FOUNDATION FOR EUROPEAN PROGRESSIVE STUDIES
FONDATION EUROPÉENNE D'ÉTUDES PROGRESSISTES

FISCAL TIGHTENING WILL JEOPARDIZE RECOVERY

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March 2010

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MAIN CONCLUSIONS

- Even though the European economy is growing again, the impact of the crisis on the member countries public budgets is now showing. In this light the European Commission recommends that 19 out of 27 countries should tighten their fiscal policy already this year with a total fiscal effort of more than 3½ percent of GDP from 2010-2014. There is a significant risk connected to tightening fiscal policy, as the economic upturn still is so fragile that tightening fiscal policy can mean that the recovery will be running out of steam.

- Calculations show that 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. Unemployment will also increase significant in the coming five year resulting in 28 million Europeans being unemployed in 2015. The effects can seem intense but they may very well be lower edge estimates, as the calculations build on mild assumptions. If lack of confidence, spill-over effects from the US and lack of reactions from ECB is taken into account the negative effects may very well be even larger.

- The effects on the European economy from tightening fiscal policy are big and this is partly due to the fact that nearly all European countries are tightening the fiscal policy at the same time. Nearly half of the negative effect on GDP and employment is coursed by the negative spill-over effects. If the spill-over effects are not taken into account then the negative effects from tightening are underestimated and the beginning upturn jeopardized.

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. In the 3rd quarter of 2009 the economic activity in EU grew for the first time in 1½ year, and GDP is expected to grow again in 2010 year-to-year.

But even though GDP in the EU is expected to grow this year it is still not enough to prevent unemployment from rising to more than 10 percent of the labour force – the highest level in a decade. That means, for every ten people willing to work one is unemployed. 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 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, and not until 2015 will employment be back at its 2009 level.

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

	2009	2010*	2011*	2012*	2013*	2014*	2015*
GDP (growth in percent)	-4.0	1.1	1.9	1.5	1.7	1.8	1.8
Employment (million people)	222.3	219.2	219.0	219.8	220.7	221.5	222.4
Unemployment (million people)	21.4	24.4	24.8	24.7	24.5	24.3	24.1
Unemployment rate (percent of labour force)	8.8	10.0	10.2	10.1	10.0	9.9	9.8
Public budget (percent of GDP)	-5.2	-5.5	-5.0	-4.7	-4.7	-4.5	-4.4

Note: * indicates the forecast period.

Source: AE on the basis of OECDs Economic Outlook 86 November 2009 and Consensus forecasters October 2009, calculated with the international macroeconomic model HEIMDAL.

FISCAL TIGHTENING

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.

Table 2. Recommendations from EU (Ongoing Country-specific Excessive Deficit Procedures)

	2010	2011	2012	2013	2014
Belgium	0.75	0.75	0.75	-	-
Czech Republic	1	1	1	1	-
Germany	-	0.5	0.5	0.5	-
Ireland	2	2	2	2	2
Greece	4	3.1	2.8	0.8	-
Spain	1.5	1.5	1.5	1.5	-
France	1	1	1	1	-
Italy	0.5	0.5	0.5	-	-
Latvia	2.75	2.75	2.75	-	-
Lithuania	1.5	1.5	-	-	-
Hungary	0.5	0.5	-	-	-
Netherlands	-	0.75	0.75	0.75	-
Austria	-	0.75	0.75	0.75	-
Poland	1.25	1.25	1.25	-	-
Portugal	1.25	1.25	1.25	1.25	-
Romania	1.5	1.5	-	-	-
Slovenia	0.75	0.75	0.75	0.75	-

Slovakia	1	1	1	1	-
United Kingdom	1.75	1.75	1.75	1.75	1.75
EU-27 (weighted average)	0.8	1.0	0.9	0.8	0.3

Note: All recommendations are published in December 2009, except recommendations for Latvia, Lithuania, Hungary, Poland and Romania that are published in July 2009. Recommendations for Greece are from February 2010 and are budget effects and not fiscal effect as it is for the other countries.

Source: AE on the basis of the European Commission, Economic and Financial Affairs, Ongoing Country-specific Excessive Deficit Procedures

As it is shown in the table above the European Commission recommends that 19 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 more than 3½ percent of GDP from 2010-2014.

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. This argument has been supported by IMF Managing Director Dominique Strauss-Kahn who says that "*What we need now are strategies that can restore fiscal sustainability, but that do not jeopardize the economic recovery by withdrawing support too soon*" (IMF Survey Magazine, 17. March 2010)

Table 3 shows an alternative forecast scenario. 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 one quarter 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 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.

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)	-4.0	0.9	0.8	0.7	0.9	1.2	1.9
Employment (million people)	222.3	219.0	217.4	216.8	216.3	216.0	216.4
Unemployment (million people)	21.4	24.6	26.0	26.9	27.7	28.3	28.4
Unemployment rate (percent of labour force)	8.8	10.1	10.7	11.0	11.3	11.6	11.6
Public budget (percent of GDP)	-5.2	-5.4	-4.4	-3.8	-3.1	-2.4	-2.2

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 OECDs Economic Outlook 86 November 2009 and Consensus forecasters October 2009, calculated with the international macroeconomic model HEIMDAL.

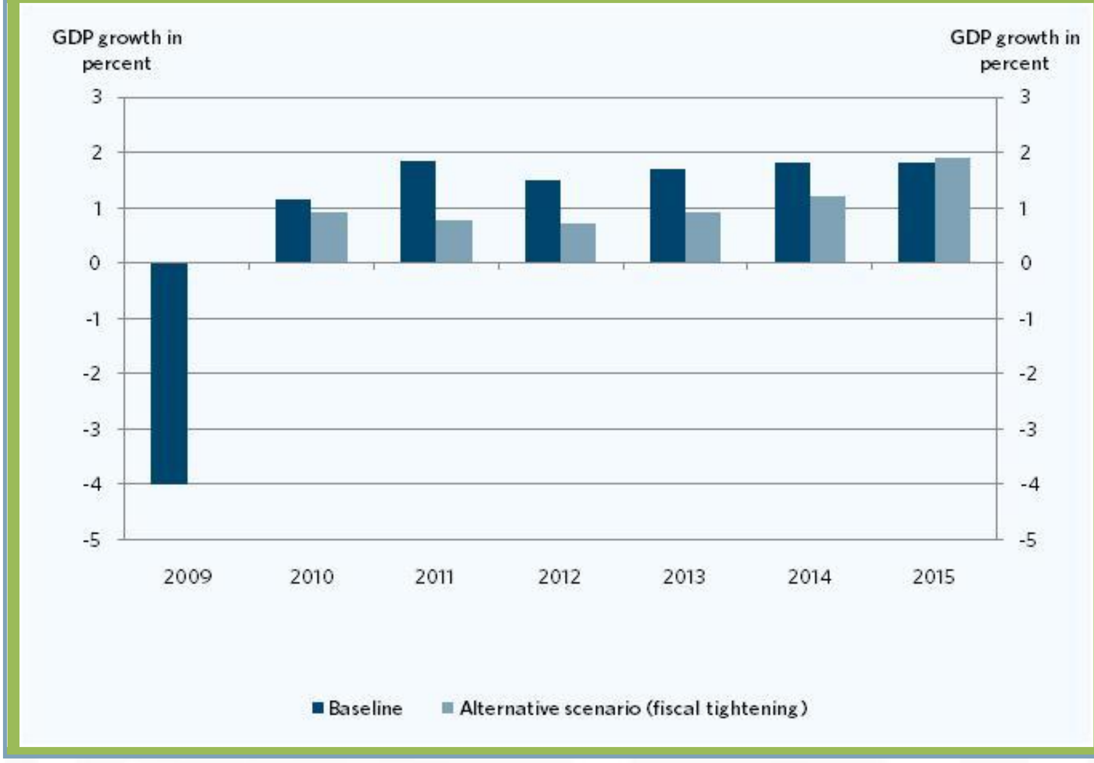
As shown in the table above a fiscal tightening will have large consequences for both GDP growth and the development on the labour market. Instead of having growth rates close to historical rates, GDP growth will be significantly lower if fiscal policy is tightened. The effect is especially pronounced 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 11½ percent of the labour force.

But 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.

Even though the effects of a fiscal tightening as recommended by the European Commission create very negative effects on the European economy the effects could be larger. As mentioned earlier, the negative effects from lack of confidence are not taken into account in the calculations. If they were included the figures would show a much darker picture. 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.

FIGURES 1 TO 4 SHOW A GRAPHICAL PRESENTATION OF THE FIGURE PRESENTED IN TABLE 1 AND 3.

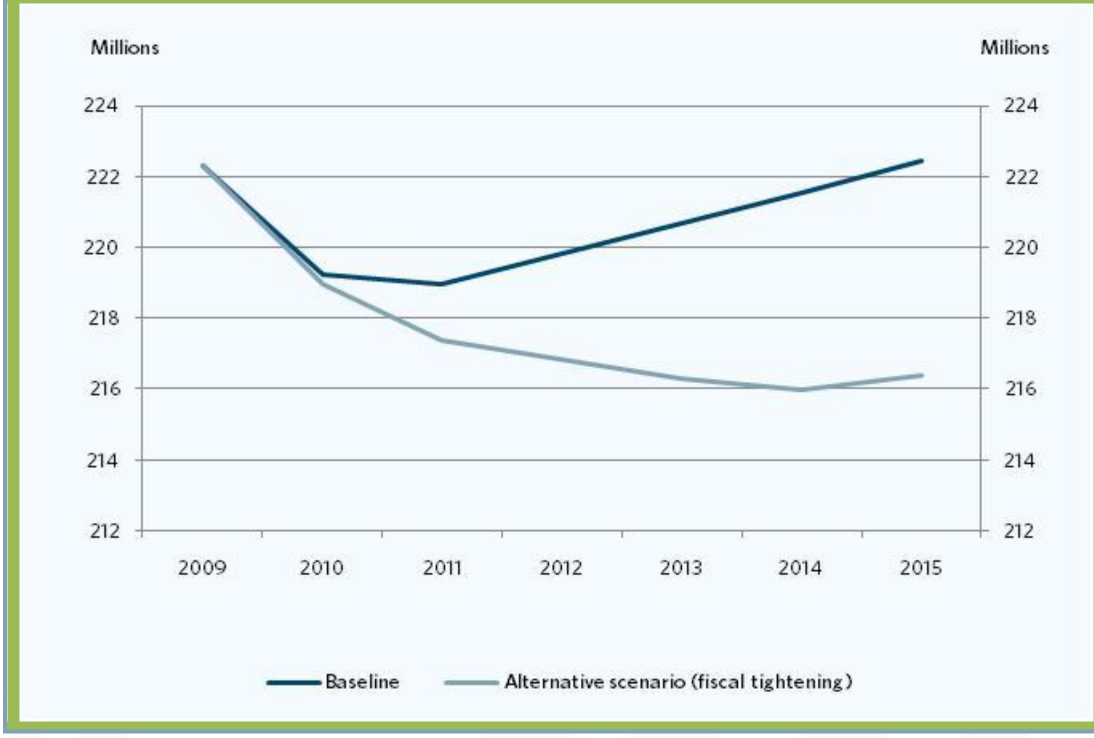
Figure 1. GDP growth in the two scenarios



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.

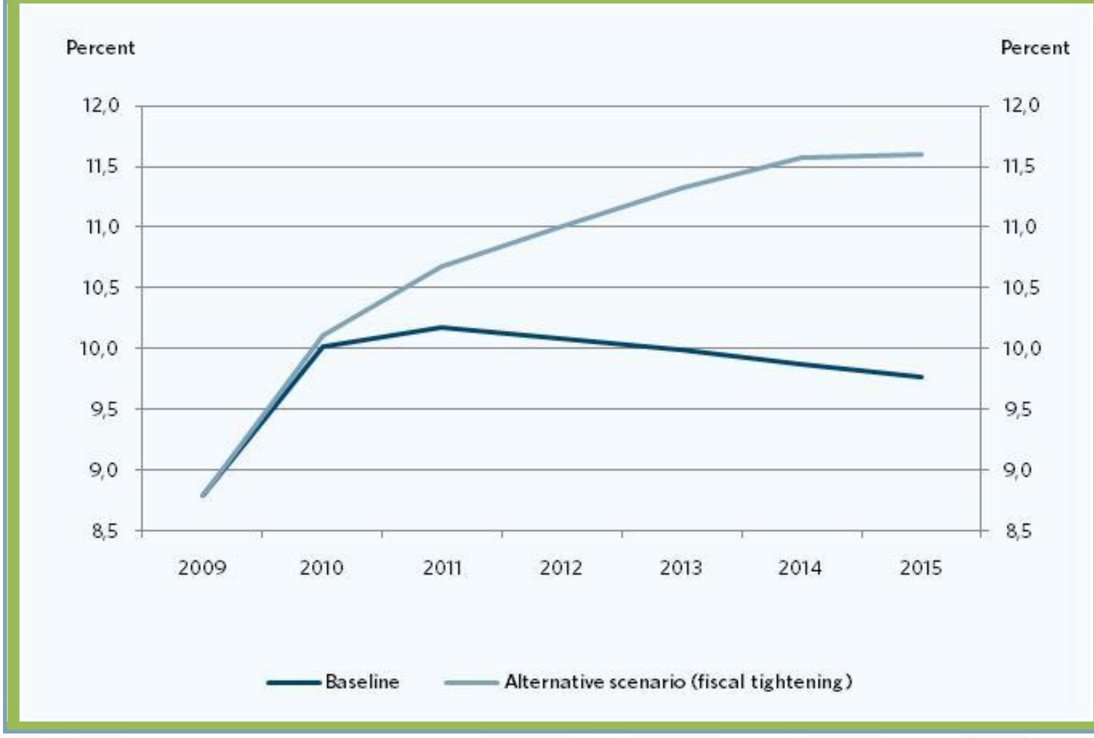
Figure 2. The development in employment in the two scenarios



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.

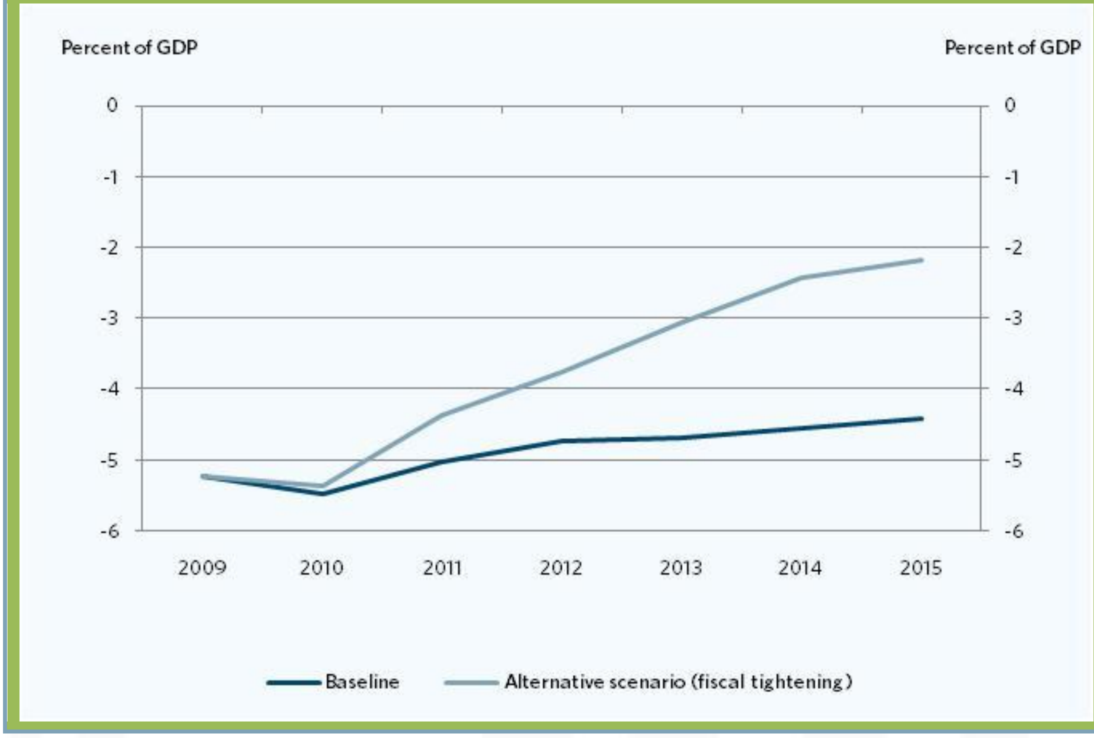
Figure 3. The development in the unemployment rate in the two scenarios



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 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.

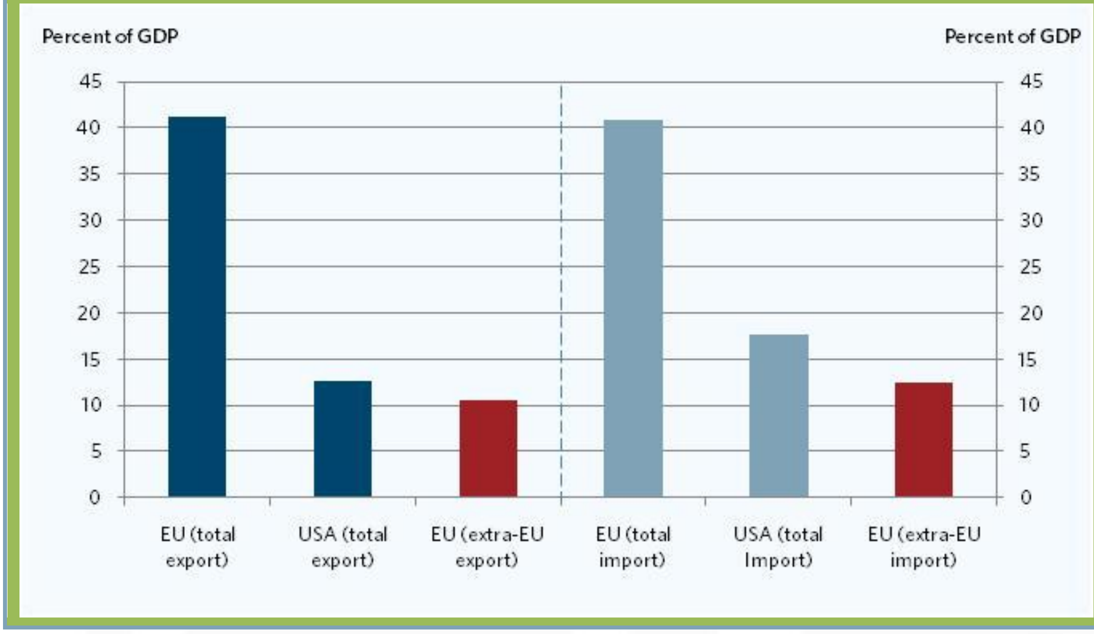
Source: AE on the basis of the international macroeconomic model HEIMDAL.

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 the 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

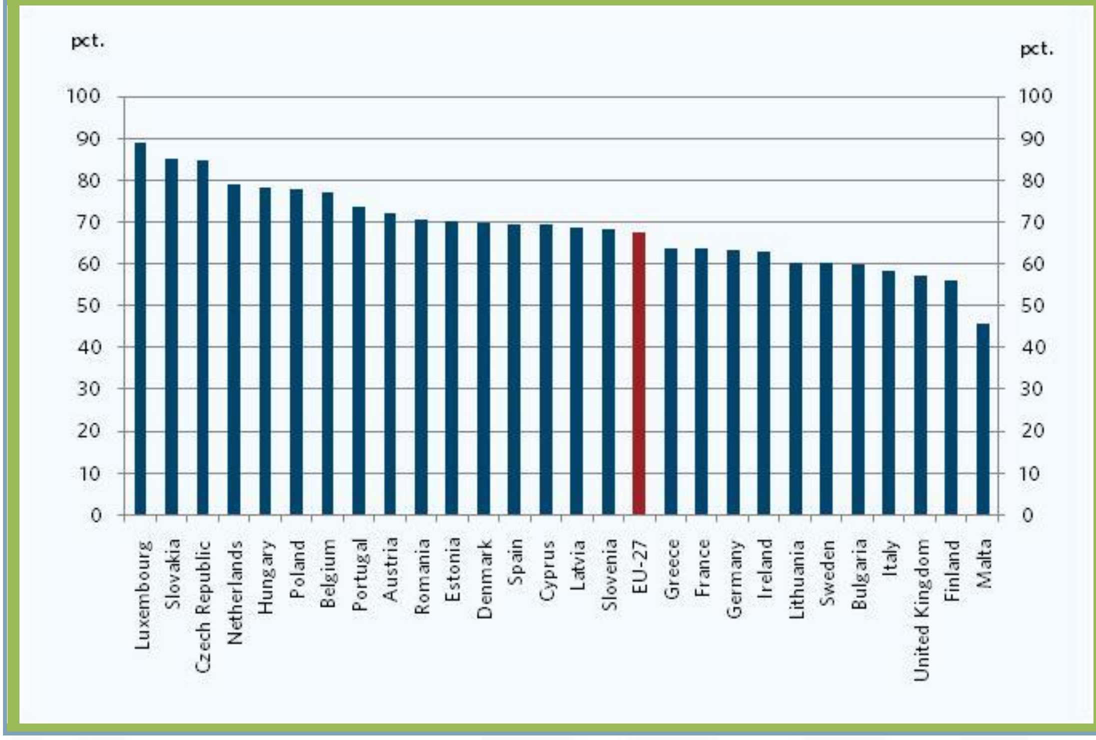


Source: AE on the basis of Eurostat.

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



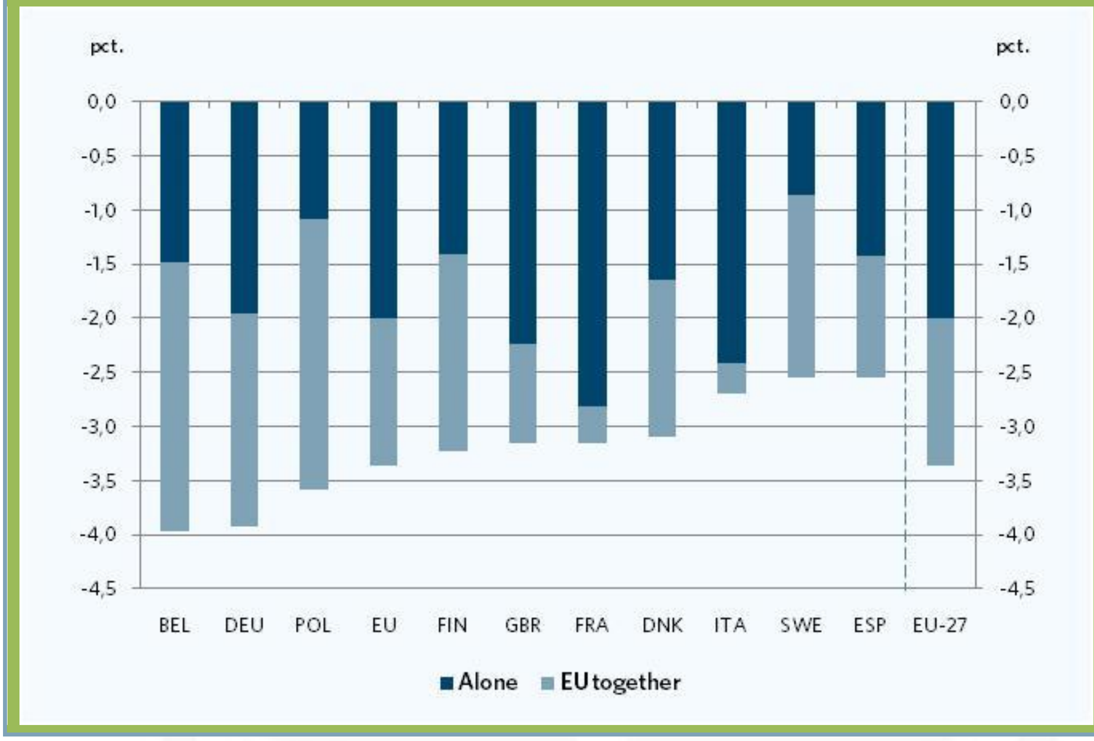
Source: AE on the basis of Eurostat

The large integration among European countries also shows in the spill-over effects between the countries. Figure 7 and 8 shows the accumulated effect on GDP and employment in 2014 when each country is tightening fiscal policy alone and together with all the other European countries. In order to illustrate comparable multipliers and spill-over effects, it is assumed in figure 7 and 8 that all countries tighten fiscal policy with the average recommended by the European Commission, cf. the weighted average in table 3. The figures show how just below half of the negative effect on GDP and employment 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 largest for smaller countries and countries that depend highly on exports.

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.

The importance of coordination has also been stated by IMF Managing Director Dominique Strauss-Kahn: “Without international collaboration, we cannot be successful in overcoming the challenges of the post-crisis era. During the crisis, it was the unprecedented extent of collaboration that saved the world from another Great Depression. Now, the need for international collaboration is even greater, as we seek to create a new economic and financial landscape—that delivers strong economic growth” (IMF Survey Magazine, 17. March 2010)

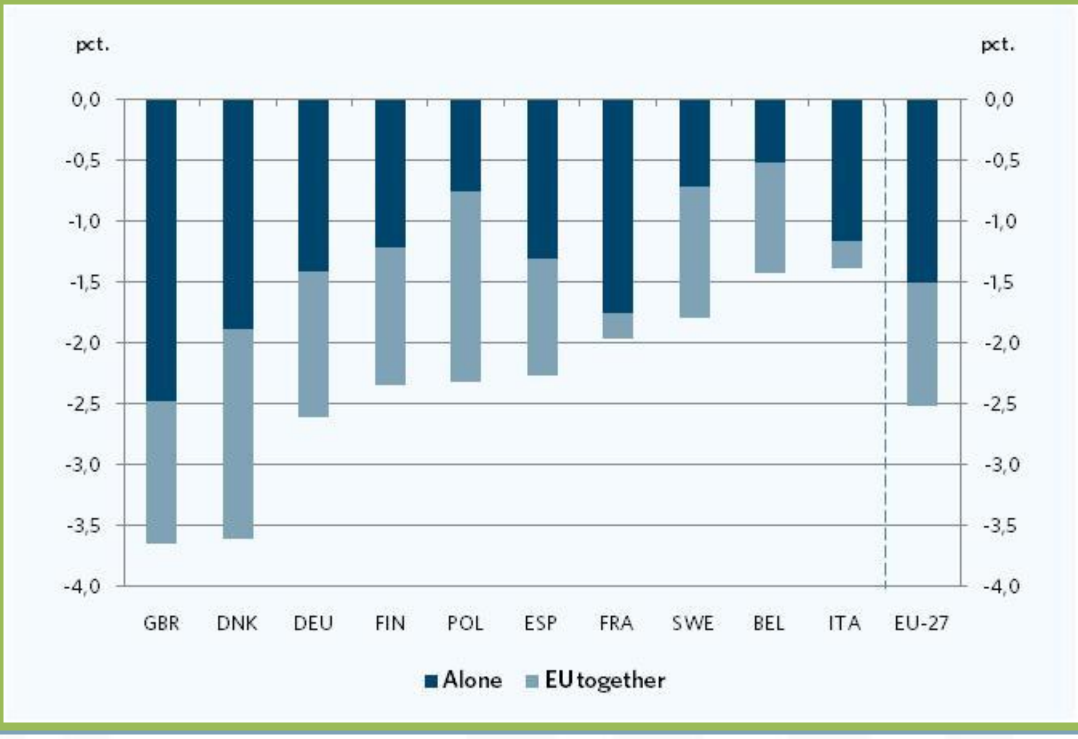
Figure 7. GDP effect in 2014 when tightening fiscal policy alone and together



Note: In the calculations is assumed that all countries tighten fiscal policy with the average recommended by the European Commission, cf. the weighted average in table 3. 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. Employment effect in 2014 when tightening fiscal policy alone and together



Note: In the calculations is assumed that all countries tighten fiscal policy with the average recommended by the European Commission, cf. the weighted average in table 3. 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.