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European Recovery II

This contribution has been elaborated in the frame of the collaboration between FEPS and ECLM (Denmark, www.ae.dk)

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Present Forecast

In OECDs latest forecast, OECD Economic Outlook Interim Report March 2009, the size of the stimulus packages has been measured. Table 1 shows the fiscal stimulus packages adopted until the end of March 2009. It is seen from table 1 that the European countries on average have stimulated their economies with 0.9 percent of GDP in 2009 and 0.5 percent in 2010.

Table 1. Fiscal stimulus packages adopted until the end of March 2009.

	2009	**2010**
	Percent of GDP	
Austria	0.9	0.2
Belgium	1.0	0.6
Czech Republic	2.0	1.0
Denmark	0.8	1.7
Finland	1.5	1.6
France	0.5	0.2
Germany	1.4	1.6
Hungary	-2.6	-1.8
Ireland	-1.9	-1.8
Italy	0.0	0.0
Luxembourg	2.7	0.9
Netherlands	0.8	0.7
Poland	0.8	0.2
Portugal	0.8	0.0
Slovak republic	0.5	0.6
Spain	1.6	0.8
Sweden	1.5	1.3
UK	1.3	-0.1
Weighted average	**0.9**	**0.5**

Note: The table only includes the countries in the EU-27 that are OECD members
Source: OECD Economic Outlook Interim Report, March 2009 and own calculations.

Table 2 shows the present forecast calculated on the international model HEIMDAL in line with the projections in the latest OECD forecast. In table 2 it is assumed that the automatic stabilisers are at work and that the member country packages adopted up until the end of March are implemented (cf. table1). In the baseline scenario in table 2 the EU-27 will go into deep recession in 2009, where private consumption and investments will drop, which in turn will diminish both export and import. The recession will also affect the labour market as employment will fall and unemployment increase by more than 10 million people over the next two years. Because profits will be lower and less people will be employed, tax revenues will decrease and expenses to public benefit will increase and the public budget will worsen.

Table 2. Present forecast for the EU-27 economy.

	2008	2009	2010	2011	2012
GDP growth (%)	0.9	-3.9	0.0	1.9	1.9
Employment (million)	220.6	213.1	207.4	208.1	209.0
Unemployment rate (% of labour force)	7.0	9.7	11.6	11.6	11.4
Unemployment (million)	16.8	23.2	27.6	27.6	27.3
Government balance (% of GDP)	-2.0	-5.6	-7.0	-6.7	-6.7

Source: Calculation by ECLM based on the international model "HEIMDAL".

The forecast in table 2 includes financial stimuli and automatic stabilisers. The financial stimulus packages adopted by member states will certainly have effects on the real economy. <u>Without</u> them, the recession would be even deeper, with further loss of growth, jobs and further increase in unemployment. Besides the fiscal stimuli listed in table 1 several governments have provided extra credit. It is uncertain to what extend the extra credit will influence the real economy, but without the extra credit it would definitely point in the direction of a deeper recession.

It is also clear from table 2, that the packages adopted until now, are not enough to prevent a severe economic crisis. <u>Therefore additional stimuli are needed</u>. There is a fundamental need for enforcing the investments in member states as well as on the EU-level.

Additional fiscal stimuli

To illustrate the magnitude of the need for extra investments in 2009 and 2010 to - just partly - respecting the common decision on a recovery plan in Madrid December 2008, we have calculated a new scenario.

As stated the outlook for the European economy would be much worse without the adopted packages. But the packages adopted up until now are not enough to prevent a severe economic crisis. Therefore additional stimuli are needed.

In the following scenario it is assumed that all European countries increase their public spending and investment so that the total stimulus in EU-27 equals 2 percent of GDP in 2009 and extra 2½ percent of GDP in 2010. The stimulus already adopted (cf. table 1) is taken into account. The European countries have already adopted packages corresponding to 0.9 percentage of GDP in 2009. Therefore they will need to spend an additional 1.1 percent of GDP in 2009 in order to reach 2 percent of GDP. Likewise the European countries have on average adopted packages corresponding to ½ a percent of GDP in 2010 and they will need to spend additional 2 percent of GDP in order to reach 2½ percent of GDP in 2010. It is clear, that the composition of the extra stimulus package differ between the member states. But it is assumed that the extra investments are implemented from the list in the PES recovery plan.

In the model simulations it is assumed that the fiscal stimuli will increase both consumer and investor confidence. This can to some extend be interpreted as the effect of extra credit. In that way the model simulations to some extend do take the provision of extra credit into account. On the other hand, the negative effect on the government budget that is coursed by provision of extra credit, is not modeled. This means that the budget estimates below can be a bit overestimated.

Table 3 shows the effects on the European economy of a scenario where all European countries increase their public spending and investments as described above, i.e. so the total spending correspond to 2 percent of GDP in 2009 and extra 2½ percent in 2010.

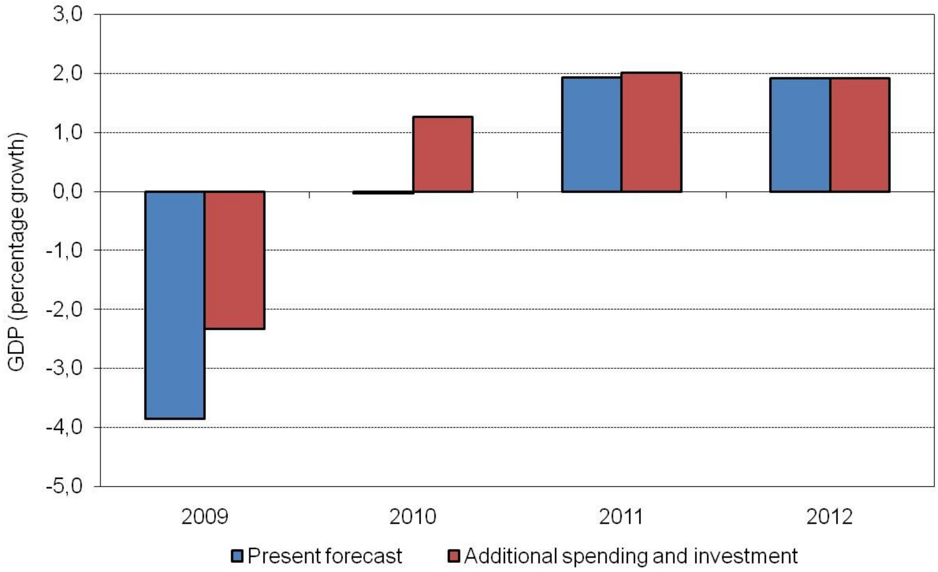
Table 3. Present EU-27 forecast with additional fiscal stimuli

	2008	2009	2010	2011	2012
GDP growth (%)	0.9	-2.3	1.3	2.0	1.9
Employment (million)	220.6	214.9	211.4	212.7	213.8
Unemployment rate (% of labour force)	7.0	9.2	10.4	10.2	10.0
Unemployment (million)	16.8	21.9	24.8	24.4	24.1
Government balance (% of GDP)	-2.0	-6.0	-7.6	-5.5	-5.7

Source: Calculation by ECLM based on the international model "HEIMDAL", on the basis of the estimates in Table 2.

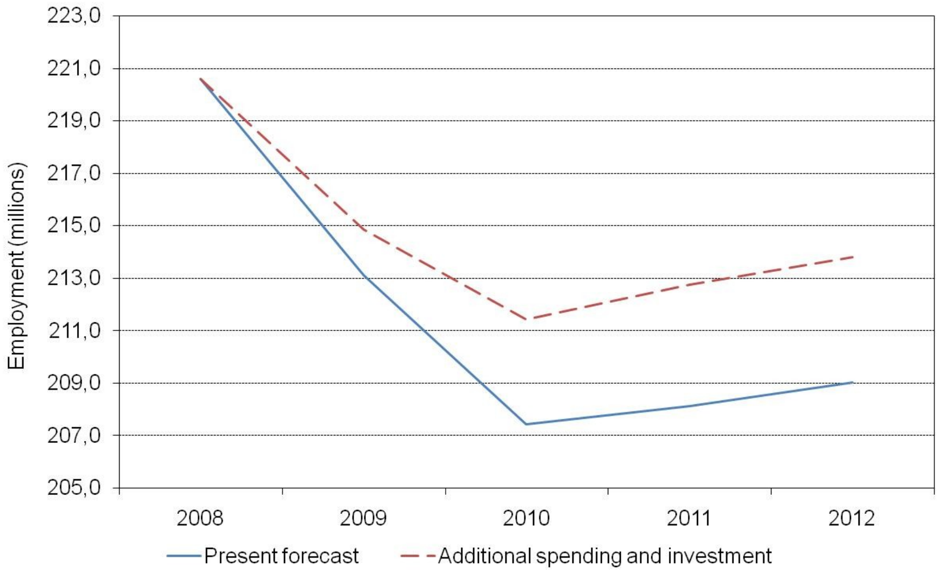
Figure 1-4 show a graphical presentation of the effect of additional public spending and investment.

Figure 1. Development in EU-27 GDP growth, 2009-2012.



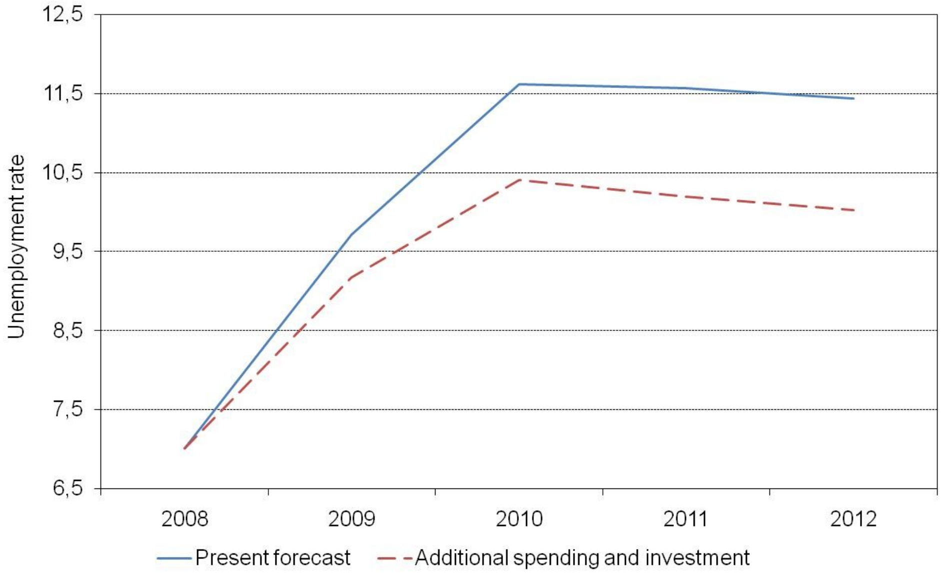
Source: Calculation by ECLM based on the international model "HEIMDAL".

Figure 2. Development in employment in EU-27 (millions), 2008-2012.



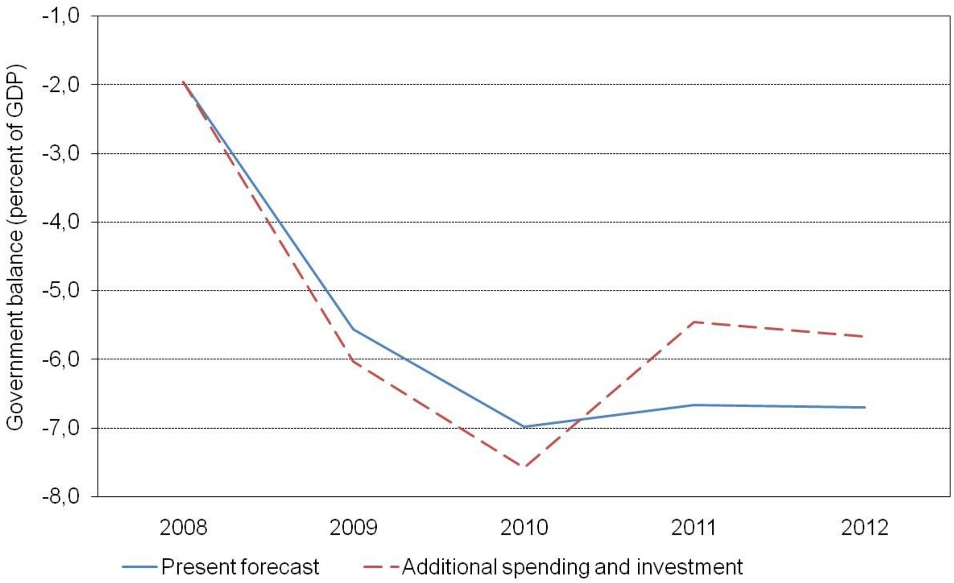
Source: Calculation by ECLM based on the international model "HEIMDAL".

Figure 3. Development in the EU-27 unemployment rate, 2008-2012.



Source: Calculation by ECLM based on the international model "HEIMDAL".

Figure 4. Effect on the public budget in EU-27 (percent of GDP), 2007-2012.



Source: Calculation by ECLM based on the international model "HEIMDAL".

On top of that further improvements can be obtained if investments are targeted at so called "intelligent" investments. Intelligent investments are investments such as education and knowledge, research and development, child care, infrastructure, green technology, social services and lifelong learning. Investing in these high quality areas will not only have a demand side effect in the short run, but will also have long lasting structural effects on the economy. That is increased productivity, higher participation rates on the labour market and lower structural unemployment. In other words if we invest in "intelligent" investments we can not only dampen the severe recession in the short run, but also improve the structures in the longer run.

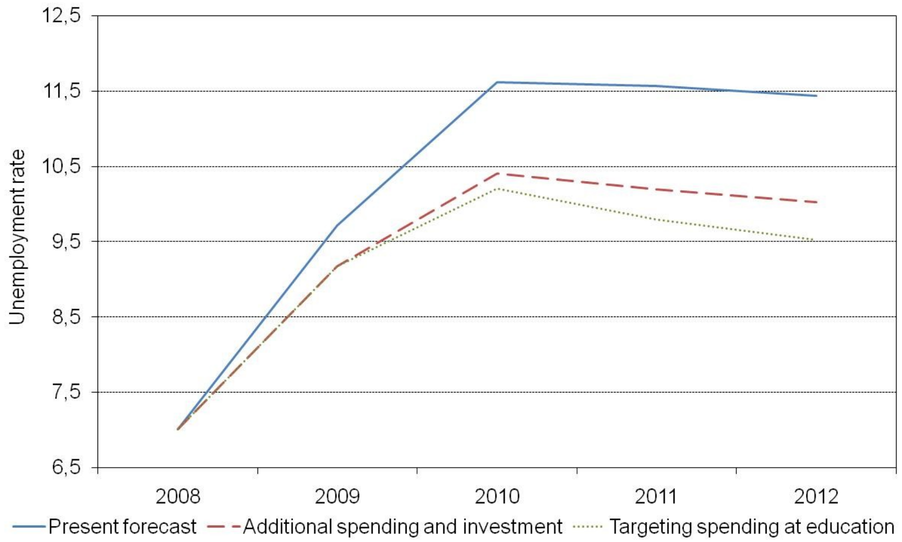
Box 1 illustrates that targeting part of the stimuli at education the unemployment rate can be reduced further in the short run.

Box 1. Targeting part of the stimuli at education

In this scenario the same additional amount is spend as above. But instead of investing broad in both capital and labour, more of the investment is targeted at education. This could have the form of "intelligent work sharing" where reduction in working time is compensated/supplemented by training/education to totally "normal" working time. And for unemployed an increased part will participate in training/education.

As it is shown from figure 5 this will reduce unemployment further as a larger share of the labour force are under education while the amount of jobs are unchanged. It is assumed that some of the investments are targeted at education and labour market training corresponding to an increasing reduction in the unemployment rate by ½ a percentage point in 2012.

Figure 5. Development in the EU-27 unemployment rate, 2008-2012.



Source: Calculation by ECLM based on the international model "HEIMDAL".

In the calculations it is assumed that the extra spending and investment in 2009 will have full effect already this year. Even though the investments are implemented this year, there is a chance that we will not see the full effect before next year. If this is the case, the effect of the extra stimuli will be smaller in 2009 but larger in 2010, compared to the calculations presented above.

Above it is also assumed that all 27 member countries are participating in the growth alliance up to a point where the member countries on average have stimulated their economies with 2 percent of GDP in 2009 and extra 2½ percent of GDP in 2010. It could be the case that some of the new Central and Eastern European member countries are not able to stimulate their economies to that extend.

The nine Central and Eastern European countries that could have trouble with expanding their public spending as described above are: Bulgaria, Czech Republic, Estonia, Hungary, Latvia, Lithuania, Romania, Slovakia and Slovenia. These nine member countries made up 4.3 percent of the total EU-27 GDP level in 2007.

If the nine Central and Eastern European countries do not participate in the expansion of public spending and investment it will not change the aggregated calculations of the effect on EU-27 significantly. This is because these countries only make up a little more than four percent of the total EU-27 GDP level. It will however effect growth and employment in the countries that are not participating, but there will still be a positive effect from the additional stimuli in the rest of EU, as the countries that are not participating will benefit from the positive spillover effects from countries that are participating.