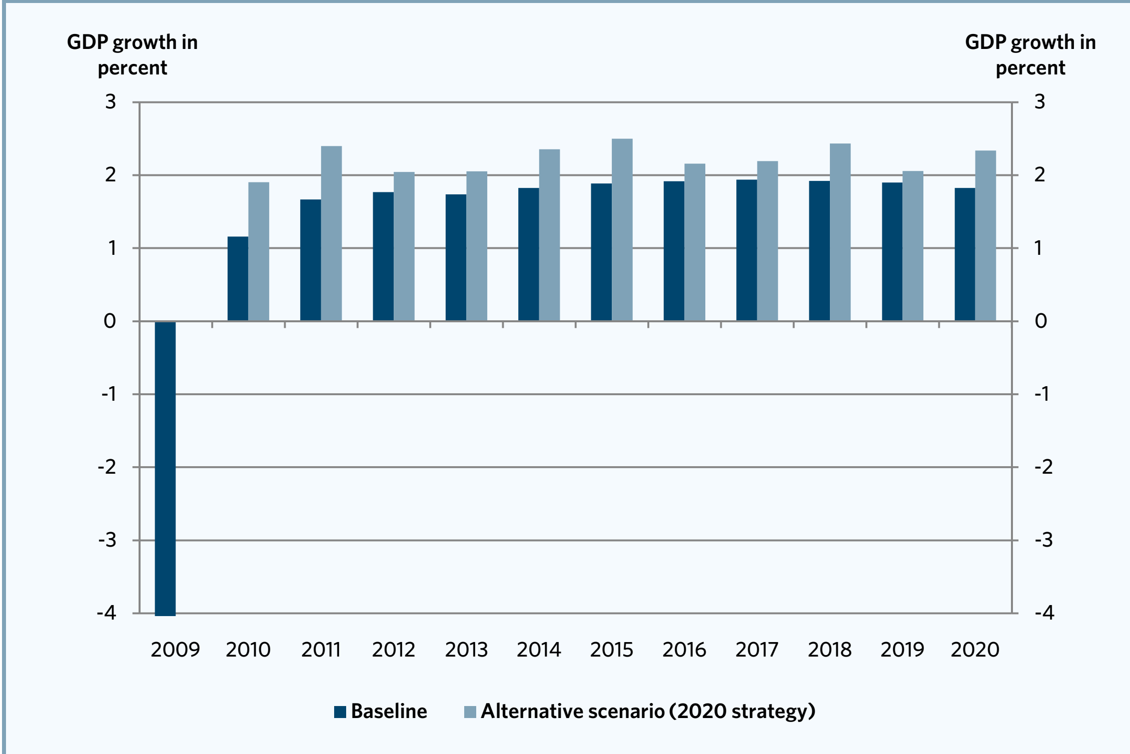
Table 5. Key figures in the 2020-strategy scenario for EU-27

	2009	2010*	2011*	2012*	2013*	2014*	2015*	2016*-2020*
GDP (growth in percent)	-4.1	1.9	2.4	2.0	2.1	2.4	2.5	2.2
Employment (million people)	221.4	220.8	222.7	224.4	225.9	227.7	229.7	234.6
Unemployment (million people)	21.3	22.9	22.0	21.4	21.0	20.4	19.6	18.2
Unemployment rate (percent of labour force)	8.8	9.4	9.0	8.7	8.5	8.2	7.9	7.2
Public budget (percent of GDP)	-6.6	-6.9	-6.1	-5.4	-5.2	-4.9	-4.4	-3.7

Note: * indicates the forecast period.
Source: AE on the basis of the European Commission Spring forecast 2010 and Consensus Forecasters April 2010, calculated with the international macroeconomic model HEIMDAL.

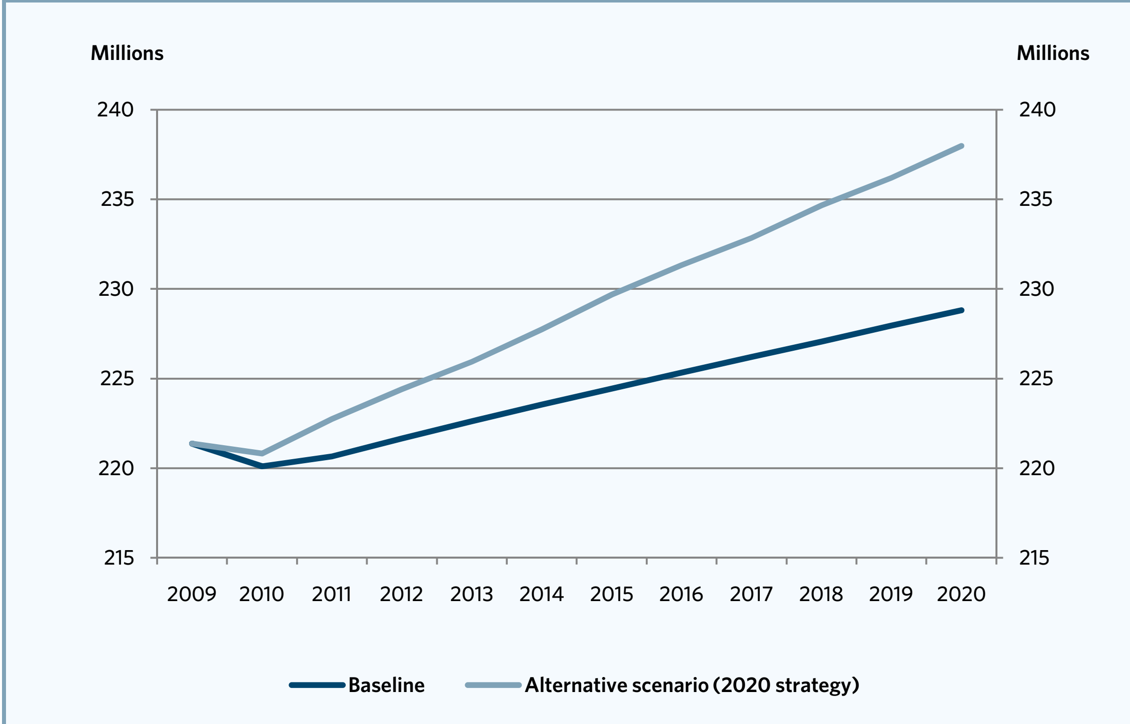
As shown in the table growth rates will on average be at above 2 percent in the coming ten years if the strategy is implemented. The structural changes in the European economy will break the unemployment curve and unemployment will fall from 2011 till 2020 where unemployment will be more than 5 million lower than without the structural strategy. The structural changes will create a lot of jobs coming from, among other things, more women in the labour force, green investments as well as all the derived jobs coming from the increased demand in the economy. Figure 14-17 show the development in the key figures in the baseline scenario and the alternative scenario with the 2020 strategy.

Figure 14 shows how GDP will rise more in all years if the structural changes are implemented, than had been the case otherwise. In the coming years GDP will on average grow 0.4 percent more each year than without the strategy.



Note: the structural changes are implemented in 2010-2020.
Source: AE on the basis of the international macroeconomic model HEIMDAL.

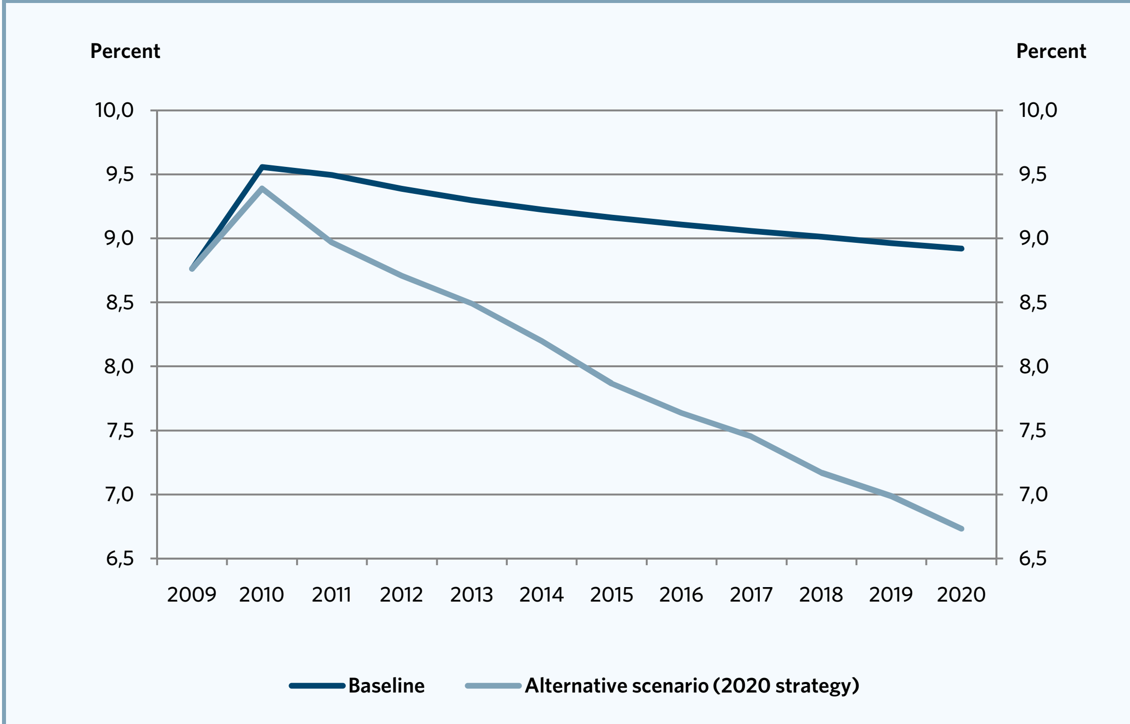
Figure 15 shows how the strategy all in all will create more than 9 million jobs over the next ten years.



Note: the structural changes are implemented in 2010-2020.
Source: AE on the basis of the international macroeconomic model HEIMDAL.

Figure 16 shows the development in the unemployment in the baseline scenario and in the alternative scenario. All in all the strategy can bring the unemployment rate down with more than 2 percentage points compared to a situation without the strategy. This corresponds to more than 5 million fewer unemployed. And that even though e.g. increasing women's participation rate also mean a higher unemployment in the short run until all the women have gained a foothold on the labour market. If active labour market policies are implemented, in order to help the women to get jobs and to be quickly integrated on the labour market, then unemployment can be expected to fall even more.

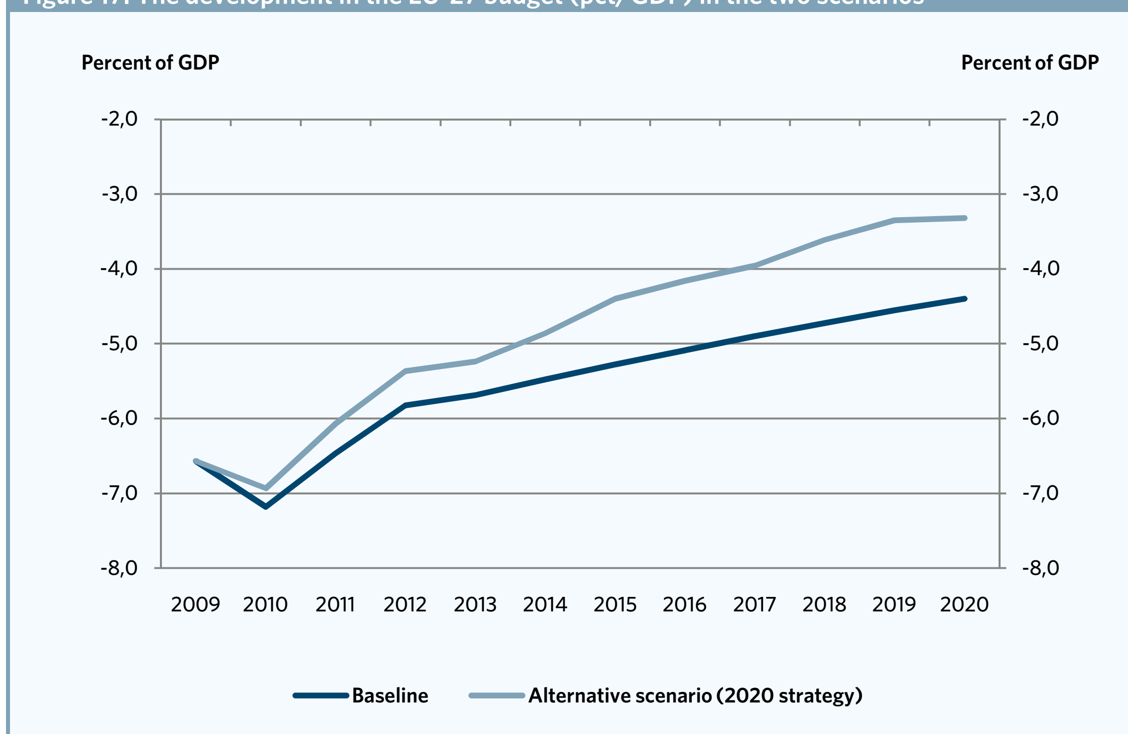
Figure 16. The development in the unemployment rate in EU-27 in the two scenarios



Note: the structural changes are implemented in 2010-2020.
Source: AE on the basis of the international macroeconomic model HEIMDAL.

Figure 17 shows the development in the budget in the two scenarios. As seen the budget is improved as the unemployment rate falls. In 2019 the budget is expected to have improved to such an extent, that the 3 percent deficit ceiling is met.

Figure 17. The development in the EU-27 budget (pct/GDP) in the two scenarios



Note: the structural changes are implemented in 2010-2020.
Source: AE on the basis of the international macroeconomic model HEIMDAL.

Table 6 shows the effect on GDP and employment in a number of countries. In the period between 2010 and 2020 GDP in EU-27 will grow by nearly 5 percent more in the scenario with structural changes compared to the scenario where nothing is done. In employment terms the total effect on EU-27 will be more than 8 million extra employed in 2020 than would have been otherwise.

Table 6. Effects from the 2020 Strategy on growth and employment, 2010-2020

	Growth in GDP 2010-2020 (percent)			Growth in employment 2010-2020 (million)		
	Baseline Scenario (a)	Alternative Scenario (b)	**Difference in percentage points (b-a)**	Baseline Scenario (c)	Alternative Scenario (d)	**Difference in million (d-c)**
Germany	19.1	24.4	5.3	1.3	2.6	1.3
United Kingdom	21.9	27.7	5.9	1.5	3.8	2.3
France	22.2	25.4	3.2	1.5	1.8	0.3
Italy	14.0	19.8	5.8	0.7	1.3	0.6
Spain	19.3	23.4	4.1	0.8	1.5	0.7
Poland	26.5	31.5	5.0	0.6	1.2	0.5
EU-27	**20.0**	**24.9**	**5.0**	**8.7**	**17.2**	**8.5**

Note: the structural changes are implemented in 2010-2020.
Source: AE on the basis of the international macroeconomic model HEIMDAL.

As shown in the figures above there is a great potential in implementing the strategy in the European countries. The strategy will draw Europe in the right direction, create jobs, cut unemployment and ensure that Europe will have a quicker return to its historical growth pad. Some of the positive effects in this scenario are due to the fact that the European countries make a simultaneously effort regarding investments in childcare, education, R&D, social expenditure etc. This means that there are positive spill-over effects on the individual country which enlarge the effects on employment and wealth and help the final effect on the public budget to be positive.