Europe: The case for helicopter money or taxation changes?

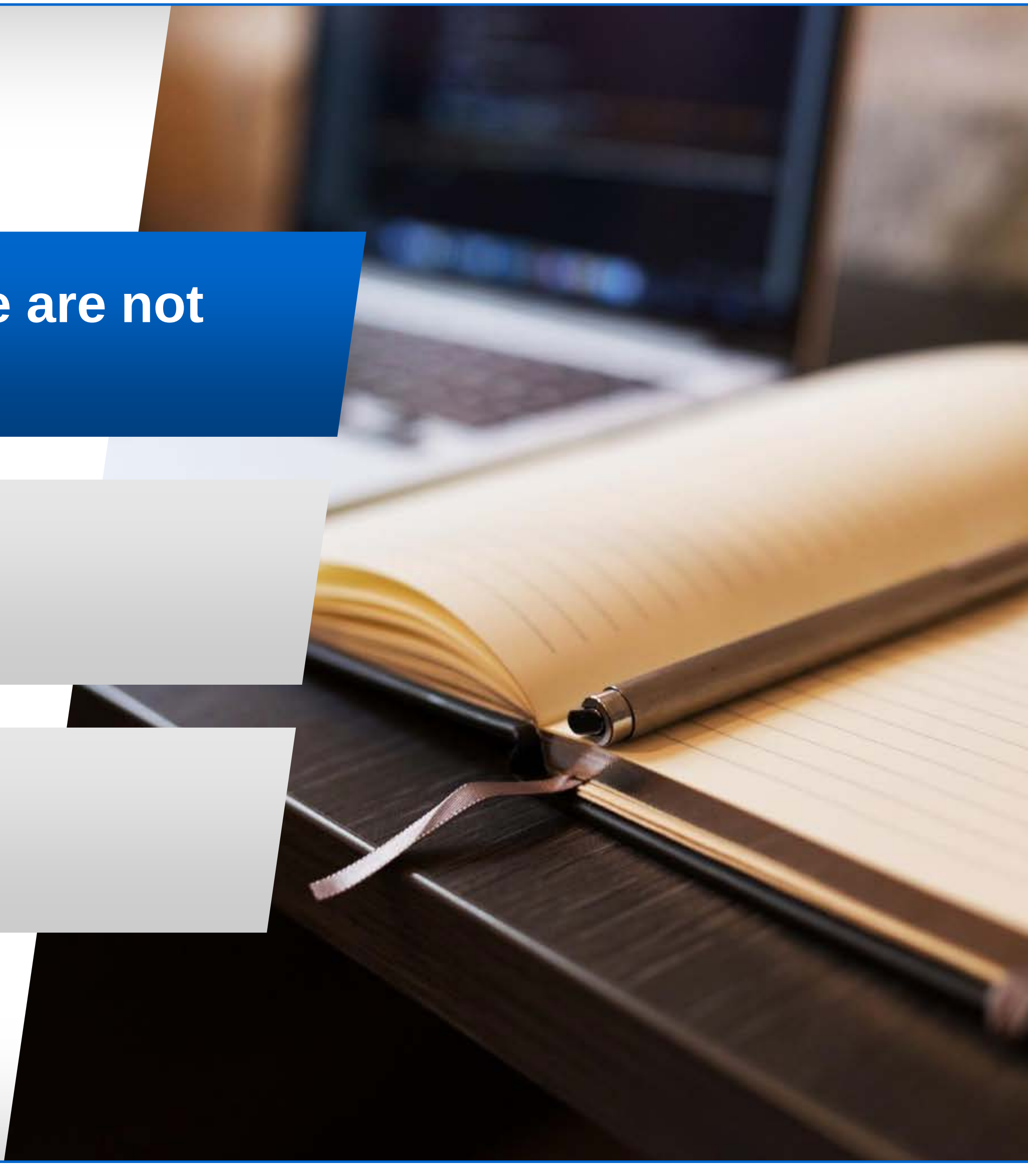
McKinsey Global Institute

Dr. Jan Mischke

Discussion document

Peterson Institute
October 15, 2015

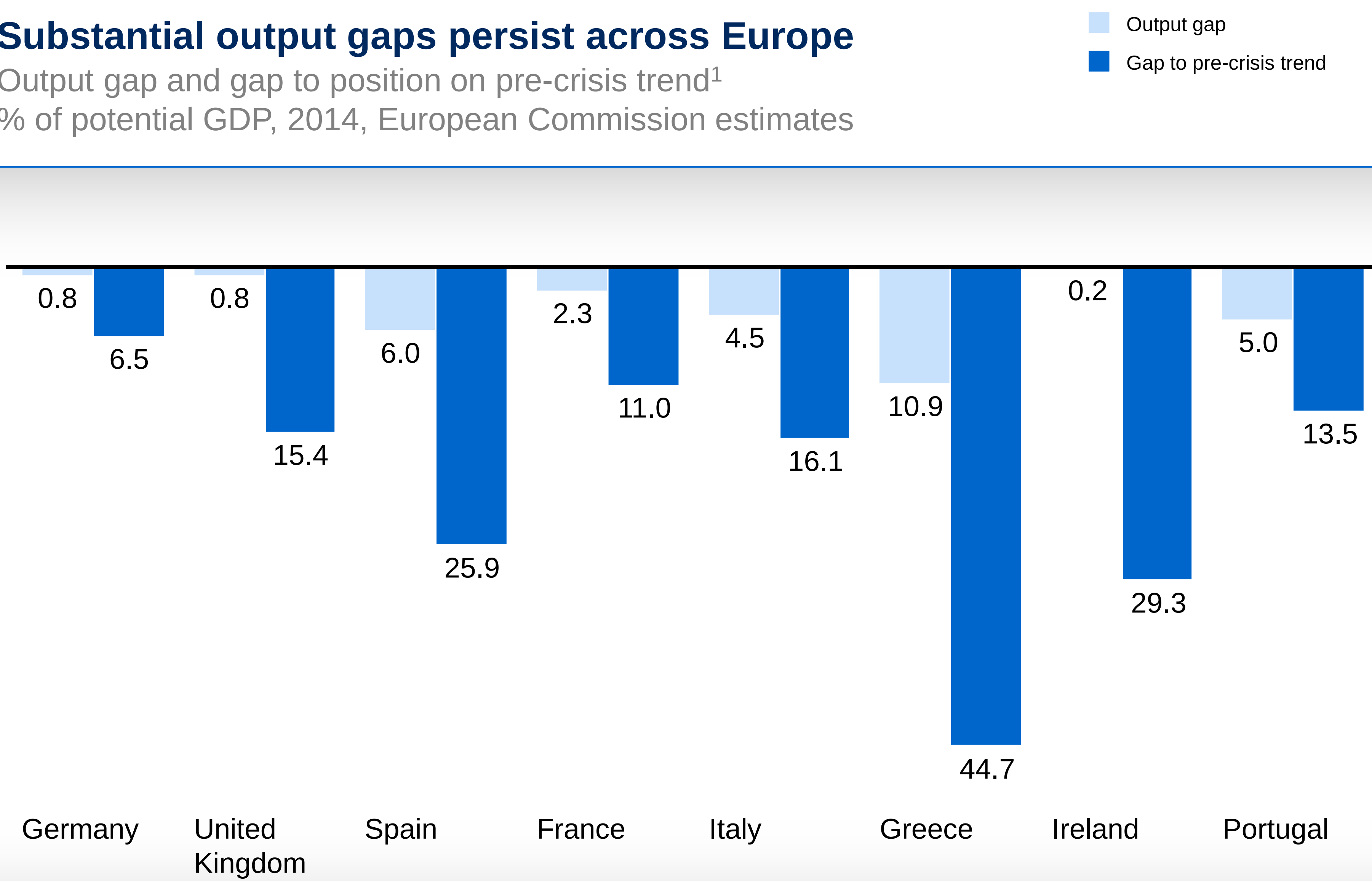
Contents



Substantial output gaps persist across Europe

Output gap and gap to position on pre-crisis trend[1]

% of potential GDP, 2014, European Commission estimates



1 Based on European Commission data. Pre-crisis trend defined from the geometric mean of actual real growth between 2002 and 2007.

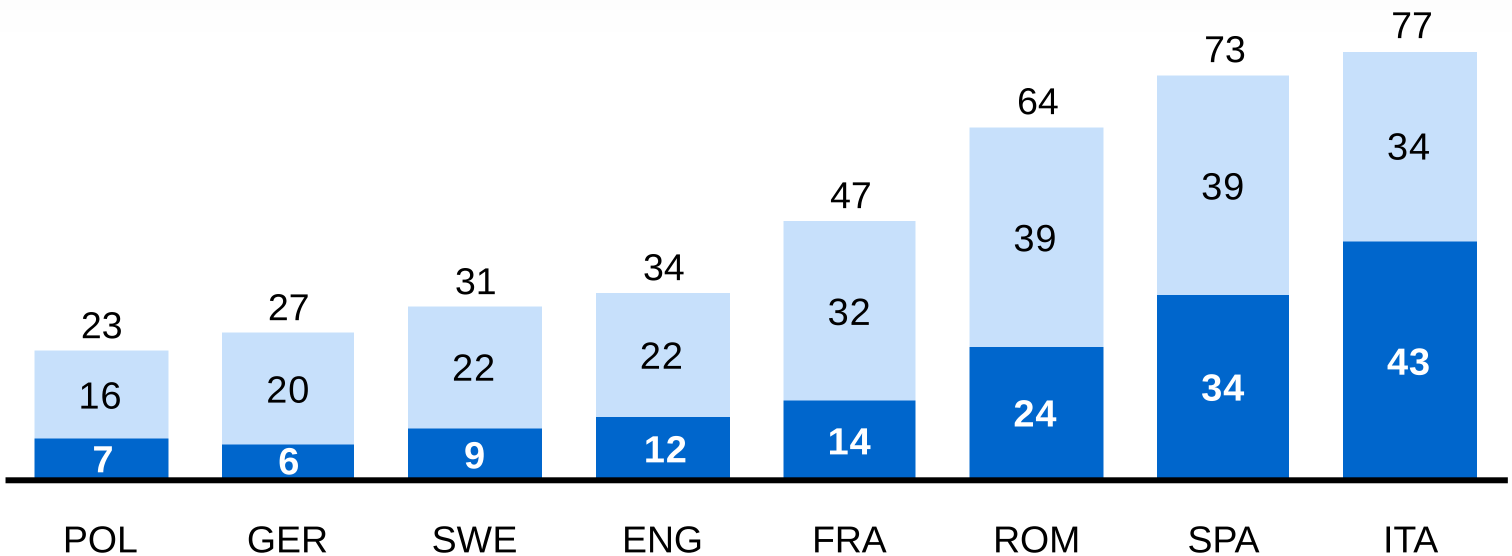
SOURCE: European Commission; IMF; OECD; McKinsey Global Institute analysis

In countries with high output gaps and unemployment, Europeans tend to be less satisfied

Unhappy
Very unhappy

Respondents "unhappy" or "very unhappy" with their country

Weighted, in %

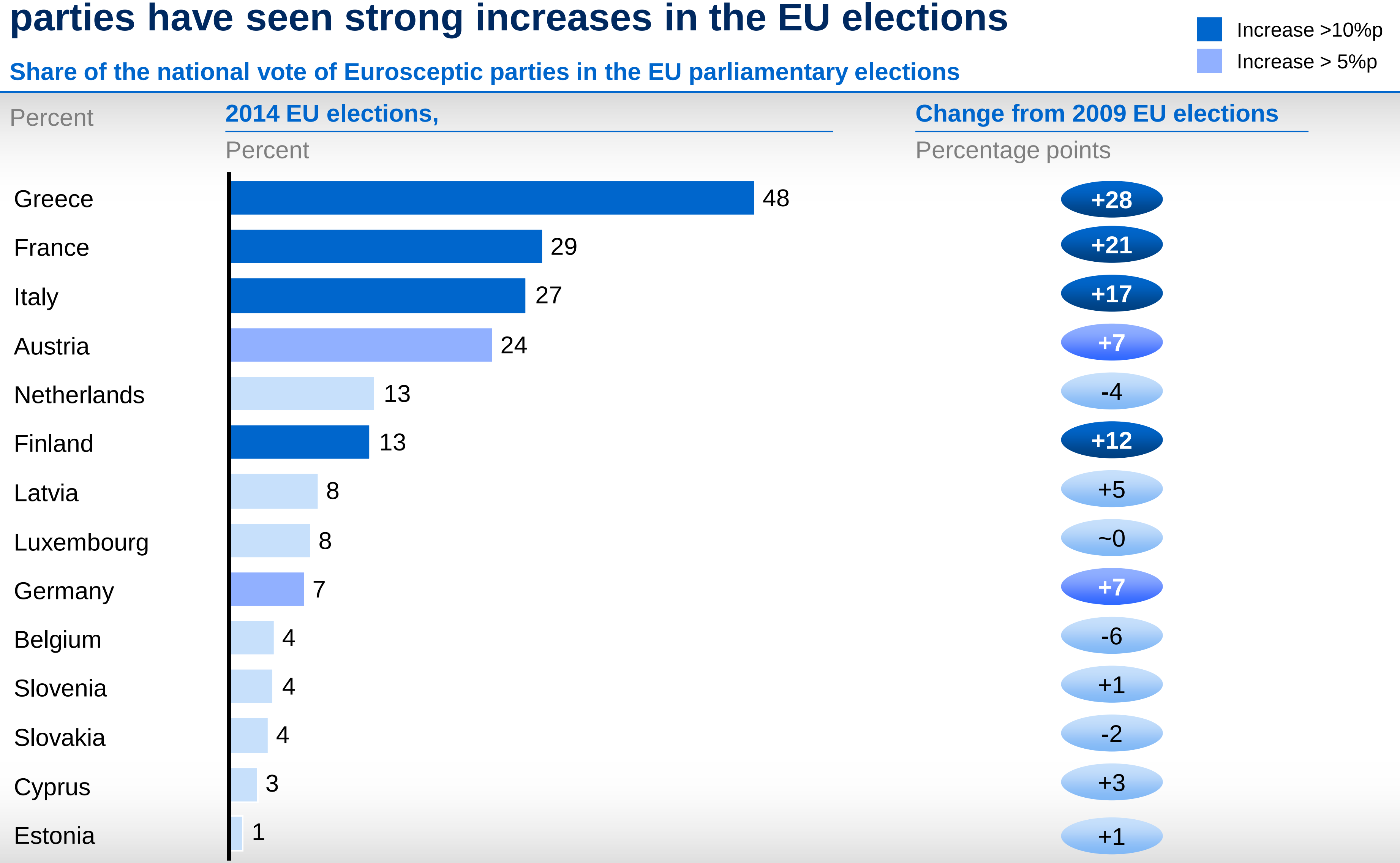


	POL	GER	SWE	ENG	FRA	ROM	SPA	ITA
Output gap % of GDP	n/a	-0.4	-0.8	-2.7	-0.4	n/a	-4.1	-4.2
Unemploy-ment rate, %	10	5	8	8	11	7	26	12

SOURCE: McKinsey survey, August 2014 (N=16,000); IMF World Economic Outlook, April 2014; McKinsey Global Institute analysis

In a deflationary environment with high unemployment, Eurosceptic parties have seen strong increases in the EU elections

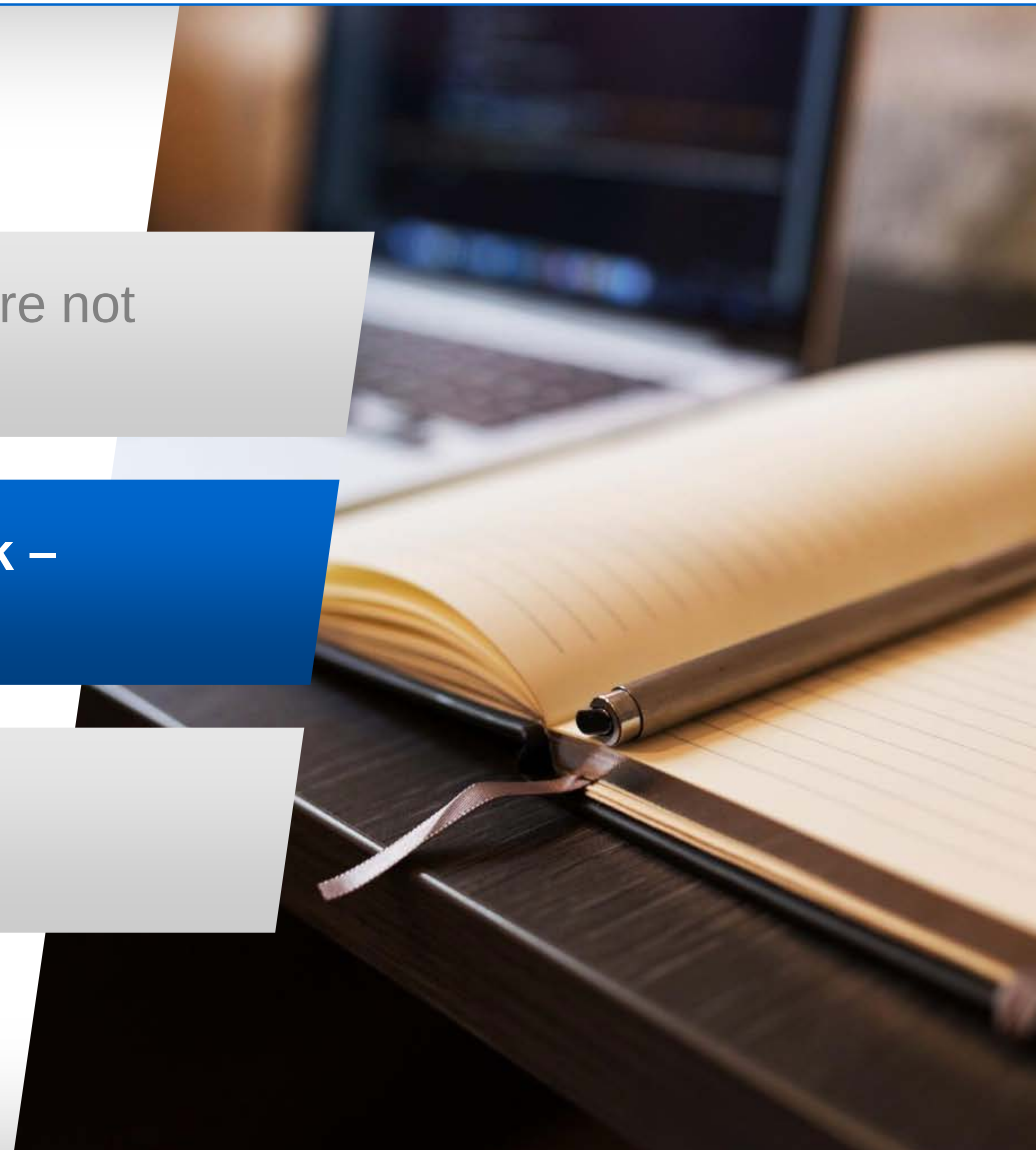
Share of the national vote of Eurosceptic parties in the EU parliamentary elections



Note: No declared Eurosceptic parties in Ireland, Malta, Portugal and Spain

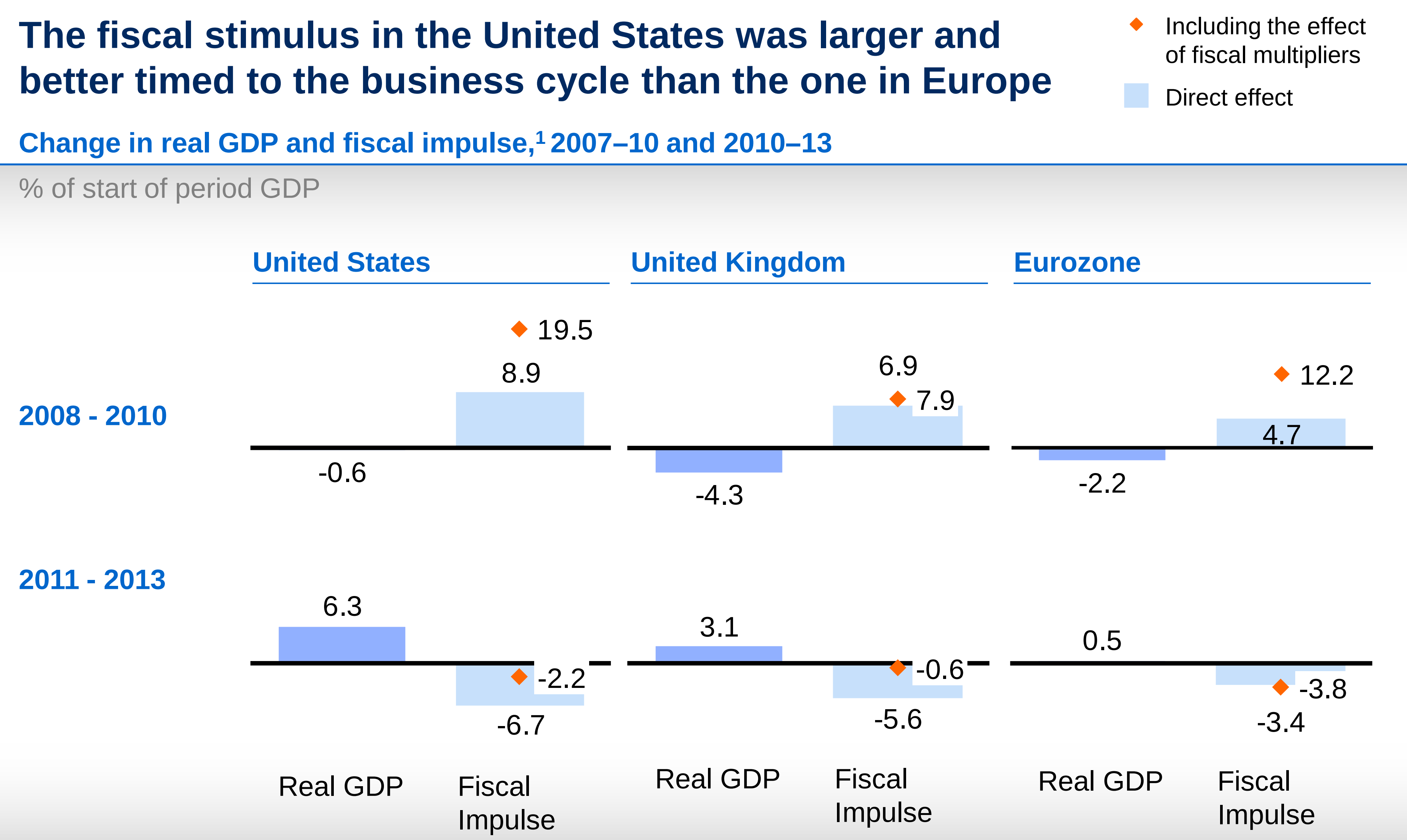
SOURCE: Press; McKinsey Global Institute analysis

Contents



The fiscal stimulus in the United States was larger and better timed to the business cycle than the one in Europe

Change in real GDP and fiscal impulse,[1] 2007–10 and 2010–13



1 Fiscal Impulse is defined as the negative change in deficits.

2 The effect of fiscal multipliers on the cumulative effect is large, although there is a great deal of uncertainty about its size. The fiscal multiplier during recession is estimated to be large (United States: 2.18; Eurozone: 2.56; UK: 1.0) while the multiplier outside of a recession is small (United States: 0.33; Eurozone: 0.43, UK: 0.1). The timing of fiscal impulse therefore plays a large role it its effectiveness.

SOURCE: Successful austerity in US, Europe and Japan, IMF, July 2012; Eurostat; FRED; McKinsey Global Institute analysis

Europe took significant action to address the crisis – but not as fast and decisively as the United States

ILLUSTRATIVE EXAMPLES

United States | EU

Timeline (crisis in Europe occurred approximately one to two quarters later than in the United States)

Decision domain	Action	2007	2008	2009	2010	2011	2012	2013	2014
Central banks	Acting as lender of last resort		November: US agency debt ($175 billion) and mortgage-backed securities ($1.25 trillion)	July: Covered Bond Purchase (€60 billion in first round)	May: Initiated Securities Market Programme to buy government bonds (€220 billion)	Maturity Extension Program: buying long-term and selling short-term securities	July: Draghi's "do whatever it takes" speech		
	Funds rate		December: Lowered funds rate to 0–0.25%	May: Reached policy rate of 1%					September: Lowered policy rate to 0.05%
	Liquidity provision, security purchases, QE		MBS purchases also provided liquidity Increase of liquidity provision to banking sector	March: Extended purchases to Treasury securi-ties ($900 billion to mid-2012) and higher volumes		Longer-term refinancing operations (LTRO): 2011/12: EUR ~1trn; targeted programme 2014	December: Monthly asset purchases while unemployment > 6.5%, totaling in $1,665 billion		January 2015: €60 billion of monthly asset purchases up to 09/2016 to reach inflation target
Bank clean-up	Stress tests/ recapital-sation		October: TARP (Troubled Asset Relief Program) gives immediate relief to financial institutions	May: Supervisory Capital Assessment Program					October–November: Comprehensive stress test and Single Super-visory Mechanism to monitor financial stability in force
			Bank nationalisations and recapitalisations ongoing beginning in 2008 in both the United States and Europe[1]						
				Bank stress tests in 2009, 2010, and 2011, but not assessed to be fully comprehensive					
Fiscal mea-sures	Regional transfers	Annual transfers between states accounting for 8.4% of GDP - as an example, Florida in 2013 recieved17.9% of its GDP through federal transfers							
		Intra-EU transfers at 1.6% of GDP only via EU budget, mostly structural, no automatic stabilizers							
	Region-wide stimulus	Cumulative 2007–10 stimulus 8.9%[2] of 2007 GDP							
		Cumulative 2007–10 stimulus only 4.7%[2] of 2007 GDP							

1 European countries faced additional challenges as the banking sector is much larger as a percentage share of GDP than in the United States, requiring larger recapitalisation amounts and limiting countries' capacities to stem banking crises. 2 Combined discretionary and automatic fiscal impulses.

SOURCE: European Central Bank (ECB); Federal Reserve System; Congressional Research Service; European Commission; McKinsey Global Institute analysis

While more definitive evaluations will be needed, there may be fewer transmission channels of QE in Europe than in the U.S.

Transmission channels	U.S.	Europe
Liquidity support for lending	✓	(✓)
Wealth effects	(✓)	?
Corporate interest rate	?	?
Household interest rate	(✓)	?
Currency	(✓)	✓
Fiscal leeway	✓	✓

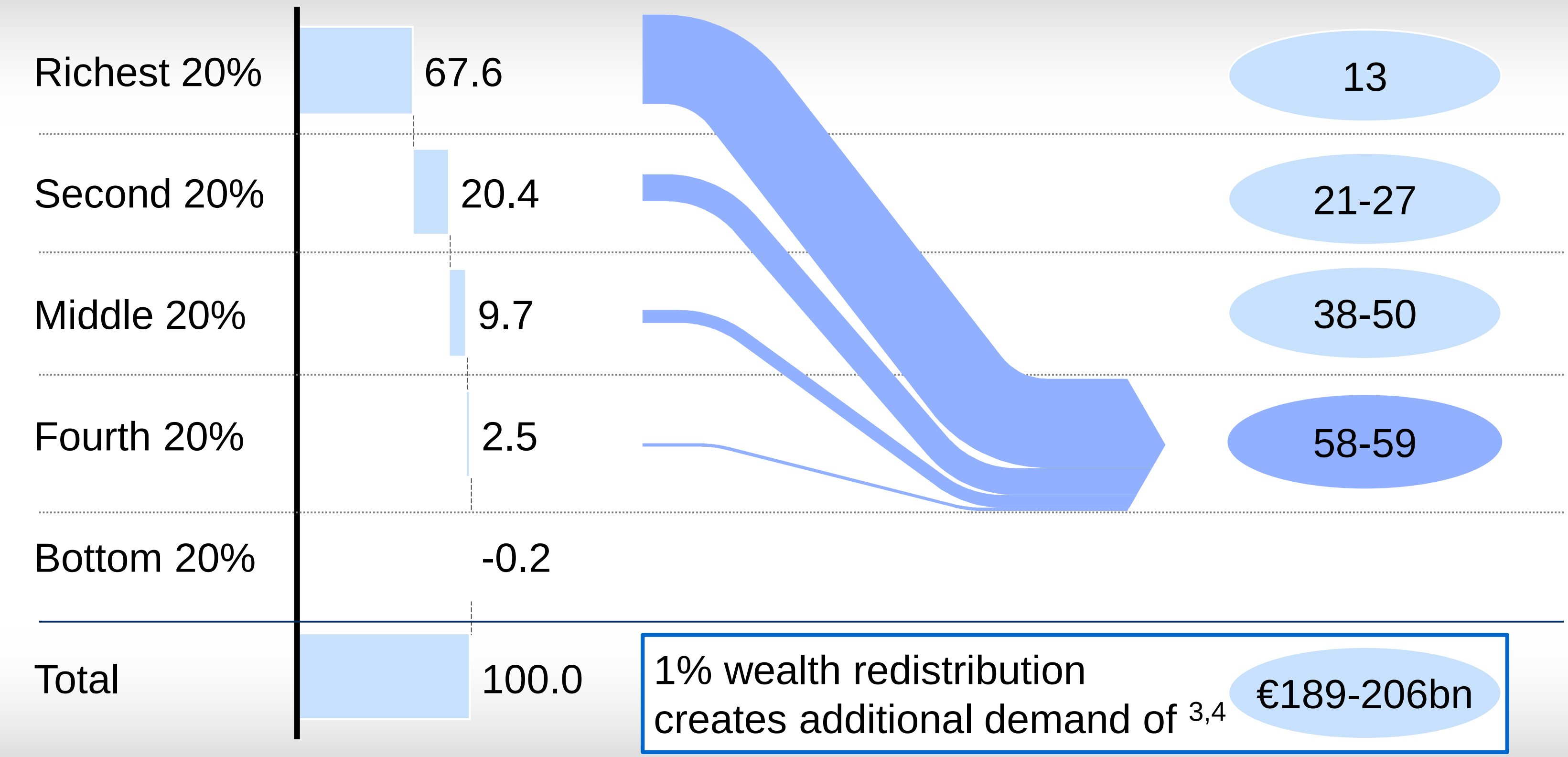
SOURCE: McKinsey Global Institute

Contents

A 1% redistribution of net wealth to the bottom 50% could increase primary consumption by €200 bn and close the output gap – but has obvious non-economic challenges

Proportion of wealth held by percentile
Net worth, percent of total, Euro Area 2010[1]

Marginal propensity to consume
%[2]



1 Data source is the Household Finance and Consumption Survey carried out by Eurosystem for the ECB across 15 European countries with reference year 2010, published as First Wave Statistics in 2013   2 Ranges: Krusell-Smith and Friedman/Buffer Stock models (wealth measure: net worth; distribution: by wealth/permanent income ratio)   3 Excludes household spending multiplier   4 Similar in order of magnitude to taxes currently levied in Norway, Netherlands, France and (temporarily) Spain.

SOURCE: Carroll, Christopher, Jiri Slacalek and Kiichi Tokuoka: The distribution of wealth and the marginal propensity to consume. ECB Working Paper Series number 1655, March 2014; ECB Statistics Paper No 2, p. 75; April 2013; McKinsey Global Institute analysis

Could there be advantages of helicopter money vs. QE in a European context?

	QE	Helicopter money
Demand stimulus	?	✓
Avoiding distributional consequences	?	(✓)
ECB balance sheet and inflation control	(✓)	✓
Financial stability	?	✓
Accepted by public	(✓)	?

SOURCE: McKinsey Global Institute

Thank you!

McKinsey Global Institute

www.mckinsey.com/mgi