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The strange reasons why Europe will have a "Golden Rule" in 2020

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Policy Brief

LUISS

October 23, 2019

THE STRANGE REASONS WHY EUROPE WILL HAVE A "GOLDEN RULE" IN 2020

(Insights on the heels of the IMF meetings in Washington)

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Abstract

As recently as the beginning of 2018, the International Monetary Fund issued one of its most upbeat economic forecasts in recent years, extolling "broad based" growth with "notable upside surprises." Yet, the recent issue of the World Economic Outlook, published in October, projects global growth for 2019 at 3.0 percent, the weakest rate since 2009. Across the world, bond markets are sounding their loudest recessionary alarm since April 2007. Paul Krugman prognosticates a "Trump-Slump" in the coming months. Lower global trade and the investment slump cause a steep drop in manufacturing activity. A recession in a part of the euro area cannot be excluded.

This brief illustrates some of the complex current economic-policy challenges that emerged during the Autumn Meetings of the International Monetary Fund in Washington, examining their effects on the European economy. The brief will conclude by asserting that Germany will favor the approval of a fiscal "Golden Rule" at the beginning of 2020, a rule that will permit a higher public debt that in turn will allow for greater investments. The political reason for Berlin's change of heart lies in the need for Europe to support the economy by itself, without relying too much on export. The more subtle reason is that a higher debt in the euro area would lead to the higher yields that the German public is craving and that are indispensable to keep the German financial and pension systems from collapsing.

The possibility of lower growth in the advanced economies

For once, the deterioration in the economic picture is not the consequence of irresponsible behavior by banks or an unanticipated economic shock. On the contrary, on one hand, it is self-inflicted by the major world leaders who have almost universally delivered poor economic policies; on the other, it is a normalization of growth in the advanced economies heading towards a new low average level of potential growth.

From Europe's point of view, a weakening economy and a hostile climate for global economic cooperation raise several problems: how can the 27 EU countries protect themselves from foreign political instability? How does one prosper with a normal growth rate that is barely above zero? What is left to do when most policy instruments have already been used and abused? Finally, given the context described, shouldn't Europe completely re-think its entire economic governance?

In the very controlled language of the IMF, the forces behind the current slowdown in global growth include: a return to a more normal pace of expansion in the US economy; less external demand and disruptions associated with the rollout of new car emission standards in Europe, especially in Germany; weaker macroeconomic conditions, largely because of idiosyncratic factors, in a group of key emerging market economies, such as Brazil, Mexico, and Russia; a slight deceleration in China's growth because of the necessary financial regulatory strengthening and the drag from the trade tensions with the United States; a decreasing demand from China and broader global trade policy uncertainty weighing on East Asian economies; a slowdown in domestic demand in India; and the shadow cast by the possibility of a no-deal Brexit on the United Kingdom and, more broadly, on the European Union.

Observers who do not have to be as moderate as the IMF would be more blunt: the trade war initiated by President Trump sits prominently atop the list of bad policies. Tariffs are still rising and are taking their toll on the global economy. Following the tariff announcements in May and August 2019, the average US tariff on imports from China will rise to just over 24 percent by December 2019, while the average China tariff on imports from the United States will increase to about 26 percent.

In the first year of his mandate, when the US economy was growing above its potential, Trump also secured tax cuts that were largely unnecessary. The "sugar high" they produced quickly wore off and is now damaging the economy. Brexit has tipped Britain into political confusion and economic contraction. European governments are almost in paralysis after the shock of a mismanaged euro crisis and the continent is barely growing.

Bad policies are by no means a prerogative of advanced economies. The dramatic worsening of macroeconomic conditions between 2017 and 2019 in a small number of economies under severe distress (in particular Argentina, Iran, Turkey, and Venezuela) accounts for about half of the decline in world growth, from 3.8 percent in 2017 to 3.0 percent in 2019. These same economies—together with Brazil, Mexico, and Russia, all three of which are expected to grow by about 1 percent or less in 2019—account for over 70 percent of the pickup in growth prognosticated by the IMF for 2020.

This is partly understandable wishful thinking on the part of the global institutions. However, watching more closely, signs of recovery in emerging markets need to be taken with caution. In fact, Argentina's economy is projected to contract again in 2020, although less than this year; and in Venezuela, the multiyear collapse in output is projected to continue. Turkey's economy might take a hit from the reckless foreign strategy undertaken by President Erdogan. Trump has openly threatened Ankara that he will get the Turkish economy's tail spinning if Erdogan continues Turkey's aggressive military invasion of Syria. After a promising start reforming the economy, India's prime minister, Narendra Modi, has turned to oppressing his country's Muslim minority, slowing down the modernization of his country.

Trade disputes are not going away and they are not even the most critical issue

Policy mistakes of the kind described above, though huge, may be dependent on the peculiar political personalities who have emerged in this historical period, accompanied everywhere by a deep disconnection between national rhetoric and global reality.

However, a real structural and disruptive change comes from what appears to be much unlike a mistake and more of a long-range, deeply thought-out strategy designed by President Xi Jinping of China. By virtue of both its fast industrialization and its protectionist policies, China has long been treated by the West as a trade threat, but trade is only part of the bigger picture.

Trade negotiations, either confrontational or concessive, have been the cornerstone of the relations between the West and China for the last few years. The effects of escalating tariffs and weakening external demand have exacerbated the slowdown in China associated with the regulatory strengthening needed to rein in the accumulation of debt. With policy stimulus expected to continue, supporting activity in the face of the adverse external shock, growth is forecast at 6.1 percent in 2019 and 5.8 percent in 2020, but medium-term growth is expected to be even lower.

Although the perspective of lower contribution to the global economy is bad enough, a much more disquieting perspective for the West derives from the "Made in China 2025" economic manifesto, issued by the Chinese government four years ago. The manifesto puts in writing China's plans to attain a leadership position in key new sectors, including robotics, pharmaceuticals and aerospace. The notion of China using its state power to take on important American and European industries instead of pursuing market reforms set off alarm bells across the Western political spectrum, but mostly provided only an underpinning for Mr. Trump's trade confrontation. On his part, as noted recently by the New York Times, Mr. Xi, rather than acknowledging China's protectionist practices, has proved unwilling to accept a new trade agreement with effective enforcement provisions. That has raised concerns about what instruments, other than trade barriers, the West can deploy to contain Chinese technology leadership in the coming future.

China is changing the way its economy works. From an exclusively export-led economy, it is turning into a more balanced economy with a mix of drivers. Overall, economic growth will probably slow down significantly in the coming decade. In the medium-term perspective, China will not be too concerned about turning into a relatively less open economy focused on the quality of its in-house technology. A relevant move by Beijing was the demand for loyalty from foreigners doing business with China. This attitude can turn into a significant political factor, fragmenting the spreading of technology from Asia to the US or vice versa.

In fact, as the IMF highlights, tensions in trade and technology linkages have been increasing since the beginning of the trade dispute. Markets are concerned by the extension of US tariffs to all imports from China and the restrictions placed by the United States on commerce with Chinese technology companies. If tensions in these areas were to intensify, the harm caused to investment would deepen and possibly lead to the dislocation of global supply chains as well as to reduced technology spillovers, thus damaging productivity and output growth in the medium term. The latest data on input-output linkages point to ever more interrelated technology, including the US technology sector's increasing dependence on value added imports from Chinese producers. In the event the global trade system is endangered and the circulation of technology restricted, Europe may emerge as the weaker link in the global chain.

The European Union is one of the most outward-oriented economies in the world. It is also the world's largest single market area. Free trade among its members was one of the EU's founding principles, and the EU is committed to opening up world trade as well. From 1999 to 2010, the EU's foreign trade doubled and it now accounts for over 30% of the EU's gross domestic product (GDP). Germany in particular has an even higher export-to-GDP ratio, close to 50%. It is no surprise that the manufacturing industry in Germany is nosediving and the whole euro-area economy is suffering.

Europe suffers in a less friendly global context

Europe is used to emerging from cycles of weak economic growth generating surpluses in its balance of payments. The new global trade tensions may prove that this conventional strategy is more difficult given the potential reactions to a higher trade deficit by the American Administration. The euro area in particular should consider the extent to which its monetary and fiscal policies can still be used to provide support to the economy.

The reasons for a rethinking of the euro area's economic governance are grounded in the aforementioned political developments in the US and China, developments that could change the incentives for preserving the current mentality of the euro area as an open market economy driven by its exports to the world. Once the external drivers of European growth become shaky, it then becomes clear that resorting to traditional economic policies (monetary policy and fiscal policy) is not easy because their margins have already been exhausted. If so, new strategies must be designed or new resources may need to be created internally, either via a non-conventional monetary policy (helicopter money) or a non-conventional fiscal policy (investment plans funded through new debt). Given these extreme alternatives, we will conclude by considering as more likely a transitional change led by the German government.

The consequences for Europe of a less benign global context are significant. In the euro area, weaker growth in foreign demand and a drawdown of inventories, reflecting weak industrial production, have kept a lid on growth since mid-2018. Activity will grow in 2020 only if external demand regains some momentum and temporary factors fade. Overall, Europe seems vulnerable to a number of external factors that lie outside its control. If trade tensions fail to dissipate or weakness persists in the stressed and underperforming economies, Europe might even see growth rates get close to zero without having the traditional policy instruments to help it get back up again. If trade controversies persist and if either the US or China become more closed, not only via trade barriers but for technological protectionism, then Europe will need to change its traditional export-led economic model. In this sense, Europe should learn to stand on its own two feet.

As already said, the fact that external impulses to achieve growth may be withering calls into question the margins left to Europe for stimulant monetary and fiscal policies. First of all, monetary policy reached its limit trying to draw the economy away from the worst financial crisis in living memory. Since the crisis monetary innovations – forward guidance on policy interest rates, quantitative and credit easing plus the introduction of negative interest rates – pushed short-term policy rates and long-term bond yields to unprecedented lows, underpinning the expansion. Policy rates, now historically low, are expected to remain at their current level. Central banks now have a wider array of tried-and-tested tools at their disposal to fight slowdowns, as well as tools that have been vetted internally but not yet introduced. Yet, bringing inflation back to target in a sustainable way is still proving challenging.

In response to heightened trade tensions and macro uncertainty, central banks have pivoted towards lower rates and more stimulus, eroding the limited policy remaining even before the next downturn strikes. In the euro zone, this means the ECB is poised to go even more negative. In September, the ECB announced a fresh stimulus package and cut the deposit rate by a further 10 basis points. Among the serious controversies, the ECB board also announced the relaunch of Quantitative Easing. The political controversies caused by very low interest rates make it hardly imaginable that the euro area's monetary policy can get more supportive than it already is.

Fiscal policy should then play a greater role, but in order for it to be effective it may need to be organized in a credible framework that is different from the one currently in place, mainly inspired by the political priority of monitoring fiscally profligate countries.

The current low-rate environment – with nominal interest rates lower than nominal growth rates - creates larger fiscal space, automatically reducing the level of debts on GDP. The euro area as a whole could exploit the new fiscal margins. However, the trust factor intrinsic to euro-area governance prevents the asymmetric initiatives of expansive fiscal policies: countries with larger fiscal space are those more suspicious of higher debts. They are also unwilling to justify other countries doing the same, claiming that otherwise, if fiscal discipline was applied to indebted countries only, the latter would be put at a political disadvantage. The current economic governance generates a typical European coordination problem favoring fiscal restraint to fiscal expansion. The lack of a euro-area budget turns the coordination flaws even more into a collective action dilemma.

Traditional arguments are used against a generalized fiscal expansion. In fact, more fiscally conservative countries claim that with global debt being at record levels, major fiscal stimulus could stoke expectations of future fiscal consolidation, undercutting and perhaps even eliminating its stimulant boost. However, interest rates could increase, responding to an expansive fiscal policy and eventually meeting the demand for the higher yield that Germany is calling for. The combination of fiscal expansion and higher interest rates would generate the ideal combination for Germany's political interests.

A likely change in Germany's fiscal stance

Berlin is well aware that the euro area is not in a condition to withstand a new major crisis. There is also a clear understanding that the original framework for economic governance is not valid in an environment where monetary policy has reached the "zero lower bound". Originally, the concept behind the euro area's economic governance was to leave national fiscal policies to operate within given limits, hoping that the sum of those national policies could approximate a reasonably appropriate fiscal stance for the euro area as a whole, in accordance with the cyclical situation. If major non-cyclical events occurred, it would be up to the monetary policy to do the heavy lifting. Now that monetary policy has no margins left, other solutions need to be designed.

In the past years, France's President Macron suggested creating a large euro-area budget that could be tapped in case stabilization was needed. In fact, the option was dismissed because the budget would have needed to be exceptionally big if variations at its margins were to have stabilizing effects on the economic cycle. More recently, a tiny budget has been created aimed at spurring convergence. However, its size and features are inconsistent with the needed stabilization function for the euro area.

Against this backdrop, a first likely solution would be the creation of a reinsurance system for national unemployment insurance schemes. This scheme would amount to a transfer of resources to slower growing economies from stronger ones. This solution is considered politically feasible and was already agreed upon and included in the so-called "Meseberg agreements" between France and Germany.

A second initiative would be the use of automatic stabilizers to their full extent. This would imply the removal of the "Schwarze Null", the German objective for its budgetary policy. Fiscal policy in Germany is constrained by two institutional arrangements in addition to the European rules included in the Stability and Growth Pact. The first, "Schwarze Null", prescribes that the federal budget should post a surplus every year. The second, the "Schuldenbremse", dictates that the budget of the Länder should post no structural deficit (subtracting the cyclical factors) and that the federal structural deficit should not exceed 0.35% of GDP. While the latter is a constitutional rule that might be hard to get around, the

Schwarze Null might be changed or abandoned in the coming months, probably at the beginning of 2020.

The gap between the two rules would allow for some additional stimulus. However, it would not be large enough to provide for sufficient fiscal impulse in case of a prolonged economic stagnation or even a mild recession. Consequently, a more ambitious fiscal rule should be introduced at German level first and subsequently at the euro-area level. This would be the famous "Golden Rule" allowing the fiscal deficit to expand beyond the structural limit to make room for new investments that would not be considered as part of the current deficit. According to the first considerations made in Berlin, a golden rule would create space for debt-financed public investments amounting to one percentage point of GDP.

The idea in Berlin is that a slightly higher level of public debt in Germany or even in the euro area could be acceptable because it would also bring higher interest rates that are craved by the German public. A higher level of interest rates is also desperately called for by the German banking and insurance systems. A debt increase enacted through the Golden Rule would also be expected to bring higher investments that could relaunch growth and thus bring the debt-to-GDP ratio back into balance.