Why Europe Must Help Itself:

Coordinated reflation can avoid prolonged recession

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This paper argues the need for coordinated economic policies between the developed countries of the West and the emerging economies of the South to revive the world economy. While the West faces the challenge of growing unemployment, the South wants to grow faster in order to reduce poverty and improve the well-being of large sections of its impoverished population. We argue that individual country or regional efforts would be inadequate to achieve these goals and thus there is the need for coordinated fiscal expansion and structural change. If the West were to undertake demand priming and the emerging economies would structurally expand their intra-regional trade, the global recovery would be hastened.

Key words: Global recession, BRICs, EU crisis, USA slowdown.

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1. Introduction: The European Dilemma

Europe's 2012 summer election season has revived the fears that a solution to the European economic crisis may be long drawn out. Many of the indebted countries have rejected the austerity package proposed by EU's management team. Given that Greece had pitched battles on the streets over the last couple of years, it was not unexpected that its populace would vote out Mr Papandreau and his coalition (Spillius 2012). It came as no surprise in France too that Mr Sarkozy lost the elections to Mr Hollande, who based his campaign on a promise of reversing the austerity programme and re-negotiating the austerity package proposed by the EU (Traynor 2012). And, in the Netherlands, the Prime Minister Mark Rutte had to resign since his party's coalition partners withdrew support over proposals for budget cuts (Kreijger and Escritt 2012). The EU's political stability is being tested as the economic crisis takes its toll on the governments that pursue the austerity path and thus ignore the need for employment generation. The question facing the political management team of the EU is whether the Maastricht treaty will survive or will have to be renegotiated.

The recent history of global economic turmoil is traced to the sub-prime crisis of 2007 in the USA, the effects of which are still being felt. For example, the US Treasury Bond rating was cut from AAA to AA+ by Standard and Poor in August, 2011. This was the first time since 1917 that US T-Bills had lost their highest rating (Jackson 2011). In late September 2010, the National Bureau of Economic Research's official business cycle-dating committee announced that business activity had reached a trough in June 2009. "The trough marks the end of the recession that began in December 2007 and the beginning of an expansion. The recession lasted 18 months, which makes it the longest of any recessions since World War II. Previously the longest postwar recessions were those of 1973-75 and 1981-82, both of which lasted 16 months" (NBER 2010). The Committee warned that this trend did not mean that the economy had returned to normalcy. Any further recession would form a new cycle and recovery might still not be achieved for a long time. A year on, the fear of a "double-dip" recession has receded in the USA but has not been eliminated. However, the double-dip recession has become a reality for the UK, even though it is not the most severely affected economy in Europe (Cohen 2012).

The European crisis emerged with Greece in 2008 and soon showed up as a wider malaise across Europe. By December, 2011, Standard and Poor (S&P) downgraded nine of the 27 EU country ratings, leaving only Germany and Finland in the Euro single currency area with an AAA rating.[1] The IMF, which normally has a 'look-South' policy when it comes to advisory services and lending for crises, is suddenly back in business again, oddly enough to bail out the North this time.

[1] Cyprus, Italy, Portugal and Spain ratings were cut by two notches while the ratings for Austria, France, Malta, Slovakia and Slovenia were cut by one notch (Elliot and Inman 2012).

Given that the world economy is very closely linked to the fortunes of the US and the EU, a contagion-effect could precipitate a world economic crisis. Forecasts already suggest that there will be a slowdown in the emerging economies such as Brazil, China, India and Turkey and earlier estimates have been revised lower both for developing countries as well as developed countries (Burns and Rensburg 2012). From a developing country perspective, this is certainly not good news.

In this paper we pose the following questions:

a) Would unilateral economic decisions by developing countries, either individually or as a group, boost their own economies and help European recovery ?
b) What economic strategy could fuel European recovery?
c) How would globally coordinated fiscal policy impact on the world economy?

We examine each of these alternatives using the CAM-AUGUR model of the world economy (Cripps, Izurieta, and McKinley 2007) which is based on the CEPR model originally developed by Cripps and Godley (1976).

We look at various options that countries might choose and compare their outcomes, not only from each country/region perspective, but also from the global perspective. The options are as follows:

1) India and Brazil unilaterally decide to increase trade and use it as a mechanism to boost their economies. With some support from China, they receive a larger preferential market share from its BRIC partner.
2) China independently decides to maintain a current account balance.
3) India, China and Brazil (BRIC partners) combine efforts, leading to a strategy that combines the two scenarios stated above.
   However, our findings suggest that none of these policies in the South would revive the US or the EU, let alone the world economy. So we experiment with three other scenarios:
4) The USA decides to reflate its economy by allowing increased government expenditure .
5) This scenario combines the BRIC initiative described above in #3 with the US initiative described in #4, with the status quo still assumed in Europe.
6) While scenario #5 helps the participating economies, the EU's crisis is unaffected by these policy initiatives. The EU could decide on an employment expansion scheme that would be the most desirable outcome for its citizens. It could target the employment rate (employed as a ratio to the working-age population) at 75% in the UK, North and West Europe and at 65% in South and East Europe. The EU blocs could do so by re-negotiating the Maastricht treaty and allowing member countries to have differential levels of debt and fiscal deficits. These targets are not out of line with what these countries have experienced in more prosperous times during the recent past.

7) Europe's task as well as that of the US and the BRIC countries becomes easier with a coordinated policy – that is, a combination of scenario #5 and #6. This scenario would help the world economy to attain normal activity quicker and with less pain.

2. Developing Country Concerns

Developing and emerging economies have begun to be more effective in regional trade blocs and in enlarging their trade without the mediation of the USA or Europe. This approach has provided them with a cushion to respond to the economic crisis centered in the developed countries, upon whom in the past they have otherwise been dependent for export markets.

Since the US-EU economies are in deep crisis, we examine a set of alternative policies that could be adopted outside the US-EU zone. Emerging countries such as India are closely watching the developments in the USA and Europe because of the close links with the EU-USA markets. We examine some of these alternative options below.

India: A Developing Country's Concerns and Response

India is the fourth largest economy in the world (in terms of GDP at PPP) and likely to move to a rank higher than Japan by 2015. The average rate of growth in the Indian economy in the 11th Five year plan was 8.2% as compared to 7.8% in the previous plan, and the 12th plan has set a target of 9% (PC 2012, 4).

Rapid growth in national income has, unfortunately, been accompanied by stagnant levels of poverty and underemployment (Deaton and Dreze 2009; Himanshu 2011; U. Patnaik 2004). But a prominent segment of India's economic management team still proposes a strategy of reduced public intervention in the economy, lower fiscal deficits and creation of an investment climate conducive to increased private sector investment and FDI inflows (Ahluwalia 2011). The target suggested for medium term fiscal adjustment is to bring the fiscal deficit to -5.5% by 2014-15 (from -7.7% in 2010-11) and achieve a 9% per cent rate of growth per annum over the 12th plan period (i.e. 2012-7).

However, the basis of such a conservative strategy has been questioned since the fundamental macroeconomic characterisation of India has been that of a demand-constrained economy (Bhaduri 2006; Rakshit 2005; Patnaik 2007). Given that even the IMF has lowered the growth expectation for India for 2012-13, and in light of the possibility of a continuing recession in the world economy, and with no viable market mechanism to reverse the economic slowdown, India needs an alternate strategy to maintain its growth rate (IMF 2012).

Would an independent expansionary policy by initiated by India reflate the world economy? Its domestic economy is obviously not large enough and its integration with the world economy is too limited to make a difference. Therefore, it will need to be part of a coordinated global policy

action or at least an influential regional arrangement in order to maintain sustained economic growth. Hence, we pose our firs Scenario.

2.1. India and Latin America increase trade: Scenario 1

India's aspirations are matched by those of Latin American countries, especially Brazil. Stronger links within the BRIC group would be desirable for both India and Brazil. India and countries in Latin America are emergent economies and would like to achieve high rates of growth. India is targeting a 9% rate of GDP growth in the medium term, as discussed above. Brazil, which is the largest economy in Latin America, has been experiencing growth between 5% and 7.5% during 2007-10 (except for 2009 when it dipped to zero) (WB undated). In this scenario we assume that Brazil targets a 7% rate of GDP growth in the medium term. Such extended periods of rapid growth are certainly possible since this been demonstrated both in the ASEAN countries (until the mid 1990s) as well as in China. India and Brazil would merely be emulating a similar growth target.

The growth in India could be supported by expansionary government spending. Such expenditures could be in the area of infrastructure or energy supply. India's expansion of such programmes as the Employment Guarantee Schemes, Education Guarantee and Health for All is likely to lead to increased government expenditures in the social sectors. In this scenario, we expect that India's public expenditure would crowd-in private investment since we do not anticipate liquidity problems or supply bottlenecks. [2] In fact, interest rates in India have been increased in the recent period in order to curb inflation. This is indicative of an easy money situation in the credit market (Choudhury and Munro 2011; Roy 2012). Domestic expansion of aggregate demand could lead to temporary inflationary pressures, as has been experienced in India in the recent past. Typically, high and prolonged inflation is politically unacceptable. So since the government is sensitive to this issue, it could use the real exchange rate to manage the impact of inflation.

Growth in domestic expenditures could cause a ballooning of the current account deficit, which would be a deterrent to economic sustainability. In anticipation of this, India could make a concerted effort to reduce fossil fuel imports and substitute them with coal even though it is more polluting. This option would at least allow it to reduce its import bill. In parallel, there could be

[2] Clark (1997) points out that economic theory is unable to provide a definitive specification for empirical investigation of the growth-inflation relationship and so it is not surprising that the claim of a negative link between inflation and per capita output growth does not stand up to statistical scrutiny (Haslag 1997). Kumar and Woo (2010) find that initial values of debt have a negative effect on investment and capital accumulation. However, such empirical analysis typically is period dependent. Also such analysis ignores inter-linkages between countries and the role of spatial impacts in output determination.

an increased effort to export. The twin effort of curbing imports and expanding exports is likely to keep the Current Account under control.

Figure 1: Growth in per capita Incomes 2000-2030, (Scenario 1)

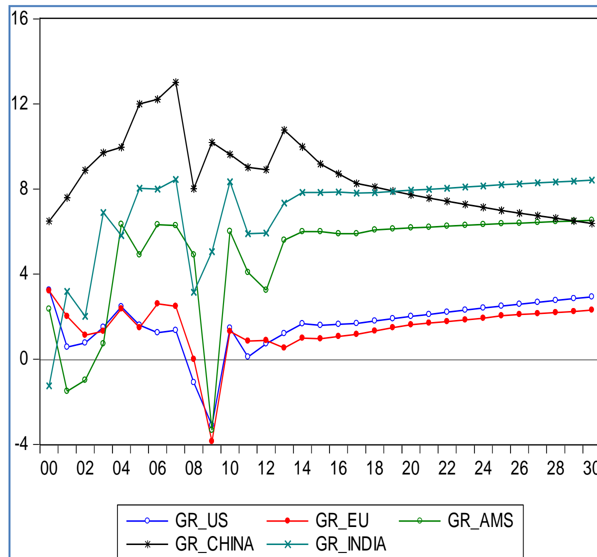
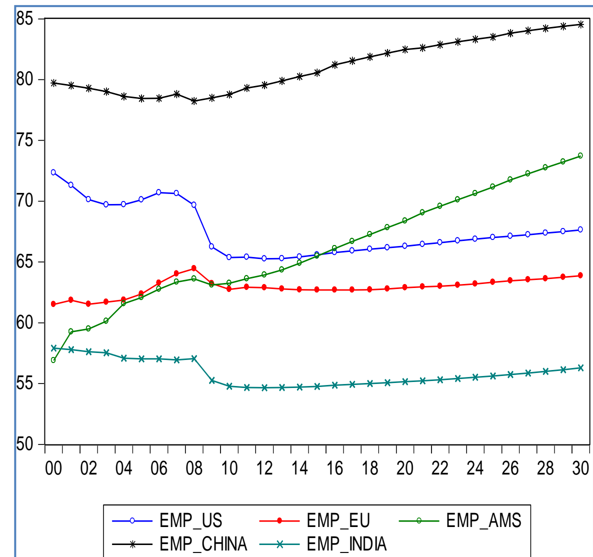


Figure 2: Employment Rates (%) 2000-2030, (Scenario 1)



However, while this effort might improve India's economic fortunes, it would leave the rest of the world unaffected. In Europe and the US, for example, employment rates would remain low (see Figure 1 &

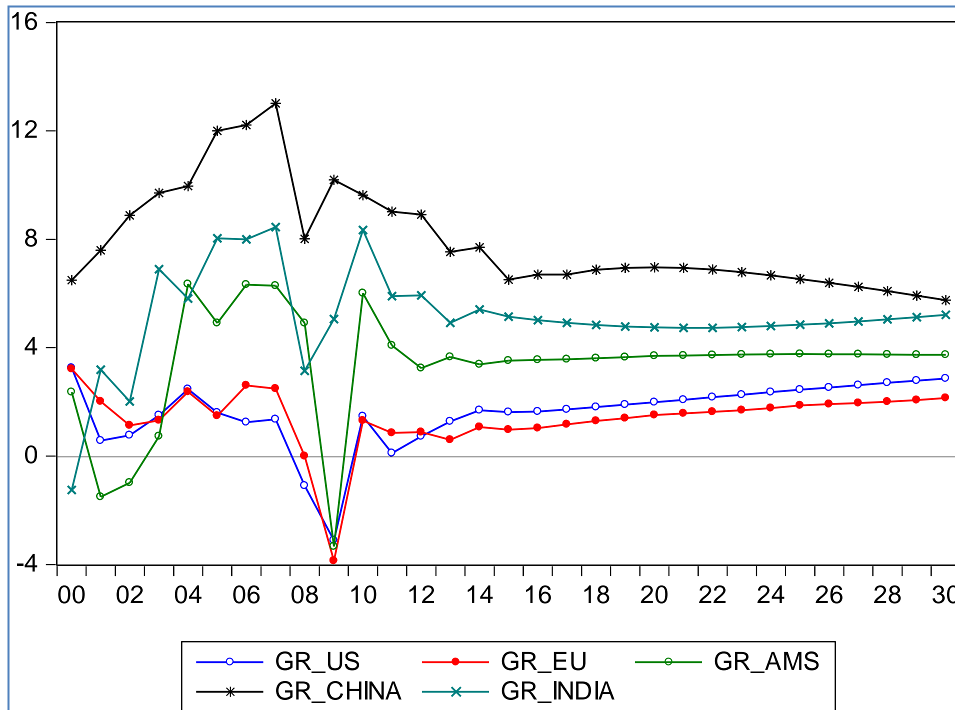
Figure 2). Hence, we pose a second scenario.

2.2 China's Balancing Act: Scenario 2

China itself has had its own set of problems. Its growth rate has been fluctuating and declining and government intervention has been needed in recent years to revive growth (Cha and Fan 2008; Economist 2012). China has also been accused of being responsible for the crisis that the EU and USA are facing. Since China has maintained large trade surpluses with both the EU and the USA, it has been accused of not importing enough from its largest trade partners (Angang 2009). In order to combat this criticism China could relax its import strategy and move from a trade surplus situation to one of trade balance. This balance could be achieved by increasing imports of manufactured goods. This policy would be welcomed by its trading partners of the West. The instrument for balancing the current account could be a revaluation of China's real exchange rate. This has been an instrument that has been used quite effectively by China in the

past for managing its external account. This scenario anticipates, in fact, the 12th Plan strategy of China, which proposes to increase domestic consumption and reduce exports (APCO 2010, 4).

Figure 3: Growth in per capita growth rates, 2000-2030, (Scenario 2)



2.3 A BRIC initiative: Scenario 3

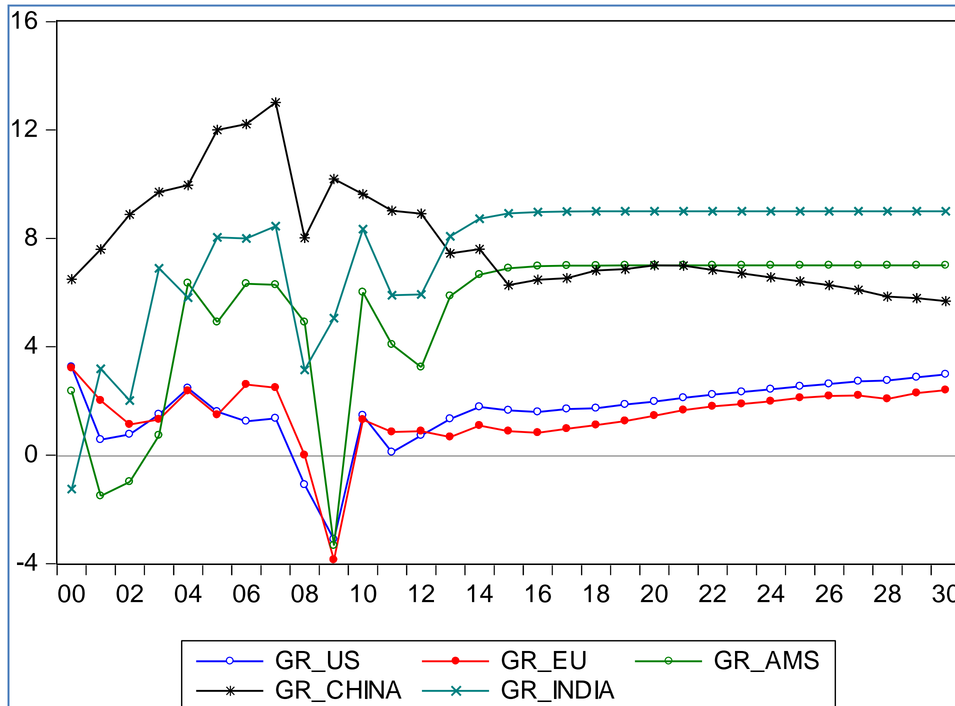
We next examine the possibility of a combined strategy: 1) India and Brazil undertake expansion in trade and 2) China becomes more accommodative and chooses a strategy of greater internal absorption. In keeping with the emerging political dynamic at the global level, an optimist would anticipate that China would allow its BRIC partners preferential access to its domestic markets. This would boost India's export prospects without significantly affecting either the access of China or other countries to the large Chinese market.

India's trade with Latin America has been steadily improving. In 2010-11 Indo-Latin American trade had crossed the $23 billion mark, thereby registering a ten-fold rise over the decade. On the policy front, India and Mercosur have signed a preferential trade treaty effective from 2009 (Heine and Viswanathan 2011). Within Latin America, Brazil dominates the trade with India. This situation is also reflected in the increased political coordination on the international arena

that has emerged among India, Brazil and South Africa (the initiative that is nicknamed IBSA). Latin America, in turn, has benefitted from increased FDI flows from India.

It is therefore plausible that bilateral trade relations and the share of trade among countries such as China, Brazil and China could improve. As we see from the results below, there would be an improvement in the well-being in these countries (see Figure 4). But the fortunes of Europe and USA would remain unaffected.

Figure 4: Growth Rate in per capita Incomes 2000-2030 (Scenario 3)

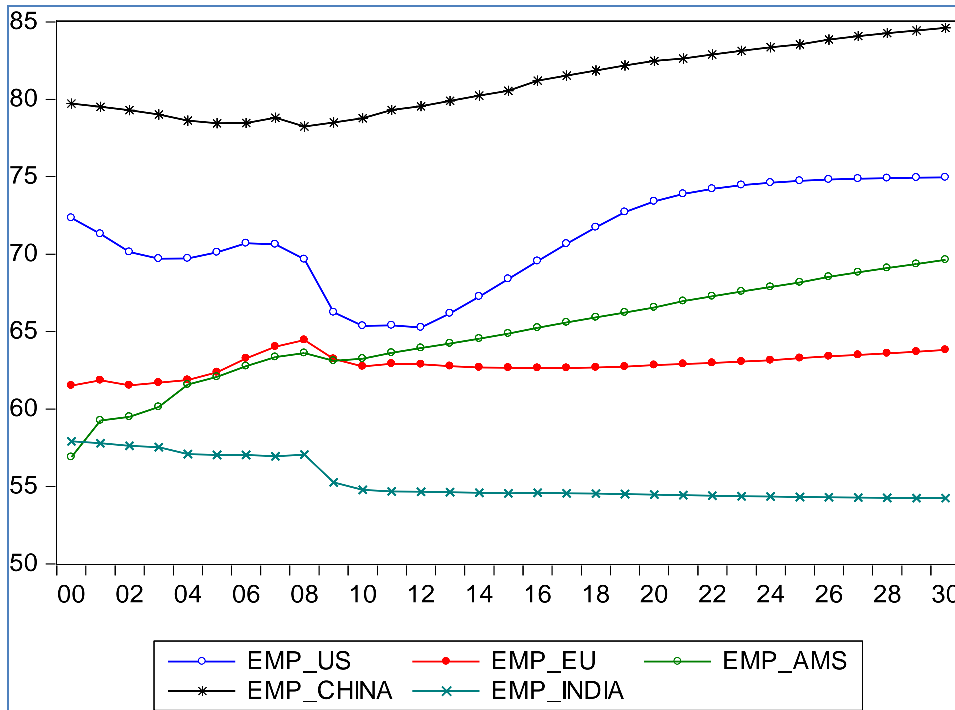


2.4 USA Reflation: Scenario 4

The outcomes above bring us to consider options for the US economy, which has roughly recorded a decline in its employment rate by 5% from its 2007 level of 65% in 2010. There is good reason to believe therefore, at least on economic grounds, that the USA could be persuaded to adopt a more pro-employment fiscal expansion strategy. It is already reeling under severe pressure to stop the out-sourcing of jobs by US companies, and the outcome of the forthcoming elections could be strongly influenced by the policies proposed for employment by the Republicans and Democrats. A fiscal expansion financed by additional borrowing (as proposed in this scenario) could lead to an increase in the employment in the US to 75%. China and Latin America would experience a positive impact from such a policy but the EU and India would not experience much effect (see below).

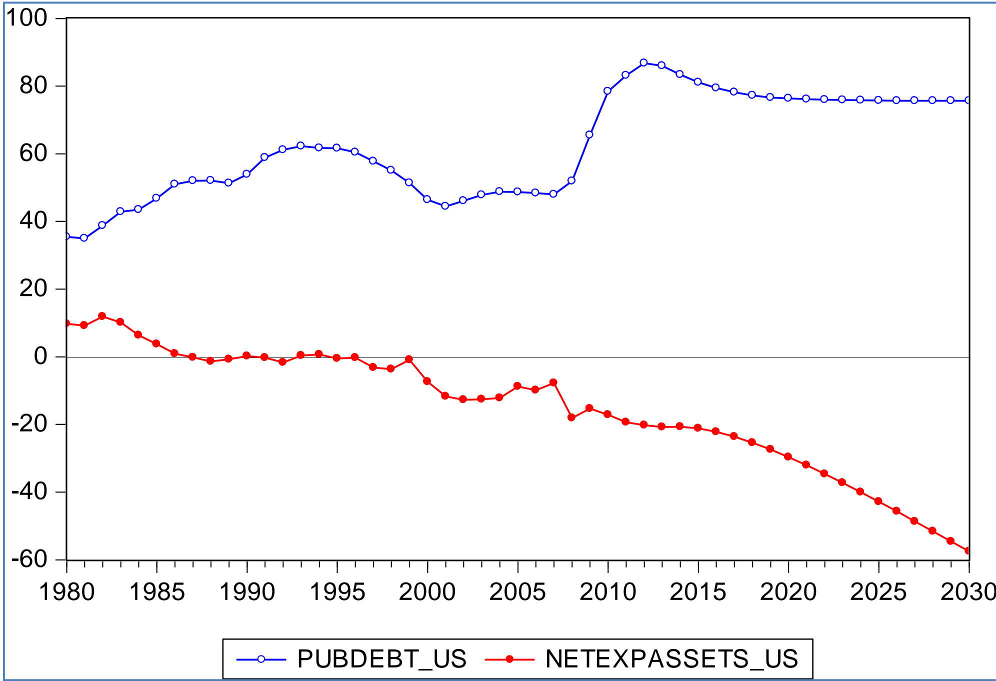
However, the public debt, as a percentage of GDP, in the USA (the blue line in **Error! Reference source not found.**) would rise. There would be an initial increase of this ratio to above 80% but it would then decline and stabilise at about 78%. There would also be a decline in the net export of assets (see the red line in Figure 5). Employment would rise to reach the target of 75%. But there would be no resultant inflationary pressures generated by this strategy.

Figure 5: Employment rates (%) with the US alone in expansionary mode (Scenario 4)



What would happen, however, if the USA undertook coordinated action together with the BRIC countries? This is the basis of our next scenario.

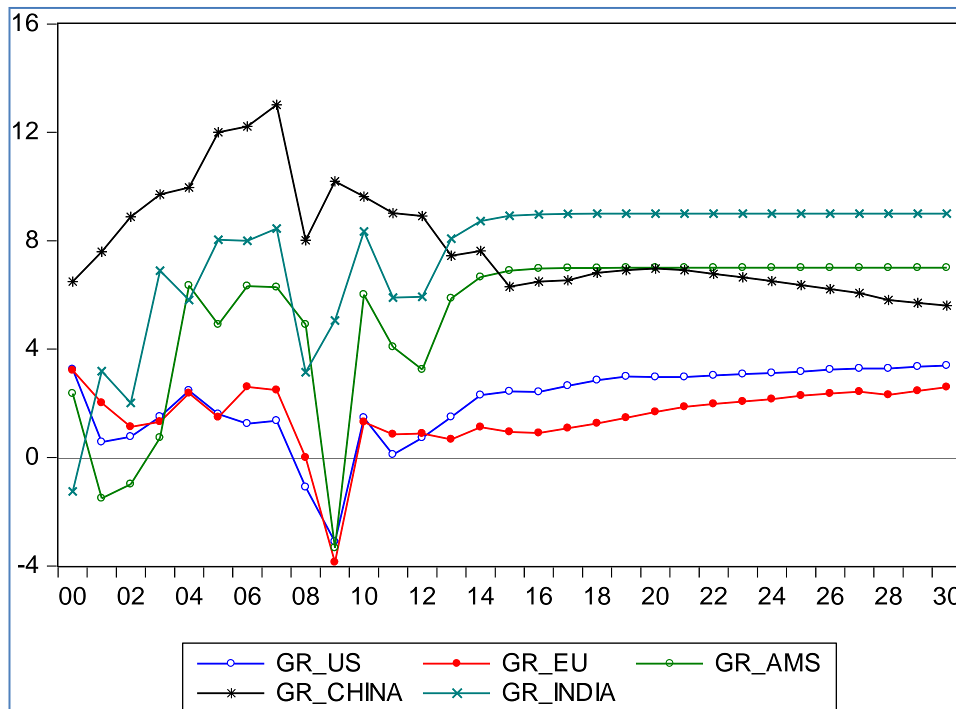
Figure 6: US Public debt and Net Export of Assets (as a % of GDP) (Scenario 4)



2.5 UBRIC Initiative: Scenario 5

In this scenario we assume that USA would reflate and BRIC countries would follow a strategy of fiscal action that would be coordinated with the policies of the USA, domestic consumption expansion in China, and trade expansion as well as fiscal expansion in Latin America and India. We call this the UBRIC strategy.

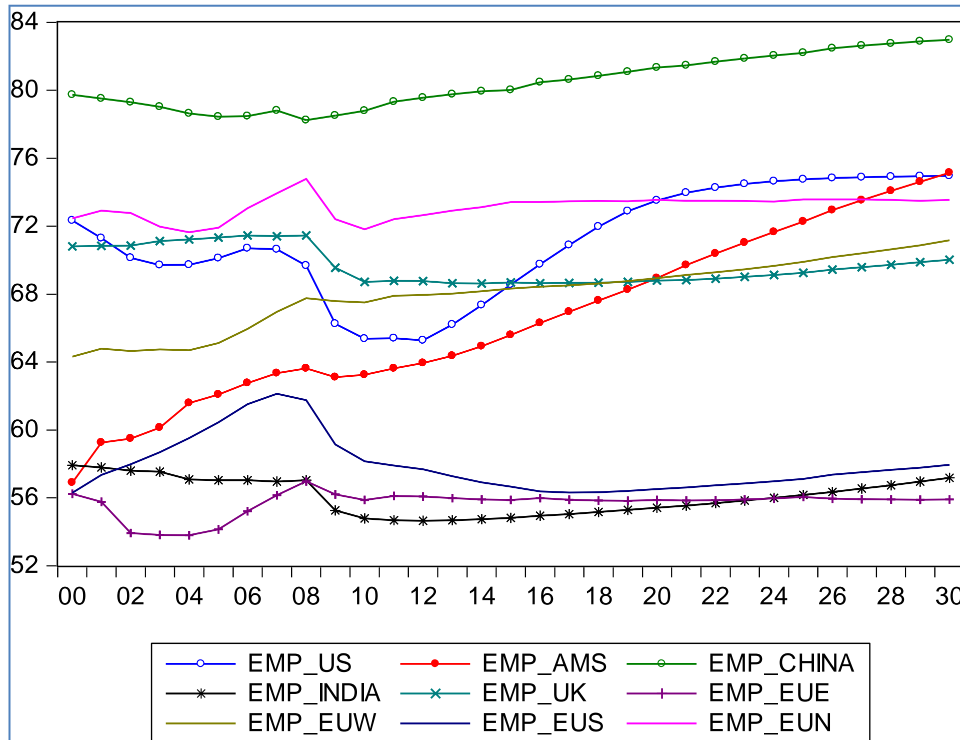
Figure 7: Growth rate in per capita Income (Scenario 5)



This scenario would work very well for India and Latin America as they both would reach their desired growth targets of 9% and 7% respectively (see Figure 7). However, China would experience a slowdown in its growth of per capita income, and the EU and the USA would experience only a marginal rise. Despite the slowdown in Chinese economic growth, it would stay above the growth rates of the EU and the USA.

It is evident that while US reflation would work well for improving its own employment rate, its improvement would provide little comfort for the parts of Europe in which the economic crisis continues (see Figure 8). Northern Europe would evidently be unaffected by the crisis. But Southern Europe and Eastern Europe would have reason to worry. The UK and West Europe would experience marginal increases in their employment rates in this policy regime but these rates might not be acceptable to its current generation which is used to historically higher levels. So the solution to European revival must also be sought from within Europe itself. This is the premise on which our next scenarios are based.

Figure 8: Employment rate in USA and various European blocs (%) (Scenario 5)



2.6 European Reflation: Scenario 6

The question that remains is whether the current conservative strategy being proposed by the EU can be an effective anti-dote to its economic crisis. One option is to maintain the status quo – and hope that the market mechanisms will allow private investment to flow in and create adequate aggregate demand and increase employment. It is conceivable that this strategy could work. But it is more likely that it will not. So there could be an extended period of economic downturn with severe social consequences (see for example Elliot and Inman, 2012).

Given the widespread unpopularity of the austerity measures, Europe might be left with two choices – (a) reflate the economy by expanding public expenditures and renegotiating the debt/GDP ceilings set by the Maastricht Treaty, or (b) confront the breakup of the Eurozone by allowing Greece and Portugal an honorable exit from the Currency Union, and obliging Spain and Italy to adopt strong austerity measures.[3]

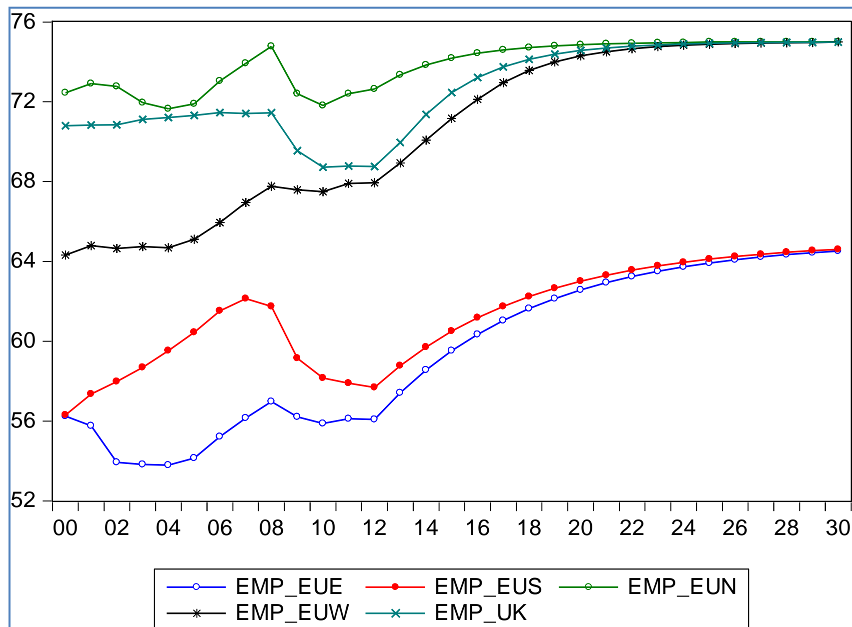
[3] With an unemployment rate of almost 24% and youth unemployment of 51% in March, 2012, Spain's economic managers would have difficulty in justifying austerity measures and might face unforeseen political fallout if they are unable to tackle the problem of unemployment quickly (Eurostat 2012).

These are difficult choices. The exclusion of Greece and Portugal from EU might permanently damage the dream of a unified Europe. It is not an option that would be politically desirable. The EU management team may be less averse to the first option, i.e., fiscal expansion, now that Premier Merkel has less support because of the change of guard in France and the Netherlands. President-elect Hollande has already indicated his disagreement with the austerity strategy (Traynor 2012). It is not impossible that EU might reconsider reflating its economies by relying on government expenditure. Probably the most desirable option for the EU would be to set employment targets of 75% for North Europe, West Europe and the UK and 65% for East and South Europe. A higher target for East Europe and South Europe would likely be economically unachievable since it would be out of line with levels achieved by both blocs in the recent past.

West Europe (namely, Germany and France), North Europe (namely, Sweden and Nordic countries) and the UK would try to achieve the above-stated employment targets by increasing government expenditures. To control any adverse impact on their increasing fiscal deficits and public debt, they would simultaneously increase government revenues (by raising taxes). Hence, they would not require a higher debt/GDP ceiling than what has been provided for in the Maastricht treaty, i.e., 60%. The increased government expenditure would be matched by two instruments – higher revenue (taxes) and the sale of government assets (privatization).

East Europe (with countries such as Poland and Czech Republic) and South Europe (namely, Spain, Italy, Portugal and Greece) would find it impossible to achieve 75% employment rates. In fact, they have not reached that level in recent history. So they would target a lower level of employment, i.e., 65% (see Figure 8). But even to achieve this level, South Europe would have to overshoot the Maastricht-dictated ceiling of a 60% debt/GDP ratio. In fact, South Europe would be obliged to raise its public debt levels to nearly 100%. Hence, there would be the need to re-negotiate the Maastricht treaty. A new treaty might allow member countries to raise their levels of public debt/GDP from the current 60% to 100% in times of crisis, such as this current economic crisis. South Europe and East Europe would also experience a lowering of their purchasing power vis-à-vis that of West Europe. The real exchange rate adjustment in the case of South Europe would be marginal, i.e., 0.9, while that of East Europe would be large, with a decline to 0.55 of the value of the Euro real exchange rate.

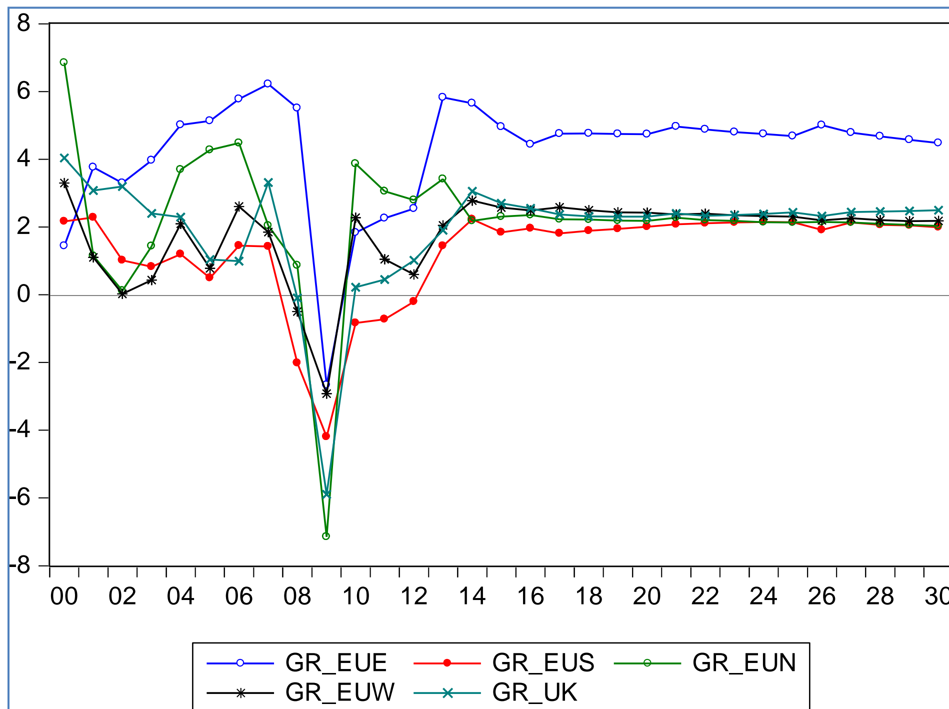
Figure 9: Employment Rates in Europe, 2000-2030 (Scenario 6)



It is easy to assume that public expenditure could be financed by borrowing but the question then would arise about who would buy these extra bonds since the markets are jittery about the manageability of the European debt, especially the debt of Greece, Portugal, Spain and Italy. The answer probably lies in instituting a federally backed issue of public bonds (see Ewing and Geitner, 2012). EU could treat the additional debt as federal debt (namely, the debt above the 60% level for South Europe) and guarantee this portion of the debt through a federal institution.

However, this strategy would lead to a near-convergence in per capita growth rates across Europe, except for East Europe, which would enjoy a higher rate of growth due to its lower starting per capita income level (see Figure 10).

Figure 10: Rate of growth of per capita income in Europe, 2000-2030 (%) (Scenario 6)



As a result of these policies, the current account would take a beating in East and South and in the UK but North Europe and West Europe would enjoy a surplus on their current accounts. This development would not be a reason for worry since much of this trade within Europe and would not lead to Balance of Payments problems. Both East Europe and South Europe would see a steady transfer of assets outside their region but this outflow managed by ensuring that other EU partners buy these assets. The external deficits in the a federated Europe would pose a challenge similar to that for individual countries (see

Figure 11).

The current account deficit experienced by the three EU blocs discussed above and the attempt to keep the public debt under control would oblige them to export assets and thus lead to a steady decline their capital assets held abroad. Again, this might not pose a serious problem since much of this transfer would be taking place within Europe (see Figure 12).

Figure 11: Current Account Deficit as a % of GDP in Europe (2000-2030) (Scenario 6)

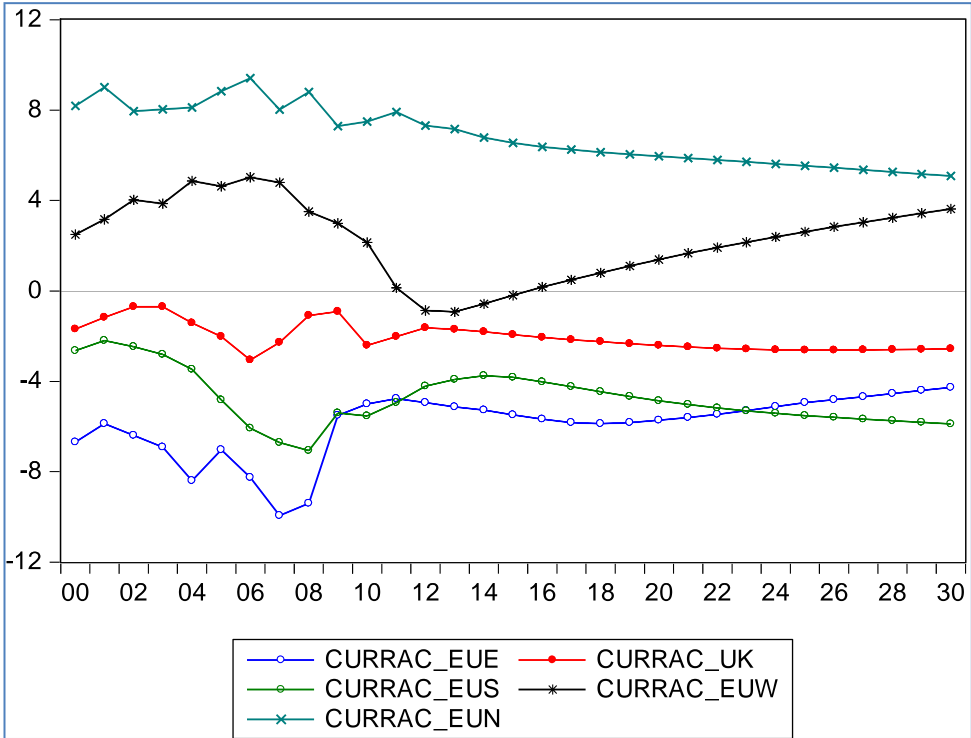
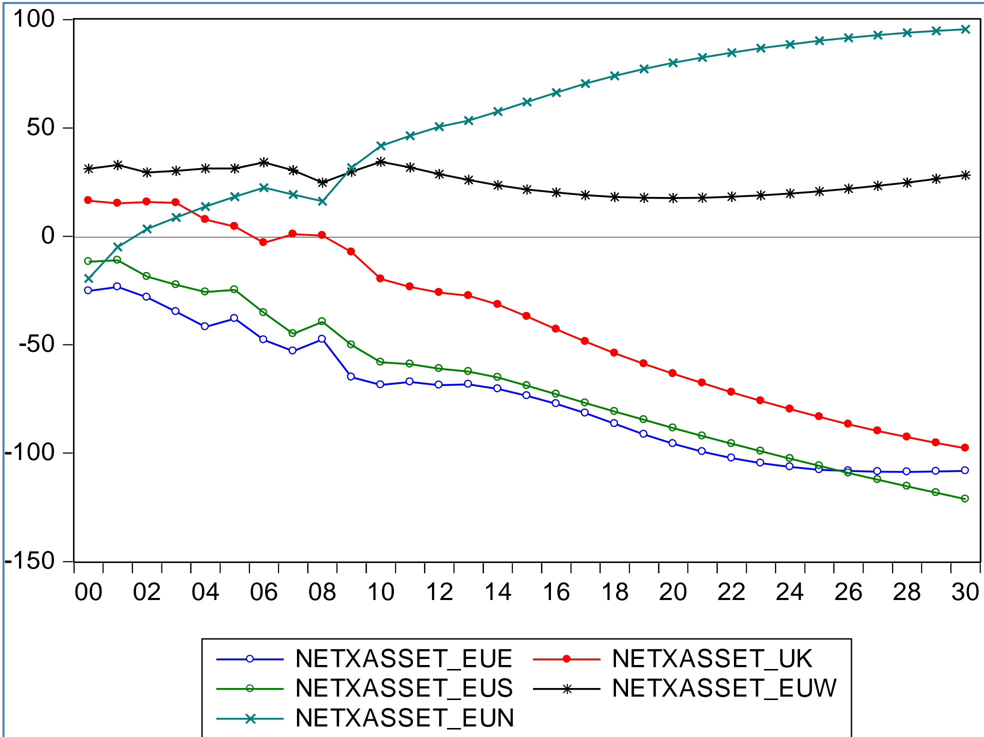
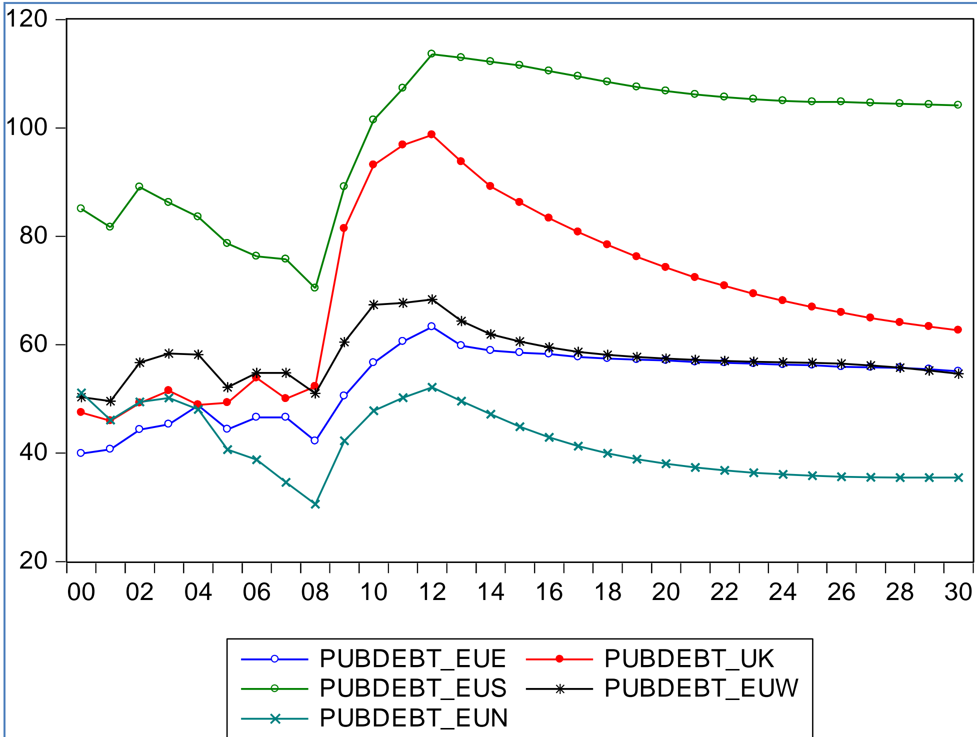


Figure 12: Net Export of Government Assets



All the European blocs except South Europe would not have a problem in meeting the Maastricht ceiling on the debt/GDP ratio (see Figure 13). The United Kingdom would overshoot the requirement during the initial years but it would fast converge to this ceiling in later years. East Europe, which has had traditionally low levels of debt, would have few problems in converging to the ceiling. North Europe would maintain, of course, its low public borrowing levels throughout the projection.

Figure 13: European Government debt as a % of GDP (Scenario 6)

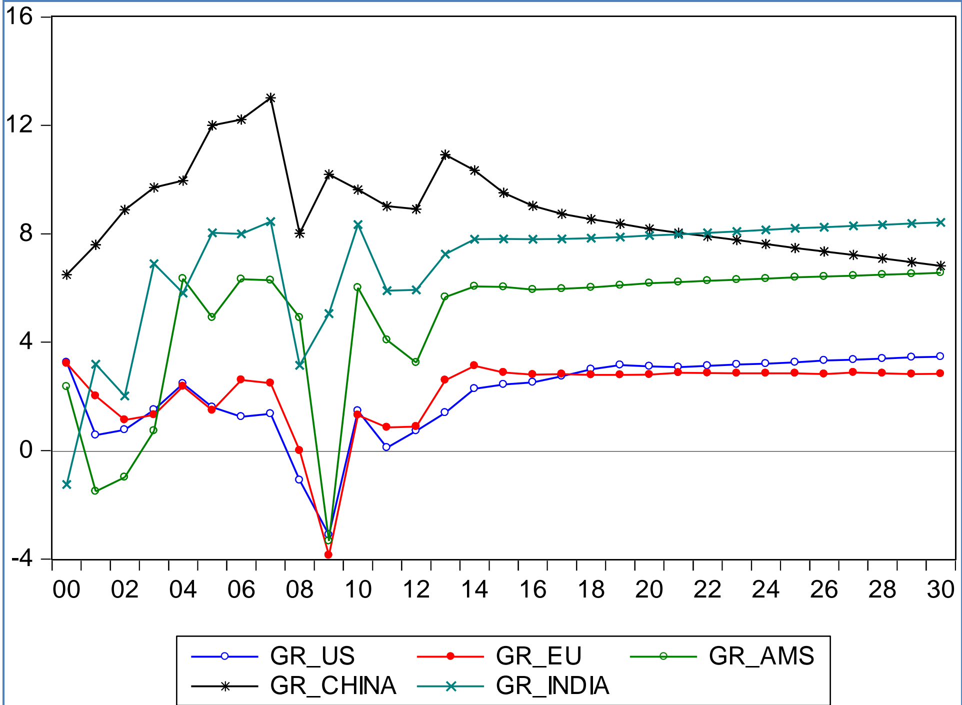


2.7 Coordinated Policy: Scenario 7

So, if the countries of the West did decide to coordinate their policies with those of the economies, there would likely be a much quicker global recovery. Growth per capita would higher than in the baseline scenario for all the countries and blocs that joined in the policy initiative (see

Figure 14 below).

Figure 14: Rate of growth of per capita incomes (%), global regions, 2000-2030 (Scenario 7)



All these countries and blocs would also experience gains in employment (see Figure 15 below). This is the primary goal of government intervention in Europe and America. Even the UK would experience a marginal increase in employment rates based on a quicker recovery than under the baseline scenario. While India would stabilize its employment rate, South America would experience much better employment outcomes.

Figure 15: Employment rate (in Scenario 7)

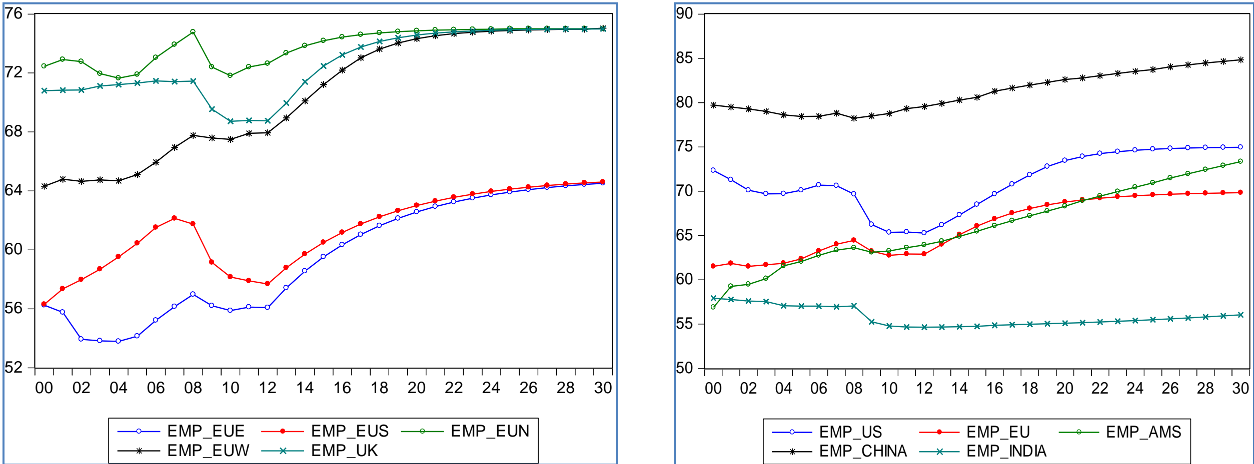
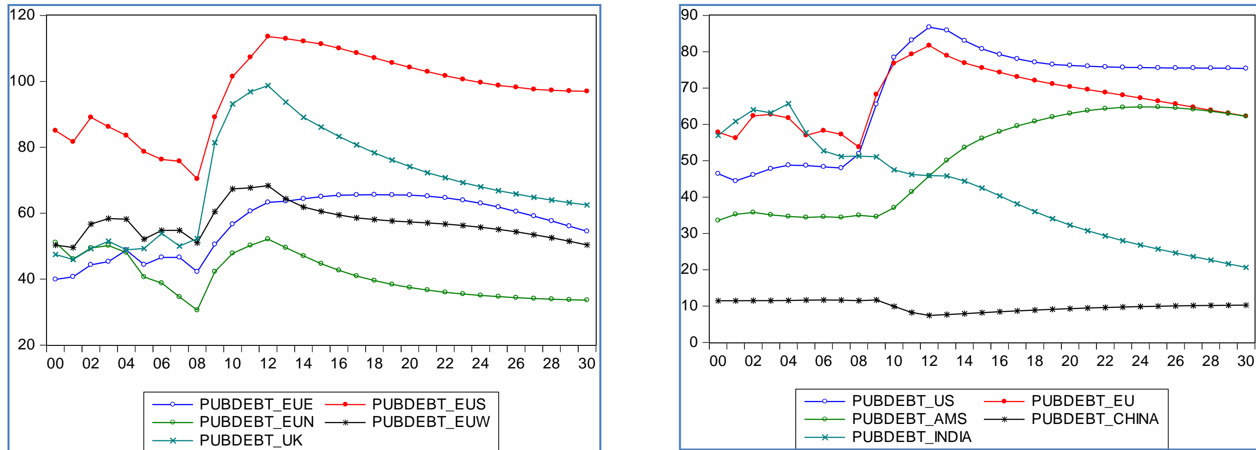


Figure 16: Government Debt as a % of GDP (in Scenario 7)



Debt would remain a concern for all countries (see

Figure 16). The combined strategy described above would lead to a situation in which the level of debt in South Europe would initially rise but thereafter decline, so that by 2030 it would be just below 100% of GDP. There would be a steady decline in India's debt but a rapid rise in Latin American debt. There would also be significant levels of debt in parts of Europe, namely, East Europe. Overall, however, the level of Europe's debt would end up at a level that was consistent with the Maastricht treaty requirement by 2030.

3. Discussion

Our scenarios suggest that regional policies by themselves would have limited gains and global recovery would require coordinated action. The question that faces us in view of the scenarios posed above is how credible are they? For example, would the USA and EU be able to expand government expenditures by running fiscal deficits?

Apparently, the rating of the US Treasury Bills is not as bad as the credit rating agencies might make it look. 10-year T-bills were at record high levels of valuation, with yield as low as 1.97% in January 2012. Therefore, there still exists a high demand for US T-Bills. As Izurieta (2011) argues, the burden of debt servicing, which is one of the main determinants of debt sustainability, is at a historic low in the USA not because there is too much debt, but on the contrary, there is too little.

A resurgent US economy would easily be able to absorb additional public debt, as it has done in the past. However, we must keep in mind that the US government would be under political

pressure from various quarters, including financial institutions, to cut public expenditures, even at the cost of delaying an economic recovery.

The Eurozone's single largest concern is of rising unemployment, especially among the youth. This concern has dominated the discussion at the World Economic Forum at Davos in end-January, 2012 and has been brought home by the election results in Greece and France. EU members may be better off re-negotiating the Maastricht treaty instead of confronting the prospect of a breakdown in the currency union. Germany, which has been the strongest economy of Europe and is relatively unaffected by the crisis in the EU, must contribute in a bigger way if the Euro is to be saved. A revaluation of the Euro or the break-up of the single currency could have a significant negative impact on Germany's exports. This is a sufficient reason for it to become actively engaged in promoting the economic recovery of the Eurozone.

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