Initiative on
Business and Public Policy
at BROOKINGS

European Macroeconomic Policies

Martin Neil Baily

The Brookings Institution

McKinsey Global Institute

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Aggregate Demand Policies in the United States

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- In the United States, the TARP was used to recapitalize the banks. The Federal Reserve has dropped interest rates to zero, provided credit guaranties and quantitative easing. The $800 billion stimulus package was used to supplement declining private demand. These were the right policies even if they were not executed perfectly.
- The US economy is recovering slowly. This has been a serious illness not a mild cold and it will take several years to recover. Taxes were cut too much after 2001, while spending continued to rise, generating chronic deficits. These bad policies are constraining our ability to provide further fiscal stimulus now.
- Policy should follow a ‘wait and see’ approach. No new large fiscal stimulus now. Re-think if there is a double dip.

Aggregate Demand Policies in Europe

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- Most European economies have safety nets that are more generous than those in the United States. The automatic stabilizers are more effective.
- Many countries discourage rapid large layoffs, which means that the drop in employment in Europe was less severe than in the United States.
- The ECB was quicker than the FED to recognize the severity of the crisis. It has followed broadly similar policies of low interest rates and quantitative easing but has been somewhat less aggressive than the FED.
- Fiscal stimulus has been smaller and is now giving way to the pressure to reduce deficits and undertake fiscal consolidation.
- Germany and France appear to be recovering, especially in Germany where there has been export-driven growth.

Fiscal Consolidation in Europe

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- Germany and France have fairly modest programs of consolidation. In Germany, the boost from strong global demand should be enough to sustain growth. France is adjusting its pensions, which will not have a big impact on current demand and growth.
- Italy is also raising its retirement age, but its economy will continue to struggle with a lack of competitiveness. Spain is being forced to make larger fiscal adjustments as a result of spillover from Greece, and this will slow Spanish growth. Spain also has a cost competitiveness issue.
- It is hard to see how Greece can pay off its debts without restructuring at some point. Ireland has moved aggressively to deal with its budget deficit and its growth has suffered as a result.
- The new coalition government in the UK inherited a very bad fiscal situation and has moved to reduce spending. This is likely to curtail its growth, although unlike euro area countries, the pound is free to adjust. The Bank of England has eased monetary policy

Fiscal Consolidation, Continued

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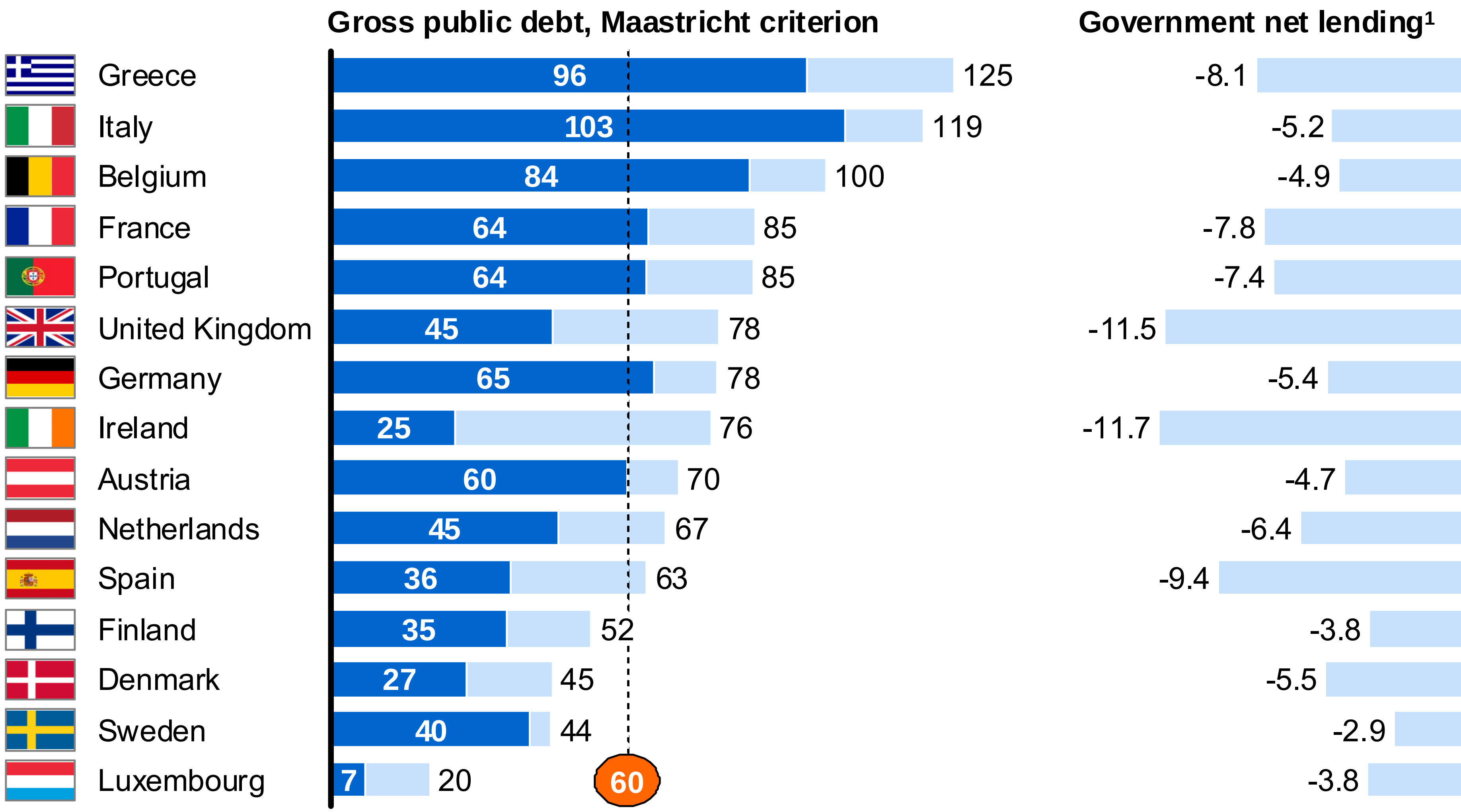
- At the past G-20 meeting, the United States pressed Europe to sustain fiscal expansion and not to undertake consolidation. European leaders resisted and argued that fiscal consolidation would be expansionary.
- Tax increases or expenditure cuts will take money out of the economy and cause a reduction of aggregate demand. There is no need to turn Keynes on his head.
- However, if there is a significant risk of sovereign debt default, this has the potential to be very damaging to economic growth. Policymakers must weigh the costs and risks and choose among unpleasant alternatives.
- In principle, sustaining fiscal expansion now while pledging to reduce deficits in the future is a way around the problem, but it depends upon the believability of the promise.

In most European countries, public debt has soared way above 60 per cent of GDP

2007 level

% of GDP, 2010 projection



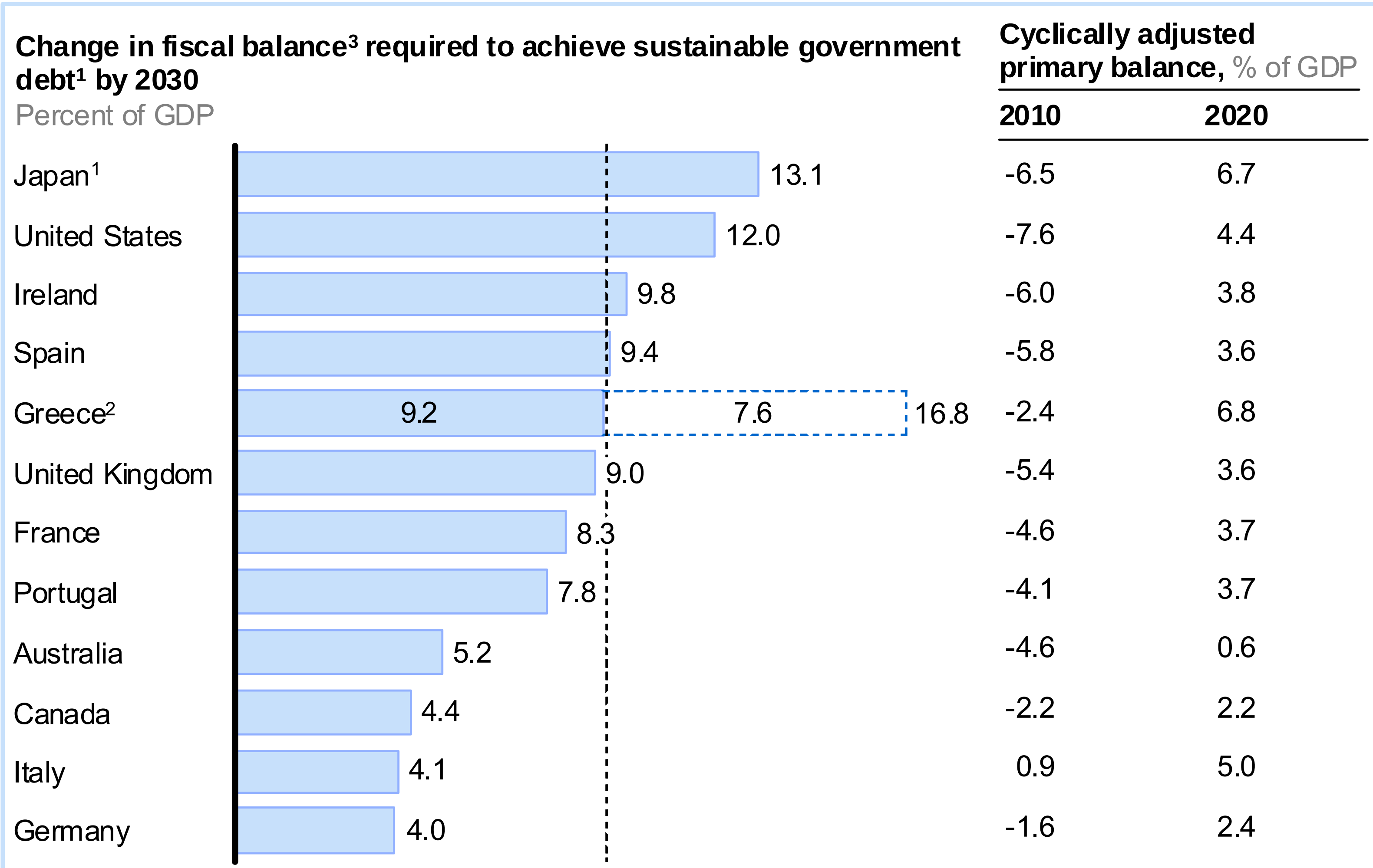
1 Differs from the Maastricht definition in that it does not include streams of payments and receipts from swap agreements and forward rate agreements.

SOURCE: OECD Economic Outlook Database, 2010

Restoring government debt to 60 percent of GDP by 2030 will require painful fiscal adjustment in many countries

Required adjustment for advanced G20 countries

Assumed 2010 adjustment in Greece primary balance



1 All countries are assumed to target a 60% gross debt to GDP ratio except Japan whose target is set at 80 percent of net debt to GDP which corresponds to a gross debt level of 200 percent of GDP. The transition is assumed to occur gradually in a straight-line fashion between 2010 and 2020.
2 Assuming Greece implements a 7.6 percent of GDP adjustment in their primary balance in 2010.
3 Fiscal balance here is the cyclically adjusted primary balance which is equal to the fiscal revenue less net interest expenditure.

SOURCE: International Monetary Fund *Fiscal Monitor* May 14; McKinsey Global Institute

Structural Employment and Productivity

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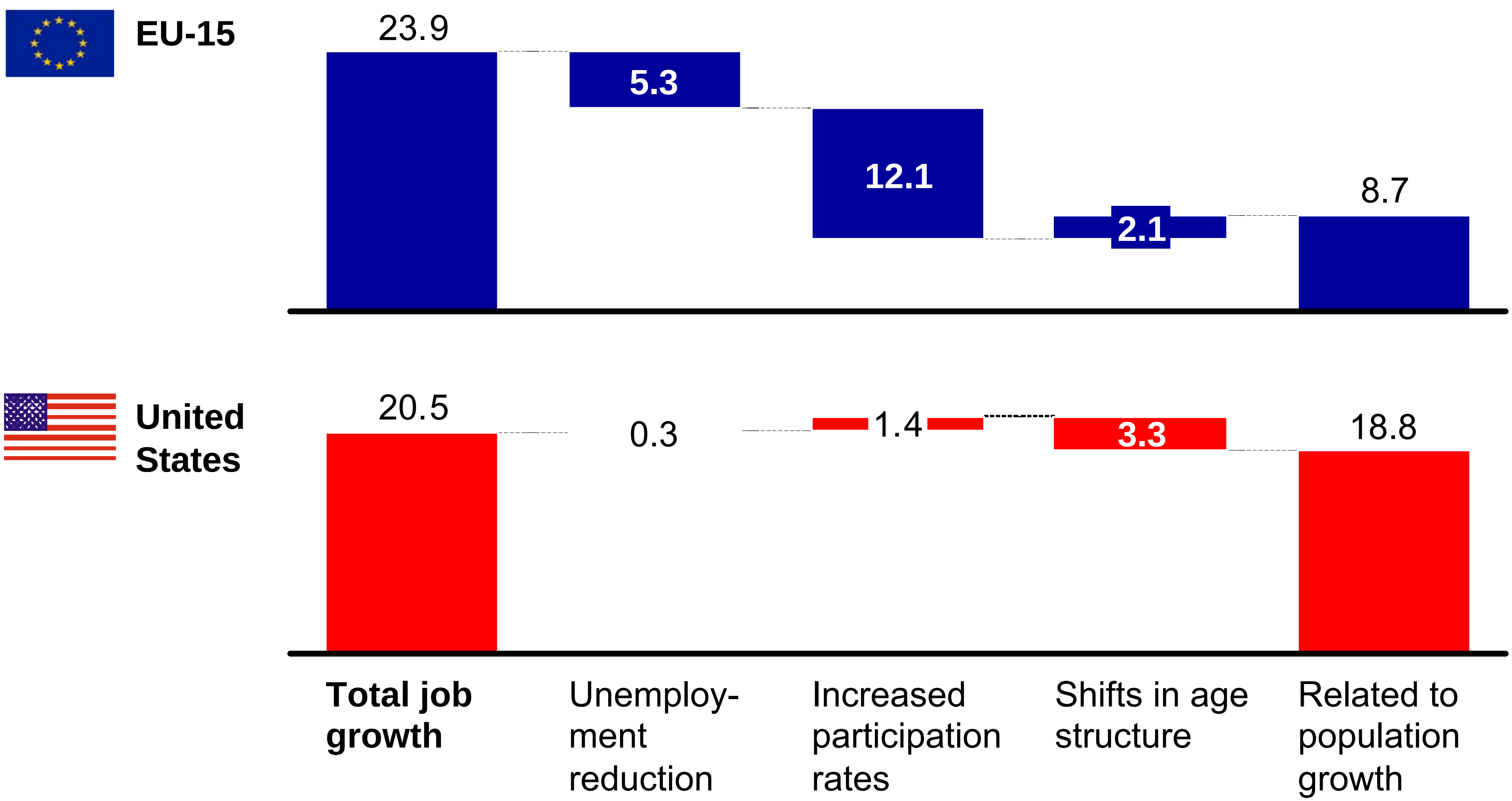
- Employment growth in the EU-15 1995-2008 exceeded the United States, especially in relation to population growth.
- Unemployment has dropped, especially in Ireland, UK, Netherlands and Denmark.
- Diverging paths of unit labor costs have created imbalances within the EU.
- The number of hours worked per year per employee is low in the EU and declining.
- Productivity growth has been very slow.

Europe has already successfully created many new jobs above population growth in the last decade

Additional jobs, 1995–2008

Million



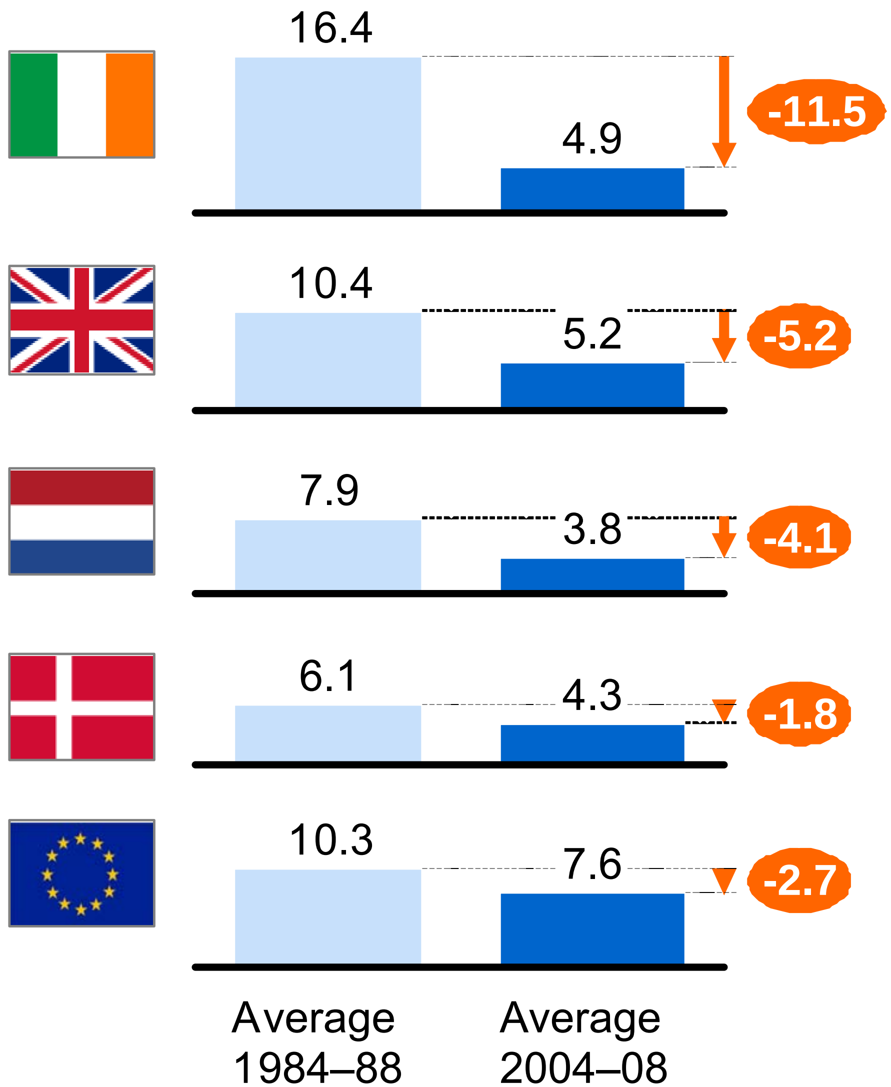
Note: Numbers may not sum due to rounding.

SOURCE: The Conference Board; International Monetary Fund; Eurostat; McKinsey Global Institute analysis

Successes in reducing unemployment include Ireland, the United Kingdom, the Netherlands, and Denmark

Unemployment rate

%

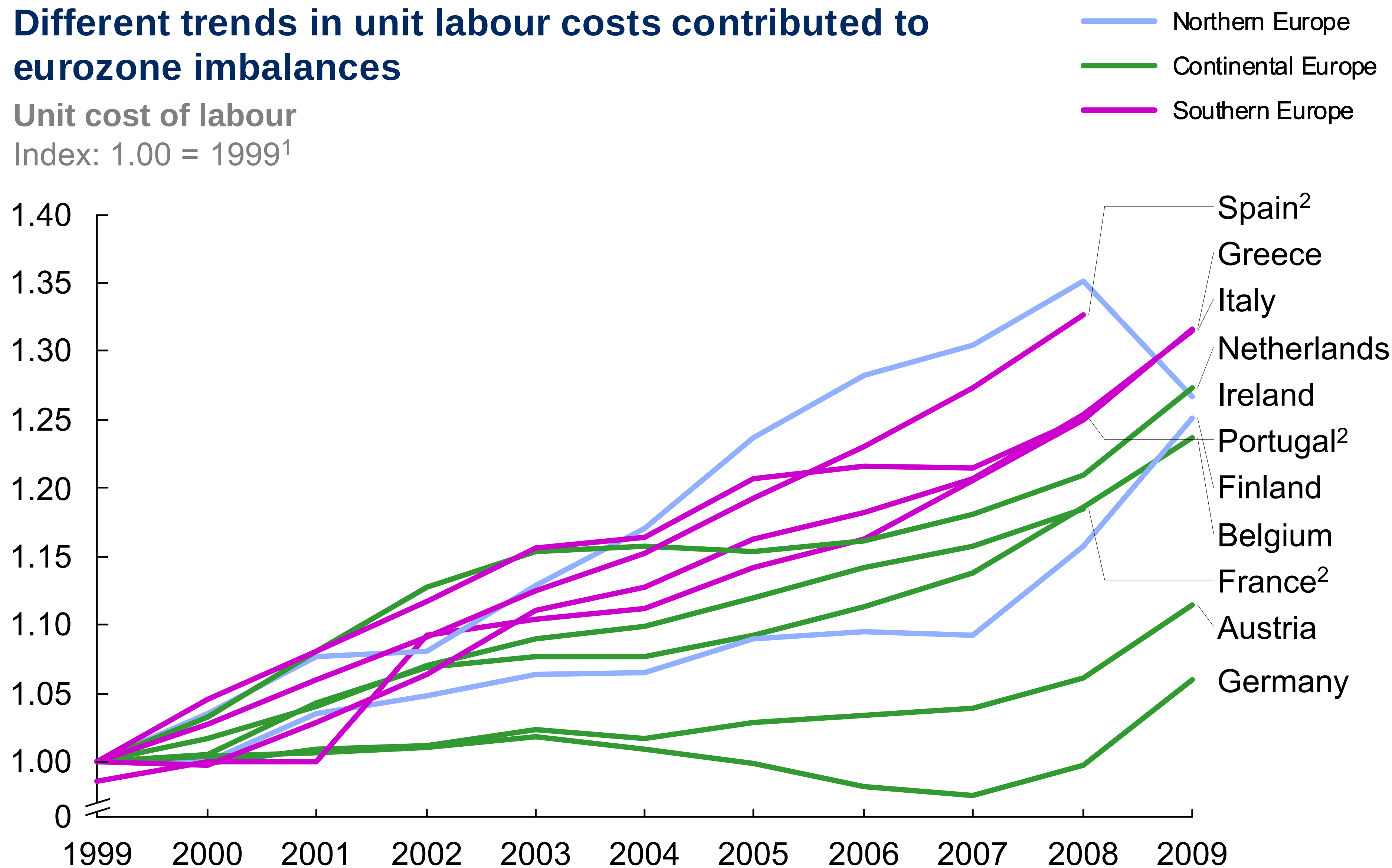


SOURCE: Eurostat; OECD

Different trends in unit labour costs contributed to eurozone imbalances

Unit cost of labour

Index: 1.00 = 1999[1]



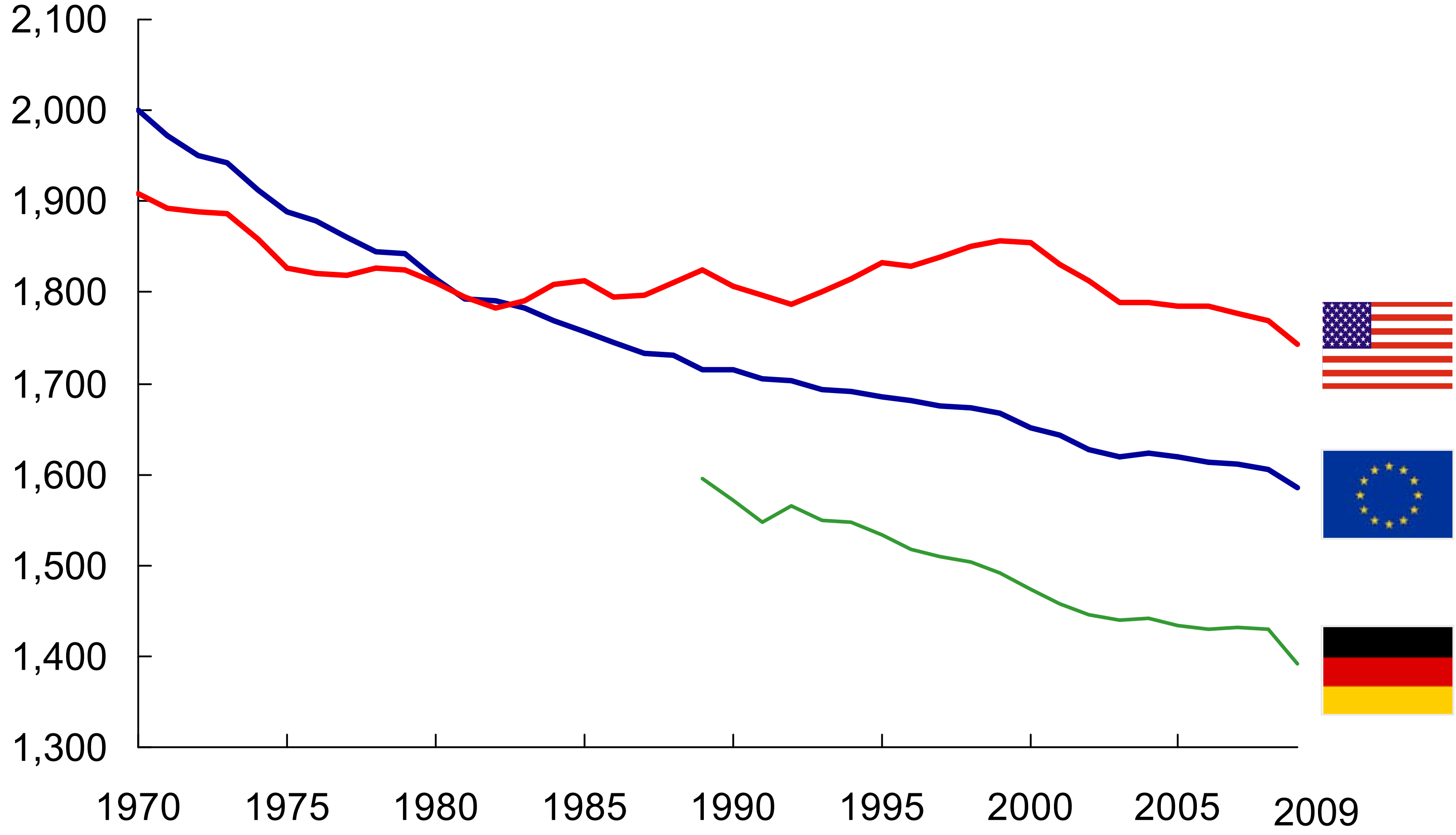
1 Instead of 1999 = 1.00, Greece is indexed to 2000 = 1.00. This is because the exchange rate between the Greek drachma and the euro was fixed in June 2000

2 2009 data not available

SOURCE: OECD

EU-15 working time has fallen substantially, widening the gap with the United States

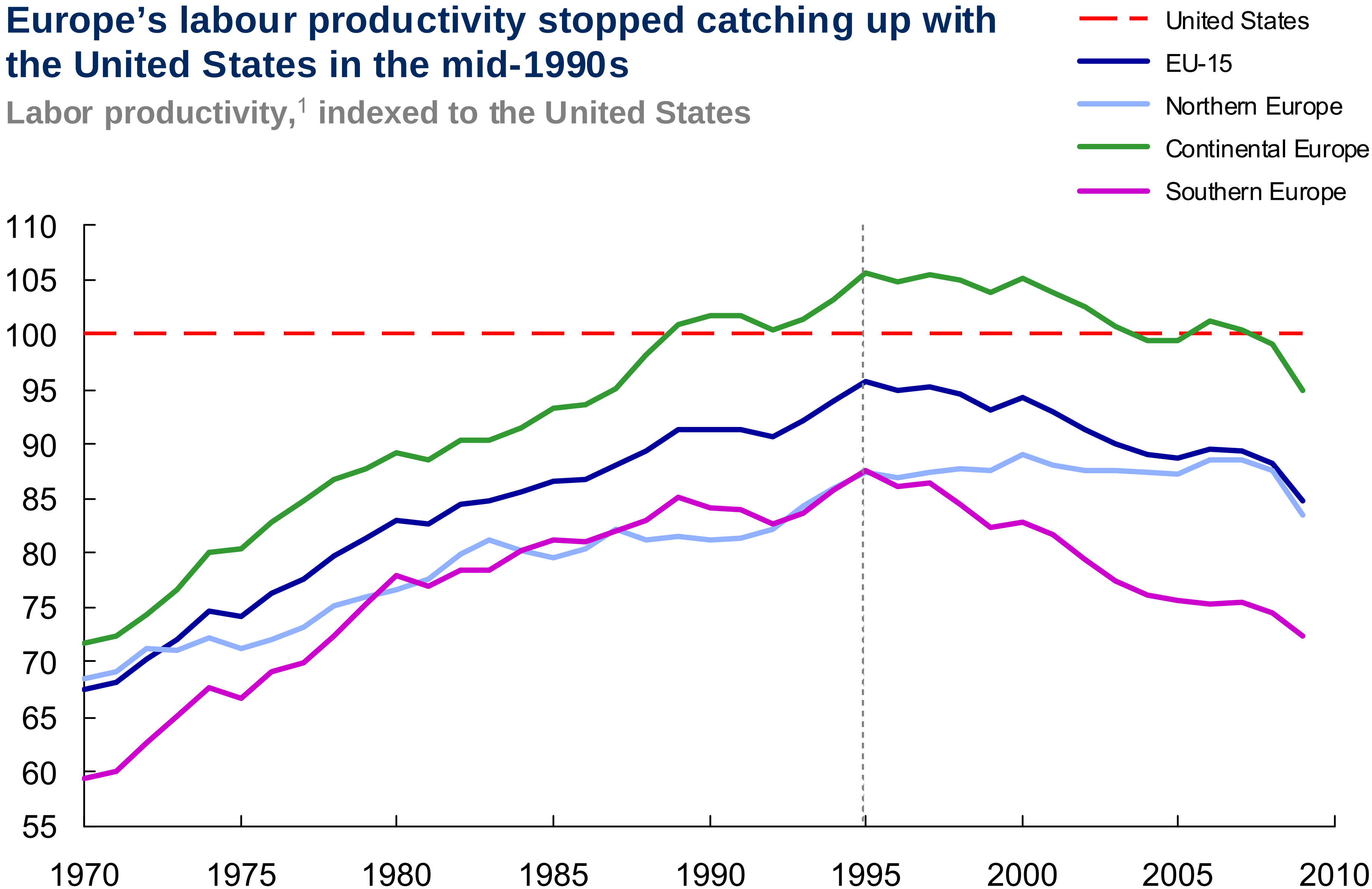
Annual hours worked per employee



SOURCE: The Conference Board; national statistical institutes

Europe’s labour productivity stopped catching up with the United States in the mid-1990s

Labor productivity,[1] indexed to the United States



1 Expressed in $ at 2009 EKS PPPs.

SOURCE: The Conference Board

Structural Policies to Improve Growth Can be Drawn from within the EU

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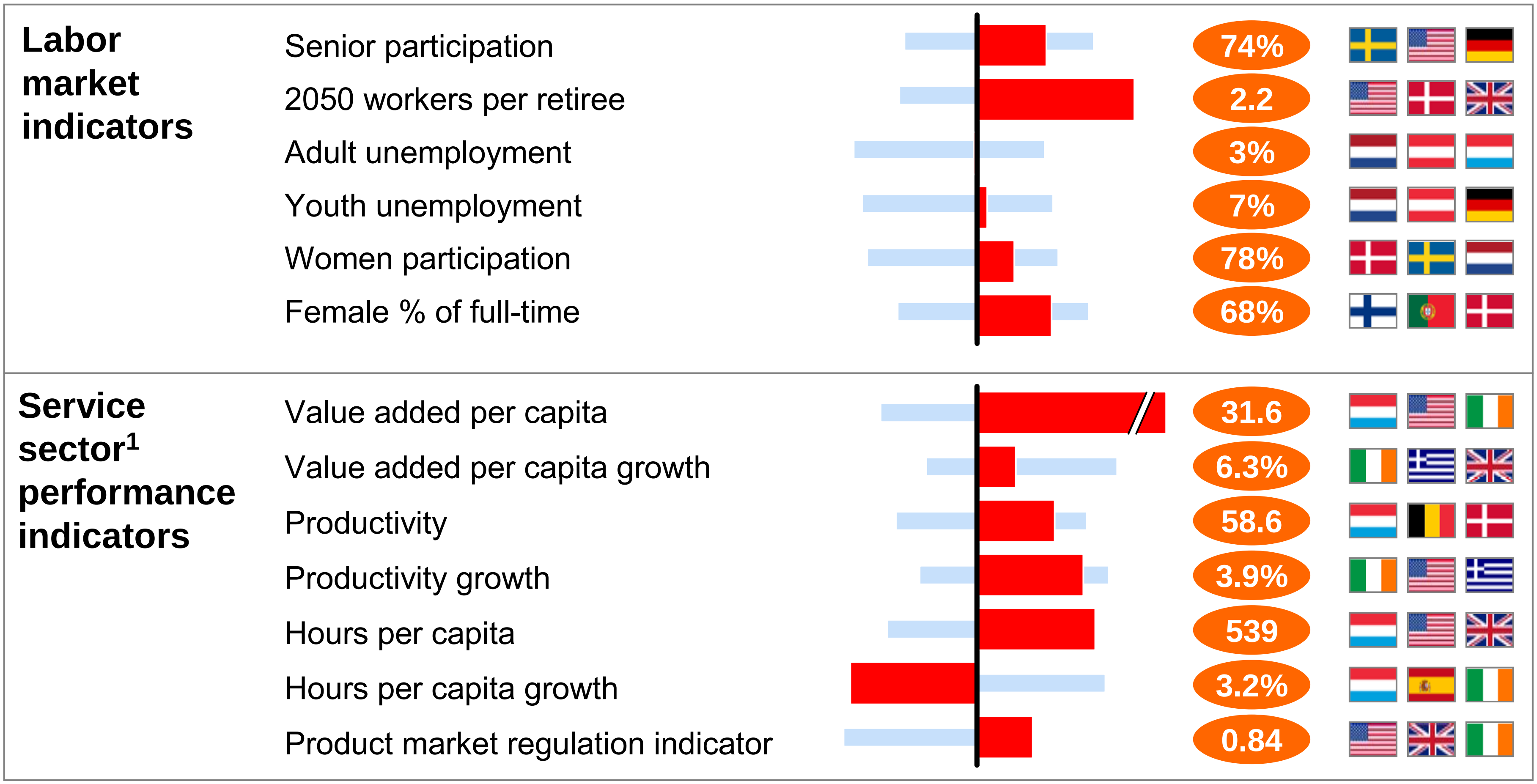
- The US generally does not define best practice along a range of economic indicators.

- Sweden undertook economic reform and it paid off.

For most indicators, EU member countries define the best practice

EU-15 average
United States
EU-15 range
x Best practice

Best practice indicator values and top three performers



1 Local, business, and professional and financial services. Range and values indicated exclude Luxembourg due the small economy strongly skewed to financial services

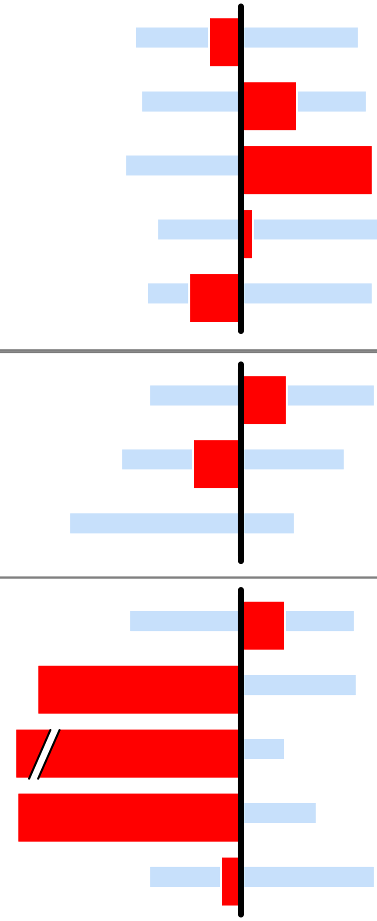
SOURCE: Conference Board; OECD; Eurostat; EU-KLEMS; WEF; Newsweek; CIA; UNODC; IMF; European Commission; McKinsey Global Institute analysis

For most indicators, EU member countries define the best practice (CONTINUED)

Best practice indicator values and top three performers

EU-15 average; EU-15 range; United States; Best practice

	Indicator	Best practice
Growth and renewal indicators	Patents per capita	296
	R&D expenditure	3.8%
	WEF innovation index	100
	OHI[1] entrepreneurial index	46%
	Science & Engineering graduates	2.3
Public finance indicators	Debt level	15
	Deficit	-0.5
	Cost of aging	1.1
Other non-GDP related indicators	Quality of life	93
	Gini index	23
	Crime rate	0.6
	Healthy life expectancy	74
	Gender gap index	83



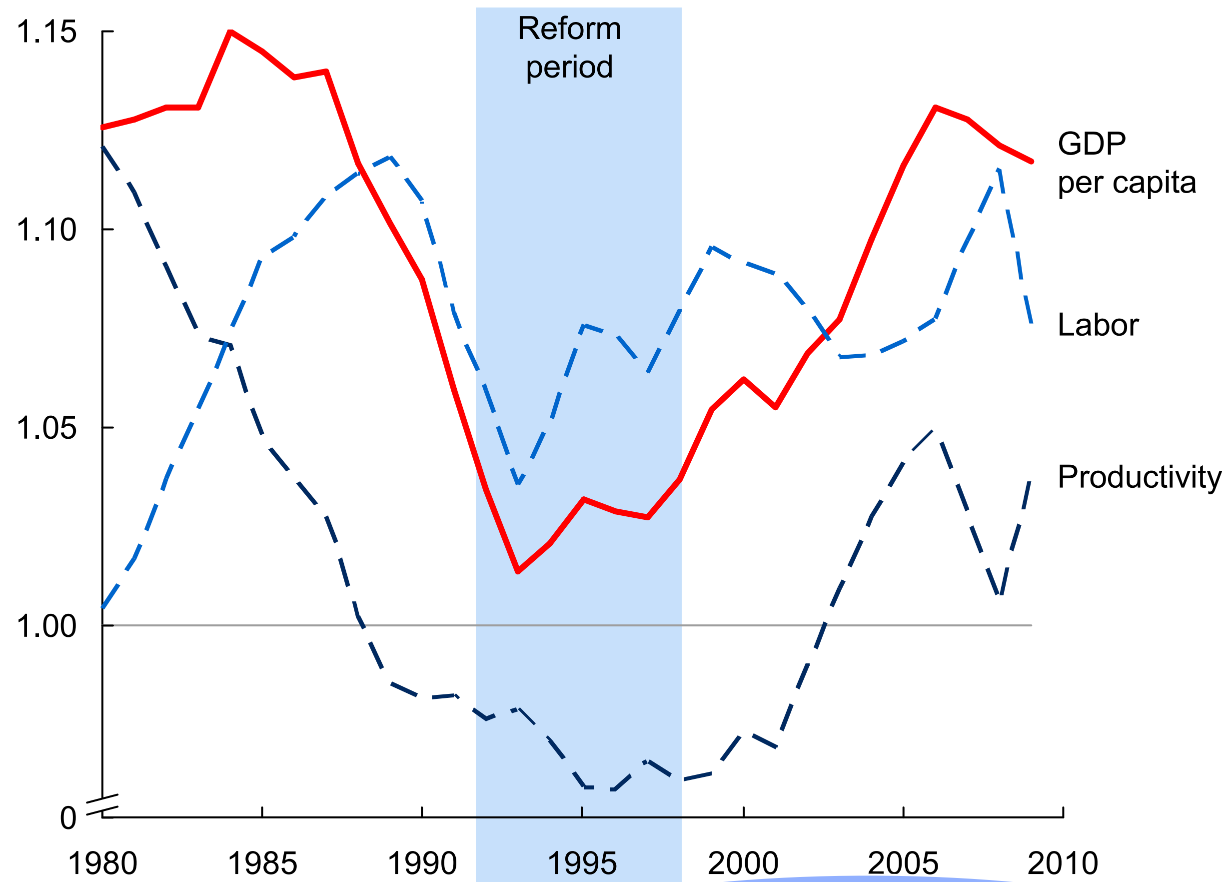
1 Organizational Health Index.

SOURCE: Conference Board; OECD; Eurostat; EU-KLEMS; WEF; Newsweek; CIA; UNODC; IMF; European Commission; McKinsey Global Institute analysis

Under the pressure of the crisis, Sweden launched several successful reforms

Sweden GDP per capita, Productivity, Labor input, indexed to EU

- Under the **pressure of fiscal and economic crisis** in early 90s, Sweden reduced government spending, eliminated the budget deficit, went to flexible exchange rate and inflation targeting
- The **tax reform** included the elimination of many distortions (like incentives for second earners), the **pension reforms** ensured a quasi-funded forward looking system (from the previous pay-as-you-go model)
- **Deregulation of network industries** and other traditional monopolies were realized to increase competition
- **Replacement rates** in Unemployment Insurance for above-median earners were substantially reduced



According to the Swedish Ministry of Finance, these policy measures were only possible to undertake as there was a “crisis mood” among the Swedish population

SOURCE: Conference Board; IMF; Reforming the welfare state: recovery and beyond in Sweden; How regulatory reforms in Sweden have boosted productivity, OECD; McKinsey Global Institute