

Macroeconomic developments and policy issues

Introduction

In the course of 2010 the emphasis of macroeconomic policy and discourse in the European Union shifted markedly away from how to prevent the occurrence of another ‘Great Depression’ – a danger policymakers believe has passed – to how to rectify the consequences for public finances of the financial and economic crisis. Government budget deficits and public debt to GDP ratios ballooned in most member states, given the unprecedented interventions to shore up failing financial institutions and make up for the gap in private sector demand which emerged after the recession and the extensive de-leveraging in the private sector.

The Europe 2020 strategy, agreed in June 2010 and aimed at fostering ‘smart, sustainable and inclusive growth’, illustrates this turning tide. The macroeconomic policy guidelines for its implementation, underpinned also by economic governance reform proposals by the European Commission and a Taskforce of the European Council, emphasise fiscal consolidation, the correction of macroeconomic imbalances with emphasis on keeping labour cost developments under check and the asymmetric correction of current account imbalances.

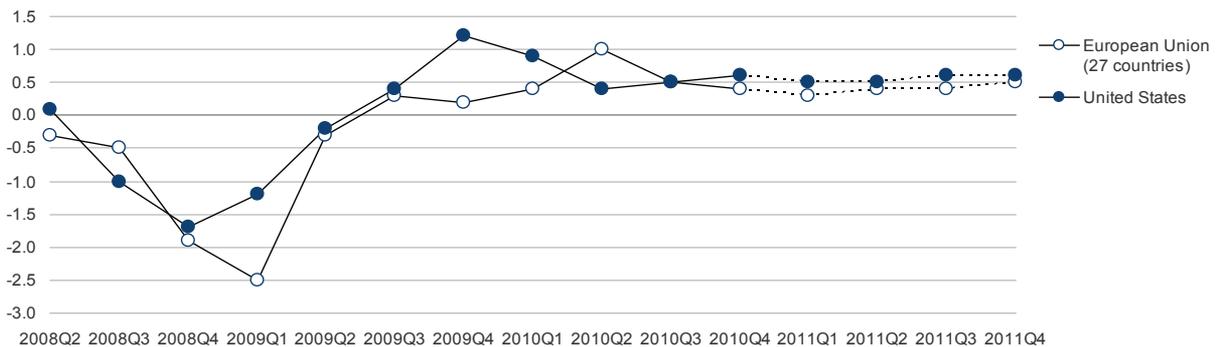
This chapter evaluates whether the current state of the European economy warrants the emphasis of the macroeconomic policy guidelines as suggested by the EU2020 strategy, their likely implications under the current circumstances with regard to growth, employment and public finances, and the outlook for the longer run. Are these macroeconomic policy guidelines likely to create the appropriate context for ‘smart, sustainable and inclusive’ growth by 2020? If not, what could be the alternative?

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Sluggish and uncertain recovery from the crisis

Figure 1.1 Real GDP growth, quarter-on-quarter, %



Data source: Eurostat (2010b).

Output growth remains fragile

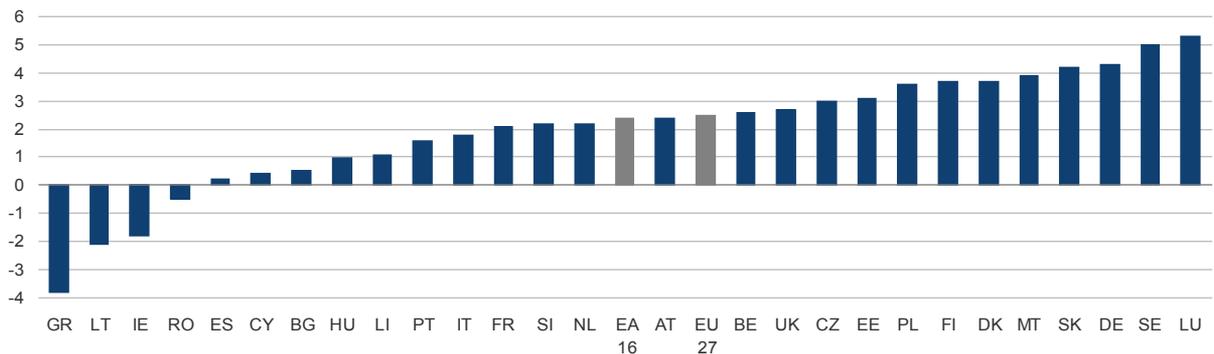
The first Council macroeconomic policy guideline for the implementation of the Europe 2020 strategy states that fiscal consolidation should start at the latest during 2011, provided that the European Commission's forecasts about recovery gaining pace and becoming self-sustaining are confirmed (European Commission 2010m: 8). According to this guideline, the pace of consolidation should entail a reduction in the government budget deficit of at least 0.5% of GDP per year, not counting the effects of the business cycle on the government deficit. These efforts, the guideline insists, should continue until the medium-term fiscal objectives of balanced government budget over the course of a business cycle and a 60% debt to GDP ratio have been met.

Although the EU economy exited the recession after the second quarter of 2009, the recovery in output growth so far (up until the third quarter of 2010) has been weak (see Figure 1.1). The latest European Commission forecasts (European Commission 2010p) predicted that there would be a further weakening in real output growth towards the end of

2010 and in early 2011, with quarterly growth rates ranging between 0.3 and 0.4%. Annual output growth is currently forecast at 1.6% in 2011 for the EU27 and 1.4% for the euro area. These projected growth rates are lower than those for the US. Moreover, as Figure 1.1. shows, these quarterly growth rates are not expected to pick up until at least the end of 2011.

Sluggish and uncertain recovery from the crisis

Figure 1.2 Change in output, 2009Q2 to 2010Q2



Data source: Eurostat (2010b).

Large variations in the strength of recovery

Even these bleak prospects constitute a 'no surprise' scenario, and any surprises are likely to be on the downside: the unresolved sovereign debt crisis (see below) and doubts about the resilience of Europe's banks have the potential to tip the European economy back into recession.

Looking into the strength of recovery by member state (Figure 1.2), we see that there is wide variation. Member states which have either faced a debt crisis or have suffered from fears of contagion, such as Greece, Ireland, Latvia, Spain, Portugal and Italy, have either seen their output continue to contract since the recovery started in the EU as a whole in the second quarter of 2009 or have experienced very weak recovery of output. These are also countries which have been forced to adopt the most austere fiscal retrenchment packages, either as part of the financial assistance they received from the EU or in an attempt to 'please the markets' and so avoid having to resort to such support.

At the other end of the spectrum, member states such as the Scandinavians, Germany, Poland, the UK, Belgium,

the Czech Republic and Estonia performed above the EU27 average in the year between the second quarters of 2009 and 2010. Most of them, especially the Scandinavians and Poland, weathered the crisis fairly well, with rather little impact on their public finances, while the recovery of the German economy has been boosted by the strong growth of demand for its exports from outside the EU. Above-trend growth rates are both normal and necessary after a recession and, as noted, the question is whether this growth dynamic can be maintained in an environment in which both the public and private sectors across Europe are seeking to reduce spending relative to income.

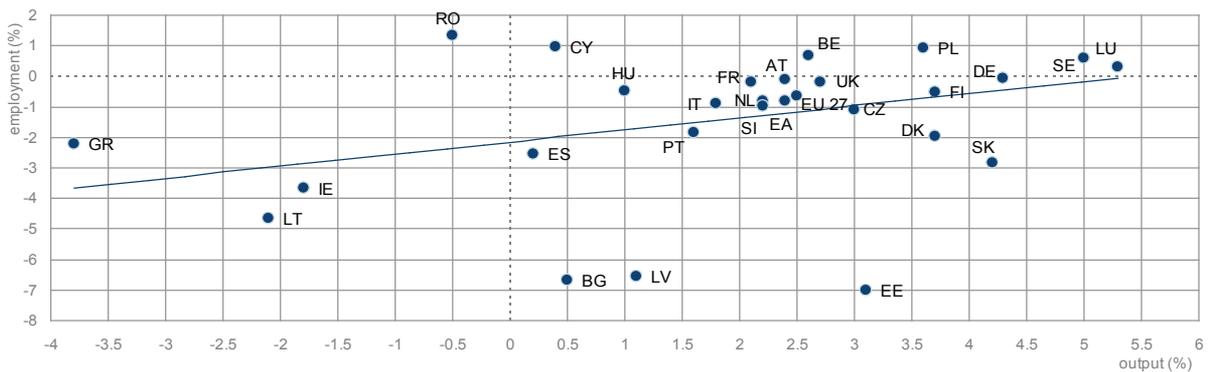
The new UK coalition government spelled out a fiscal consolidation programme for the economy during the second quarter of 2010, comprising massive spending cuts and due to last until 2015-16. The effects of the programme on output growth remain to be seen, although some early signs are not encouraging (Office for National Statistics 2011). Moreover, of the countries which have performed relatively well in terms of output growth since the second quarter of 2009, Belgium has now moved up into the ranks of countries for which the likelihood of facing a public debt financing crisis has increased and, for that reason, fiscal retrenchment action may be expected soon. Last but not least, Germany, Europe's largest economy, will be embarking on a programme

of public finance consolidation that will seek to implement the 'fiscal brake' (*Schuldenbremse*) recently enshrined in its Constitution.

On a positive note, the switch of the growth locomotive from the periphery to the centre of the euro area will help to reduce the imbalances to which attention was drawn in previous *Benchmarking Working Europe* reports, and to which we return in the next sub-section.

Sluggish and uncertain recovery from the crisis

Figure 1.3 Change in output and employment, 2009Q2-2010Q2



Data source: Eurostat (2010b).

Bleak job creation prospects

The recovery since the second quarter of 2009 has been too weak to lead to positive net job creation in the majority of EU member states. As Figure 1.3 illustrates, the majority of EU member states registered employment losses, which in a number of cases were very severe, between the second quarter of 2009 and the second quarter of 2010, in spite of their output having increased during that period. This is hardly surprising, insofar as employment adjustments usually follow output fluctuations with a lag. The question, however, is whether output growth developments, as currently forecasted, are likely to generate sufficient additional employment to reverse these losses in the foreseeable future.

The aforementioned predictions of an annual 1.6% output growth in 2011 hardly leave much space for optimism. If productivity per worker grows at about 1.2% and if the population of working age (15-64) grows at about 0.4%, that is, at their average growth rates in the ten years before the crisis, then there will be no increase in employment rates from their depressed post-crisis level; the net job increases will, in this case, merely

absorb the growth in the working-age population.

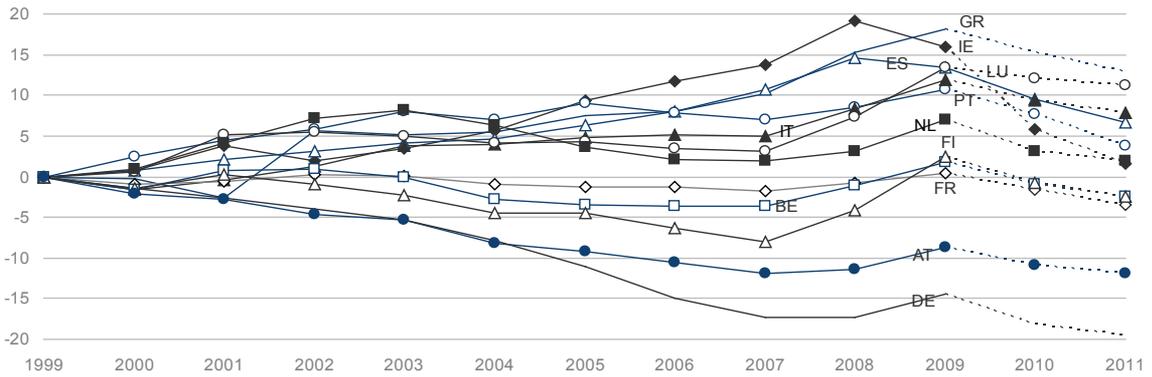
The employment prospects are particularly worrying in high-productivity-growth countries such as many central and eastern European countries. Such tepid rates of economic growth imply a falling demand for labour, assuming that productivity growth returns to pre-crisis levels. Of course, this would also condemn Europe to continuing high unemployment, because under these conditions there will be insufficient new jobs created to employ new entrants to the workforce, never mind to reabsorb those who became unemployed during the crisis.

This, in turn, casts doubt on whether the current recovery in output growth can be sustained. High unemployment rates mean lower household incomes and spending. Moreover, the higher and more widespread the risk of unemployment becomes, the more likely it is that even households with members in employment will increase their savings as a precaution against potential income losses in the future. Both these developments are bound to suppress private demand for consumption and investment and, consequently, output growth in the short-to-medium run. A weak recovery keeps unemployment high, thereby sapping demand so that the economy becomes locked in a Keynesian high-unemployment equilibrium.

More worryingly still, if the current increases in unemployment last for long, unemployment persistence will arise and inevitably limit the effectiveness of other initiatives currently planned under the Europe 2020 strategy for delivering smart, sustainable and inclusive growth. It will be extremely difficult, for example, to meet the 75% employment rate target, and the unemployed absorb government resources that cannot then be used to meet other policy goals. Investment in education, early and higher, is likely to be wasted if insufficient numbers of jobs are created to employ people, as the unemployed suffer erosion of their skills. The poverty target that refers to jobless households is, in turn, likely to be severely undershot under conditions of persistently high unemployment, while the inevitable downward pressure on wages will inevitably be associated with higher rates of material deprivation (see also Chapter 3).

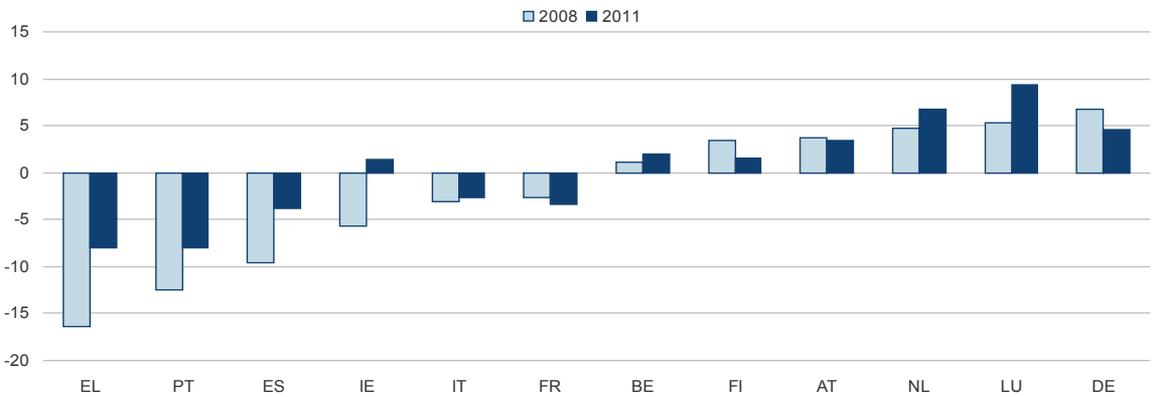
Macroeconomic imbalances

Figure 1.4 Nominal unit labour costs adjusted for ECB's inflation target, Euro Area 12 (1999=basis year)



Data source: Ameco.

Figure 1.5 Current account balances, Euro Area 12, 2008, 2011



Data source: Ameco.

Macroeconomic imbalances

Macroeconomic imbalances adjusting asymmetrically

Correcting current account (or 'macro-economic') imbalances is a key element of the new proposed economic governance architecture. While the European authorities had long been obsessed with the position of the public sector, and specifically the size of fiscal deficits, in past years this chapter of the *Benchmarking Working Europe* report has repeatedly pointed to concerns about the development of current account imbalances within the euro area.

Had such analyses influenced policy, the unsustainable situation of countries such as Spain and Ireland, which never encountered problems with the Stability and Growth Pact (SGP; see next section) but had large current account deficits, would have emerged in time for corrective action to be taken. Nonetheless, the analysis of such imbalances is not straightforward, for they are not always malign.

These imbalances reflected two main drivers: faster economic growth in the peripheral economies of the south (Spain, Greece, Portugal) and west (Ireland) of the euro area compared with the core (especially Germany) and, linked to that, faster increases in nominal wages and prices in the former compared with the latter (see also Watt 2010b).

Figure 1.4 shows the pace of nominal unit labour cost (ULC) growth (wages allowing for productivity growth) for the twelve founder members (including Greece) of EMU, adjusted for the 2% annual price inflation target of the ECB. The order of the countries in the figure reflects their position in 2008, at the point when the crisis hit. It shows that, at the extremes, Germany had improved its wage competitiveness by more than 17% compared with the benchmark, by

2008, while Ireland, Greece, Spain, Portugal and Italy had lost competitiveness to the tune of between around 19% and 9%. France constitutes 'best practice' in terms of ensuring ULC growth in line with the ECB target for overall price stability.

Figure 1.5 shows the current account position of the same EMU countries, again ranked according to the pre-crisis position. There is a striking correlation between the country rankings in the two figures: the faster nominal ULC growth, the bigger the deficits; the slower nominal ULC growth, the bigger the surpluses on current account. Correlation is not causation, however. Price-setting also requires analysis as a factor behind the faster wage-price spiral in the southern countries. The outcomes were 'market-driven' to the extent that asset-price booms generated what subsequently turned out to be unsustainably fast economic growth in the periphery. Nevertheless, the problem of correcting the competitive imbalances remains.

The values for 2009-2011 show how the crisis has impacted on ULC developments and the current account position (the 2010 figures being estimates and the 2011 data Commission forecasts (see European Commission 2010p); see also p.9). One positive fact is that substantial falls in the current account deficits of the major deficit countries (in the case of Ireland turning into a substantial surplus) are forecast. This quite sharply reflects expected corrections in ULC growth compared with the 2% inflation benchmark; in Ireland the correction is particularly (and perhaps unrealistically) pronounced. In fact, both wages and prices are expected to fall in absolute terms (deflation). While this helps to rectify imbalances, it has serious negative consequences for fiscal consolidation and for the banking system.

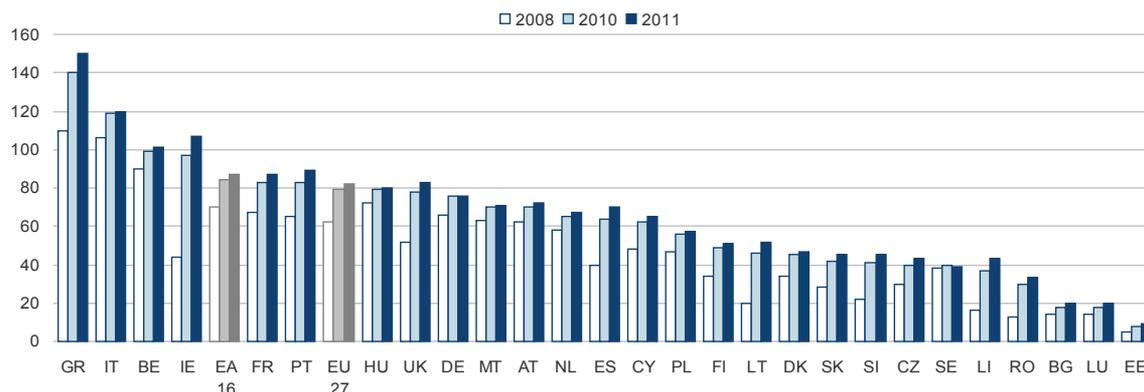
Conversely, Germany's surplus is shrinking, but only somewhat. More worryingly, after a crisis-induced brief upturn in the pace of ULC growth in Germany, Austria, Finland and Belgium, in which nominal wages had previously grown too slowly with respect to national productivity growth trends, ULC trends

in these countries once again appear to be headed towards a renewed decline vis-à-vis the euro-area benchmark rate of increase.

Under these conditions – which, to repeat, are forecasts – the closing of the current account imbalances from the side of the surplus countries does not appear likely to be lasting. More generally, the figures point to a one-sided adjustment: substantial relative disinflation of nominal wages in deficit countries and falling deficits, but no adequate or sustained pick-up in wage growth in surplus countries. A more symmetrical adjustment, with faster average economic growth and also a higher aggregate inflation rate, would be desirable, but this would require a shift in macroeconomic policies. Numerous documents related to the EU2020 strategy, including the Commission's Annual Growth Survey (European Commission 2011), are explicitly asymmetric in their policy recommendations: they call on deficit countries to ensure wage moderation, but require surplus countries not to raise the pace of wage increases but rather to perform structural reforms such as extending shop opening hours.

Macroeconomic imbalances

Figure 1.6 Public debt, gross (% GDP)



Data source: Ameco.

Public debt/GDP ratios: a mixed picture

The macroeconomic policy guidelines for the implementation of the Europe 2020 strategy imply that the most important policy lesson that the EU drew from the crisis is that more fiscal discipline is necessary in the future to avoid similar crises. Does the existing evidence support this view?

Looking at the public debt figures in Figure 1.6, the following observations can be made:

- In 2010, the debt-to-GDP ratio remained below the 60% Maastricht limit in 13 out of 27 member states, despite the massive effects of the crisis. These countries are forecast to keep their public debt below that limit in 2011 as well.
- Of the countries whose debt rose above the 60% limit, Cyprus, Spain, the Netherlands, Austria, Malta and Germany are expected to be below 80% in both 2010 and 2011. Half of these countries, namely Cyprus, Spain and the Netherlands, had debt-to-GDP ratios below 60% in 2008. In fact, Spain and Cyprus had very low debt-to-GDP ratios, of 40 and 48% respectively. The other three, namely

Germany, Malta and Austria, had debt-to-GDP ratios only marginally above 60% in 2008. Comparison of the magnitude of the recession and of the fiscal interventions that it required with the increase in public debt in these countries and their performance up to 2008 does not allow the conclusion that more fiscal discipline prior to the crisis would have helped them to fare better in terms of stabilisation. In fact, Spain and Cyprus, the countries in this list with the lowest debt, had the weakest recovery between 2009 and 2010, suggesting that the ‘fiscal space’ they had both created prior to the crisis did not facilitate more active use of their fiscal policies to help their economies recover (see Figure 1.2).

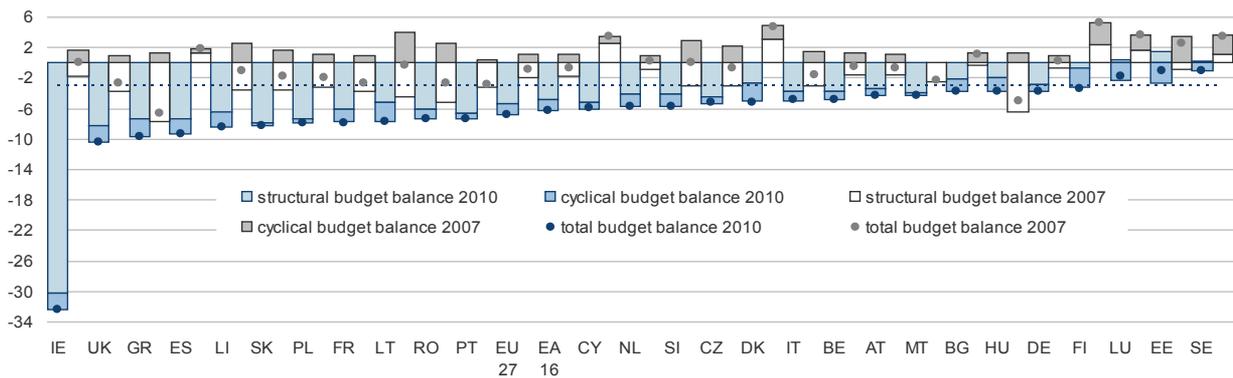
- Of the countries whose debt is going to be above 60% of their GDP in 2010 and 2011, only Belgium, Italy, Portugal, France, Greece and Ireland are expected to exceed or remain above the 90% mark, which is the threshold identified by Reinhart and Rogoff (2010) as being associated with lower output growth in the medium-to-long term.
- Of these countries, Belgium and Italy did not experience any substantial increase in their debt in the aftermath of the crisis. These two countries have, in fact, coped with higher than 90% debt-to-GDP ratios for many years. While this may not necessarily have helped their economic performance, nor – once

again – does it warrant the conclusion that more fiscal discipline before the crisis would have allowed them the space to keep their public finances in better order or to use fiscal policy more actively to weather the recession under the current circumstances. After all, as Figure 1.2 shows, they have both seen their output increase since the recovery started in 2009, while Belgium was also one of the few EU members that experienced some employment recovery between 2009 and 2010.

- Greece, Portugal and France saw their public debt rising, with the two former having been characterised as insolvent (Buiters *et al.* 2011) following the European debt crisis that broke out in the financial markets in 2010, a diagnosis which, at least initially, was not wholly justified on the fundamentals of these countries (Wyplosz 2009) but rather illustrated the panic of the markets faced with the indecisiveness of European policymakers. All three countries had moderate-to-high debt ratios prior to the crisis (ETUC and ETUI 2010).
- These developments mark a sharp contrast with the case of Ireland, whose debt shot up from 25% of GDP in 2007 to a currently projected 100% in 2010. The fact that these four countries started out from very different points to end up in the same critical situation casts doubt on how far more fiscal discipline would have helped prevent their current state.

Macroeconomic imbalances

Figure 1.7 Government budget deficits, EU27, 2007, 2010



Data source: Ameco.

Blame it on government budget deficits?

Government budget deficits in the vast majority of EU member states remained above the 3% of GDP threshold in 2010, a sharp increase since 2007 when the average deficit was 0.9% in the EU27 and 0.7% in the euro area. As can be seen from Figure 1.7, there is, except in the case of Greece, no straightforward association between the government budget balance in member states in 2007 and the extent to which it had deteriorated by 2010. This is not surprising, as different member states were exposed to the causes of the crisis and experienced the severity of the recession to differing degrees, while they also have automatic stabilisers of different strength. Would more fiscal discipline have helped avert this deterioration?

A few observations are again in order:

- Of the member states that registered above-EU-average budget deficits in 2010, only Greece had already exceeded that threshold in 2007, just before the crisis. There had been several countries against which the Excessive Deficit Procedure had been

initiated prior to 2007, including France, Portugal, Poland, Hungary, Italy, Germany, the Netherlands and the UK. All of these had managed to reduce their budget deficits below 3% by 2007. Hungary was an exception but it had already achieved a substantial adjustment of its deficit and in spite of the recession, its budget deficit was below average by 2010.

- As Figures 1.6 and 1.7 suggest, all these member states ended up in very different situations with regard to their public finances by 2010. This suggests that their prior public finance management record alone did not predict either these developments or the capacity of these member states to weather the crisis using counter-cyclical fiscal policy without jeopardising the sustainability of their public finances.
- The most dramatic increases in budget deficits between 2007 and 2010, however, were observed in Ireland, Spain, the UK, Latvia, and Lithuania. These countries share some common characteristics, including low to very low debt-to-GDP ratios prior to the crisis, ranging from 9% in Latvia to 44% in the UK in 2007. All of them, except the UK, also had either very low budget deficits or surpluses in 2007 and had come nowhere near to being referred under the Excessive Deficit Procedure.
- But all five countries suffered from excessive debt in their *private* sectors.

Once the credit crunch began in 2008 (earlier for Latvia), governments in these countries had to take measures that included supporting financial institutions with unsustainable balance sheets to avert a banking system meltdown. Excessive bank credit expansion had fuelled housing market bubbles in the run-up to the crisis. Thus, in addition to rescuing financial institutions, the governments of these countries saw a sharp decrease in their tax revenues as the booming construction and financial services sectors collapsed or sharply contracted.

These points on the evolution of public debt and government budget deficits suggest that although, in cases like Greece, Portugal and France, more fiscal discipline prior to the crisis would have shielded these countries from facing debt financing crises in the markets or being at heightened risk thereof, the relative importance attached to this lesson in shaping the macroeconomic policy guidelines of the Europe 2020 strategy is completely unwarranted. The problem was caused, rather, by severe imbalances in the accounting sheets of member states' private sectors (see also De Grauwe 2010).

Macroeconomic policy responses

Figure 1.8 Fiscal adjustment packages in the EU

	AT	BG *****	CY	DE	DK	ES	FR	GR	HU **	IE	IT	LT ***	LU	PL	PT ****	SE	UK **** *****
Overall size of the package (bn euros)	-13.6	-0.8	-0.3	-80.0	-3.3	-15.3	-83.2	-37.6	-9.4	-15.0	-37.0	-5.2	-0.7	-0.2	-21.7	1.4	-129.0
Planned end year	2014	2011	2013	2014	2013	2012	2014	2013	2010	2014-15	2012	2012	2014	2013	2013	2011	2014-15
2010 (% GDP)		-2.3				-0.5		-5.6	-4.4	-2.6	n/a	-4.0		-0.6	-1.2		-0.5
2011 (% GDP)	-0.8		-1.4	-0.4	tba	-0.9	-1.0	-6.3	-3.8	-3.8	tba	-2.2	-1.5	tba	-4.9	0.4	-2.0
2012 (%GDP)	-1.1		tba	-0.7	tba	tba	-1.0	-2.4	-1.5	tba	tba	tba	tba	tba	-2.8		-3.7
2013 (%GDP)*	-1.2		tba	-0.9	tba	tba	-1.1	-2.0		tba			tba	tba	-3.6		-5.0
2014 (%GDP)*	-1.4			-1.0			-0.9			tba			tba				-6.1
Share of Expenditure cuts in package	53		35	65	60		73	57		66	60		74	0	66		73
Share of Revenue increases in package	47		65	35	40		27	43		33	40		26	100	33		27

Source: Theodoropoulou and Watt (2011). See this working paper also for more information on methods and data reliability. (*) In all cases except the UK and Portugal, the share of fiscal adjustment over GDP in 2013 was based on our own extrapolated GDP figures. (**) The figures for Hungary concern 2007, 2009 and 2010 respectively. (***) The figures on Latvia cover only part of the consolidation programmes since 2008, as accurate official figures are not available. There is also uncertainty about the end-year of the fiscal adjustment programme. (****) Distribution of adjustment over time is shown as a % of National Income; forecasts of measures available until 2014-15 only. (*****) The figures for Bulgaria and the UK were converted into Euros using the exchange rates of 25 February 2011 found in <http://www.xe.com/ucc/>.

From fiscal stimulus to austerity packages

In spite of the still fragile and only weak recovery, 2010 saw a turning policy tide. In the course of 2010, serious concerns began to arise in the financial markets about the solvency of several member states, such as Greece and Ireland. In response to such crises, support packages, with strict conditionality, have been grudgingly provided by EU governments, in tandem with the IMF, culminating in the setting up of the European Financial Stability Facility.

Thus, in line with the recommendations in the context of the Stability and Growth Pact and the Europe 2020 guidelines, and as a response to an actual or threatened public debt crisis, austerity packages have been introduced or are currently planned in most member states. This will withdraw demand from the economy unless it is offset by higher private-sector or foreign demand (see also p.9)

As Figure 1.8 shows, there is wide national variation in the planned fiscal retrenchment. Typically, this adjustment is more concentrated in the early years

of the programmes, especially in those member states that have already faced or are considered more likely to face strong pressures in the financial markets for financing their debt. As shown earlier, these are also the member states with the weakest, if not non-existent, recovery in output growth.

The emphasis in these packages has been mostly (Cyprus and Poland being exceptions) on cutting public expenditure rather than on raising taxes. The bias towards cutting expenditure is especially pronounced in countries with right-of-centre governments, such as France, the UK and Italy, where typically three quarters of the adjustment bears on the expenditure side. In many member states, the axe on spending has fallen mostly on social protection and public administration, while on the revenue side, indirect and environmental taxes and social security contributions bear the brunt of the adjustment (Theodoropoulou and Watt 2011). These indications are bound to give cause for concern about their implications for inequality and poverty (see also Chapter 3).

The emphasis on dropping the axe on the expenditure side rests on the assumption that such cuts will have a positive offsetting effect on private sector spending thanks to the 'confidence' that austerity policies induce in consumers and investors. Not only is the empirical evidence for such effects extremely

limited, a detailed study by the IMF (2010) clearly identified the conditions under which the normal 'Keynesian' contractionary impacts of fiscal consolidation are expected to be strongest. They are a) when monetary policy is not able to offset the fiscal contraction with more expansionary monetary policy; b) when countries are not able to devalue their currency to promote net exports, and, similarly, c) when external demand is weak, limiting export growth, for instance because trading partners are also engaging in austerity policies. All three of these conditions apply to the case of euro-area countries.

It comes as no surprise then that national experts, especially in member states where the most severe austerity packages have been adopted, remain mostly sceptical about the plausibility of the growth forecasts on which announced fiscal consolidation programmes rest (Theodoropoulou and Watt 2011). In evaluating the likely impact of such austerity policies, it is worth noting that at the end of 2010 the USA opted for a further substantial fiscal boost to its economy by prolonging substantial tax reductions and raising spending. The package has improved the recovery outlook for the economy (IMF 2011).

Macroeconomic policy responses

All central banks are not equal

The interest rates of the European Central Bank, the US Federal Reserve and the Bank of England remained at the record levels to which they had been lowered in 2009, that is, 1%, 0-0.25% and 0.5% respectively. This, however, does not mean that the monetary policy of the three central banks has remained unchanged since then/for the past year.

In November 2010 and in the face of weakening recovery with a persistently high unemployment rate at 9.6% and an inflation rate, which at 1.1% in September (compared to the previous year) undershot its target, the US Federal Reserve announced a second phase of quantitative easing, in the context of which it intends to buy \$600 billions worth of Treasury securities up to the end of the second quarter of 2011, at a pace of roughly \$75 billions per month. Quantitative easing is the means by which a central bank can attempt to increase liquidity in an economy when the interest rates are already very low and, therefore, cannot serve their usual purpose in this respect.

The scale at which the European Central Bank has engaged in quantitative easing has been far smaller and initially confined to buying safe private sector securities. In May 2010, however, at the culmination of the Greek debt crisis and as the rise in government bond yields began to spread, the European Central Bank started buying government debt in the secondary markets, as a complement to the establishment of the European Stabilisation Fund. According to the ECB's announcements, these purchases have been 'sterilised'; in other words, the ECB has withdrawn any liquidity that the purchase of government debt would provide in the euro-area money market. Moreover, the Bank itself has not been particularly transparent about the level of these transactions.

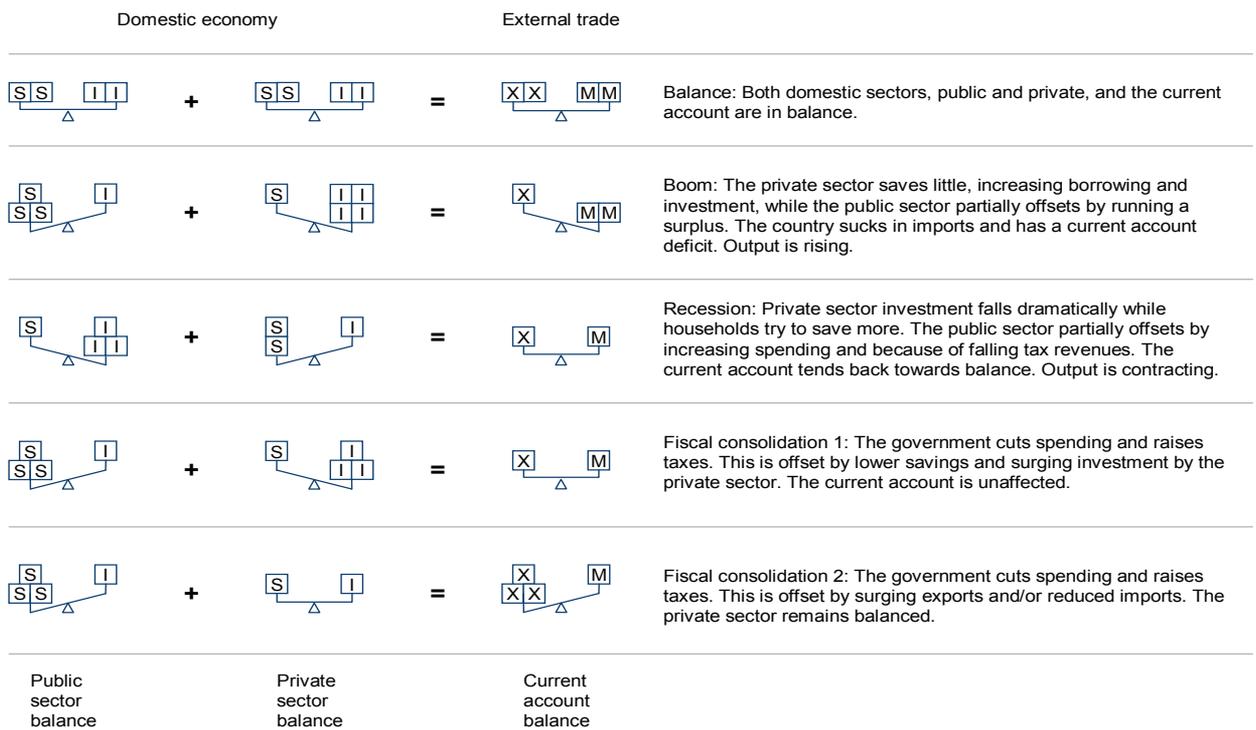
The contrast in approaches between the Fed and the ECB, by raising the relative supply of dollars to euros, predictably

resulted in a depreciation of the dollar vis-à-vis the euro, which will tend to further stimulate the US economy while depressing that of Europe.

In actual fact, the aims of the measures being pursued on either side of the Atlantic are rather different. Whereas the Fed is actively trying to stimulate the economy and raise employment by openly pumping money into the economy (quantitative easing), the ECB is merely threatening those speculating against the sovereign debt of euro-area members with a 'bloody nose' via unannounced purchases of such debt. In other words, the quantitative easing actions of the ECB aim more at staving off the public-debt-financing crisis than at stimulating the economy of the euro area. More generally the ECB has made it clear that it is keen to exit such extraordinary measures. This is despite the fact that the ECB's own forecasts, and those of other leading institutions, indicate that inflation is likely to remain below target for the foreseeable future (ECB 2010: 88). Even on its own narrow definition of its mandate, the ECB should be doing more to stimulate the European economy, all the more so given the plans for fiscal austerity set out by member state governments discussed above.

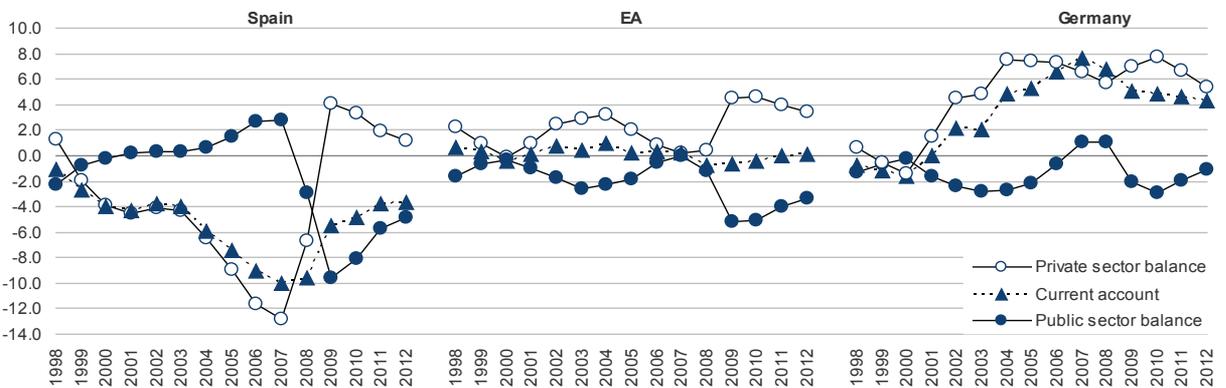
Looking ahead: are the growth and employment goals compatible with the consolidation demands?

Figure 1.9 Stylised illustration of sectoral (im)balances



Source: ETUI own input.

Figure 1.10 Real GDP growth, quarter-on-quarter, %



Data source: Eurostat (2010b).

Looking ahead: are the growth and employment goals compatible with the consolidation demands?

Growing imbalances corrected in the crisis

How is the implementation of the Europe 2020 strategy's macroeconomic policy guidelines likely to affect macroeconomic conditions in Europe in the current decade? Are these guidelines likely to create an environment that fosters smart, sustainable and inclusive growth? Are they likely to help steer public finances back onto a sustainable path?

According to the Commission's forecasts, budget deficits in the EU (including the euro area) will be on average curtailed by 1.7 % of GDP (European Commission 2010p: 202). Of that consolidation, 1.4% of GDP is expected to be structural in nature, with the remainder attributable to the cyclical effect of the forecasted output growth in the area.

As we have seen, fiscal debts and deficits are supposed to be reduced swiftly and substantially under the EU2020 strategy and then to stabilise at a position of 'close to balance or in surplus'. However, at a given level of output, this desired reduction in budget deficits implies either that the private sector or the country's current account – or both – must adjust (see Figure 1.9 for an illustration). Everybody cannot increase their saving at the same time. If the public sector wants to reduce its indebtedness (that is increase the public sector savings-investment balance), one of two things – or a mixture of the two – must happen. Either the private sector must take on more debt (decreasing its savings with respect to investment); or the country must borrow less from (or lend more to) the rest of the world. This means that it must either reduce its current account deficit or increase its surplus: simplifying somewhat, this means that it must either export more or import less.

If the private sector's plans are not commensurate with this planned fiscal

consolidation, for instance because, following a credit binge, households also want to repair their balance sheets by themselves increasing their savings, and/or if the current account does not move in the right direction to the requisite extent, then the decision by the public sector to reduce spending relative to income will cause output to fall. This will bring about the adjustment needed to equate the sectoral balances: the private sector will end up saving less than it wanted and low growth will reduce net imports. But clearly this is a high-cost strategy, and one that risks perpetuating the economic and employment crisis and, indeed, the fiscal problems, because it will hit government revenues. Fiscal austerity, under such conditions, is largely self-defeating.

Figure 1.10 shows how the three sectoral balances developed for the euro area and for the most important deficit country (Spain) and surplus country (Germany) during the ten years up to the crisis (1998-2008) and how they are forecasted to develop by the European Commission in the coming period (2009-2012). We choose these countries to illustrate, in a relatively simple way, broader trends. Let us start with the euro area: it has roughly balanced trade and current account, so the private and public sector balances are the mirror image of one another. When private demand collapsed in the crisis and households cut spending and firms investment, public deficits rose sharply and this helped to cushion the blow to output that would otherwise have occurred. For most of the period during which it was a member of EMU, up until the crisis, Spain was characterised by high and rising private sector and current account deficits. Towards the end of that period, government surpluses acted to dampen private-sector exuberance. Germany, by contrast, was characterised by growing current account surpluses and private sector surpluses, to which was added, towards the end of the pre-crisis period, fiscal consolidation. Thus Spain and Germany formed opposite poles of sectoral balances that, at the level of monetary union as a whole, were broadly balanced. These imbalances at the national level were then corrected in the crisis, particularly dramatically in Spain.

Looking ahead: are the growth and employment goals compatible with the consolidation demands?

Figure 1.11 Summary table of COM forecasts for the period 2009-2012

	DE		ES		EA	
	2009	2012	2009	2012	2009	2012
Real GDP growth	10.7		4.6		8.5	
Investment growth	27.1		-3.5		13.0	
Export growth	39.0		33.4		34.8	
Intra-EU export growth	30.4		26.1		33.3	
Imports	44.1		21.5		34.3	
Intra-EU imports	38.0		14.1		31.8	
Investment/GDP	16.5	19.0	24.4	22.5	18.9	19.7
Export/GDP	33.5	42.3	15.5	19.8	28.8	36.0
EU-exp/GDP	20.9	24.7	10.8	13.1	19.2	23.8

Source: Ameco. Note: The single columns are the rates of change 09-12

Do the sums add up growing forward?

The question is whether the envisaged path of fiscal consolidation is plausible, given its implication for the other balances. We examine this by taking the European Commission (2010p) forecasts for the relevant variables. As can be seen (Figure 1.11), the public sector balance (that is the budget surplus/deficit less public investment) is expected to be reduced in both countries, from -9.6% in 2009 to -4.8% in 2012 in the case of Spain and from -2% to -1.1% in Germany over the same period.

According to the forecasts, these deficit reductions are supposed to be offset as follows. In Spain the current account is to improve by almost 2 percentage points (pp) of GDP (from -5.5 to -3.6%), while private sector savings minus investment picks up by around 3 pp. In Germany the improvement in the public balance of just under 1 pp reflects a fall in the current account surplus of around 0.7 pp and a rise in private sector saving minus investment of more than 1.6 pp.

To see how plausible such changes in the private-sector and current-account balances are, we need to consider the absolute

shifts in the underlying aggregates and their assumed relationship with total GDP against the background of how the level of GDP itself is supposed to develop (Figure 1.11).

Real GDP growth in Germany is expected to be quite strong at 10.7% over the four-year period, more than twice the rate expected in Spain. Investment growth is predicted to be very strong, driving up the investment share from 16.5 to 19% of GDP, which is slightly higher than the average in the ten years up to the crisis. This increase in the investment share appears plausible, at least in the sense of being compatible with the predicted strong economic growth. The concern is more on the export side. Germany is predicted to see its total exports increase by almost 40% and exports within the EU by 30%; yet at the same time most of the countries of Europe are seeking to cut import demand and increase their own net exports. On these assumptions, Germany's total export share would be over 40% of GDP and more than 20% of GDP would consist of exports to other EU countries.

Against the background of very sluggish growth in Spain (just over 1% a year), investment is actually forecast to contract by a not insubstantial 3.5%; the investment share of GDP falls by 2pp. However, if investment falls, then there has to be an even larger drop in savings (of the order of 5pp of GDP) if the envisaged private sector adjustment is to materialise. The question is how this is to come about: such a fall in savings would imply an economic boom, but in

fact sluggish growth is forecast. There may be some consumption-smoothing effect, but it seems unlikely given weak private sector balance sheets to be so strong. Turning to the external balance, despite the fact that Spain cannot devalue within the euro area and that price increases are expected to be broadly in line with those in Germany, Spain is forecast to enjoy very strong export growth, not far short of the German performance both within and outside the EU. The export/GDP share is, we are told, to rise by as much as 4.3 pp of GDP to 19.8%, a figure higher than during any of the ten years preceding the crisis. This would certainly be desirable, but must remain doubtful not least given the forecast failure to improve price competitiveness.

All in all, the forecast figures seem inconsistent and implausible. Germany is set to continue an export-led growth strategy, not least reflecting higher exports to other EU member states, in the context of a needed substantial fall in net imports by many of its EU trading partners. Fiscal consolidation in Spain should imply higher investment, but instead it is set to fall. This suggests an implausible reliance on the Spanish private sector to dis-save in the context of sluggish growth and high unemployment. Moreover, the envisaged Spanish trade performance appears highly unlikely, given the lack of a depreciation 'safety valve' and the fact that no improvement in price competitiveness vis-à-vis Germany is expected in the coming four years.

Conclusions

Gloomy macroeconomic prospects threatening Europe 2020 objectives

The analysis contained in this chapter leaves little room for optimism on the question of whether the current and currently foreseen macroeconomic conditions and policies are likely to support the Europe 2020 objectives of smart, sustainable and inclusive growth. The exceptionally critical circumstances are not alone to blame; equally important factors have been the macroeconomic policy choices that have been promoted and are to be expected in the years to come.

It does not appear that the most appropriate lessons have been drawn from the crisis in designing the economic policy aspects of the EU2020 strategy. The focus on fiscal 'rectitude' has been increased further, despite the lack of evidence that it was an important cause of the crisis. So much misguided rectitude threatens to kill the recovery – and the fiscal rules themselves will be the next victim, repeating the experience of the mid-2000s crisis of the Stability and Growth Pact. The extension of surveillance to macroeconomic imbalances is welcome in principle but flawed in practice.

Our analysis clearly suggests that the sectoral-balance prerequisites for fiscal consolidation without a major output contraction – namely robust private-sector demand and/or strong growth in net exports – in Europe over the coming period are not given. This suggests strongly that the budget plans will not be realised, and nor will those of the private sector, or politicians' targets for improvements in net exports. Private sector dynamism and/or net export growth in

many countries will not be sufficient to offset the withdrawal of public demand. Instead, the necessary adjustment of the sectoral balances will come about via falling GDP (or slower-than-forecast growth). This in turn means that overall rates of GDP growth are very likely to prove weaker than expected.

The crisis clearly showed that allowing monetary policy to focus solely on micromanaging consumer price inflation was inadequate, but the ECB appears to be regarded as sacrosanct: there is no talk of reforming the role of the central bank as an essential part of an economic governance framework that ensures crisis-free, job-creating economic growth. Likewise, there is no place in the proposed new architecture for measures to limit tax competition and generate additional government revenues via coordinated taxation of financial transactions or fossil energy.

The opportunity to use the crisis to establish a market for Eurobonds to promote needed public investment and reduce government borrowing costs has been passed up. There is a serious risk that the misguided policy content of the new economic coordination mechanisms will discredit the whole idea of strengthening the degree of economic policy coordination, even though more meaningful coordination is exactly what is needed to respond to the crisis.

The major problem is that, if the (macro)economics are wrong, all the other laudable targets and procedures in the EU2020 strategy – raising education standards and R&D spending, reducing poverty – will prove entirely illusory, further undermining the credibility of Europe.