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The fiscal stimulus that is not: why there is no fiscal expansion in sight for the eurozone

Lorenzo Codogno

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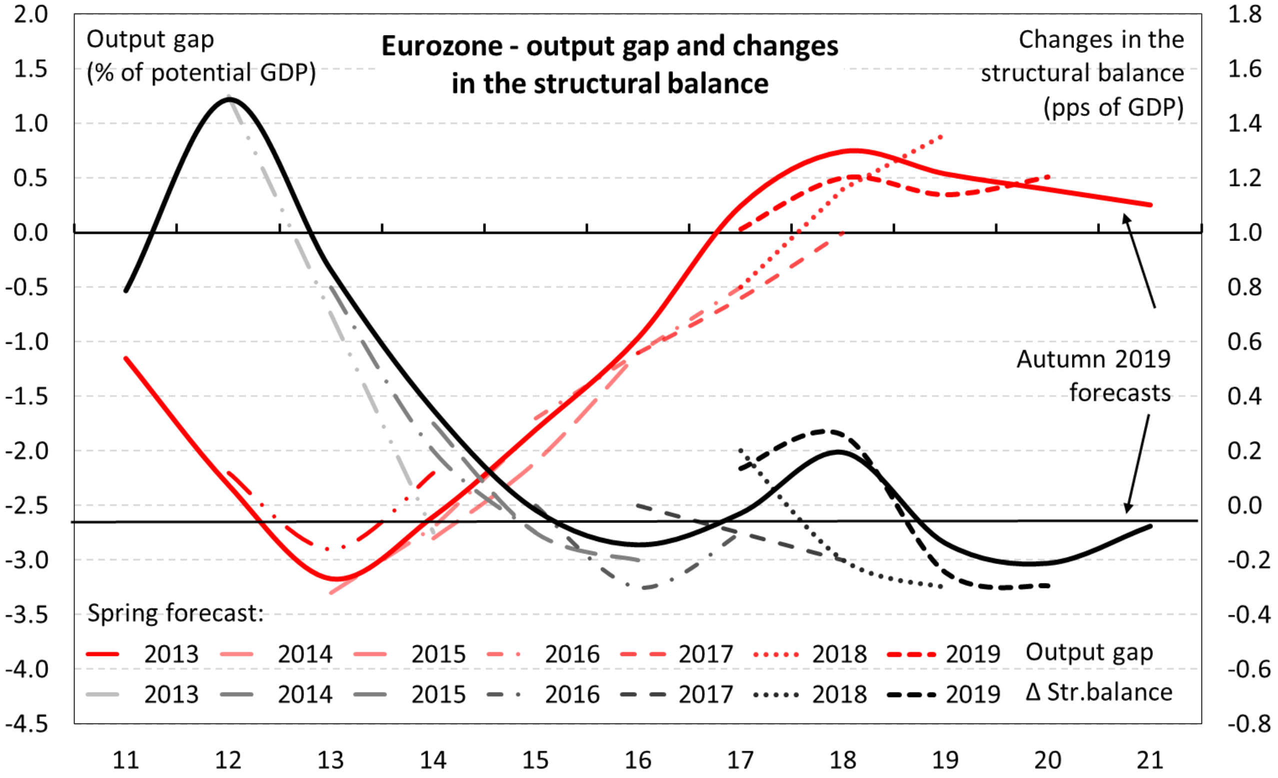
- Constrained monetary policy requires fiscal policy to play a greater role in supporting the Eurozone economy, as former ECB President Mario Draghi recently suggested. Yet, among the three potential routes that could be taken in this regard, none seem destined to be implemented.
- Leaving aside structural issues, which may well prolong current economic weaknesses into the medium term, the current policy mix will most likely withdraw oxygen from the Eurozone's already suffocated aggregate demand.

Euroland or Neverland?

As in Peter Pan's fictional island of Neverland, people in Euroland refuse to grow up and face reality. The "never-never" refers to the idea of a countercyclical fiscal stimulus, which still faces massive opposition in European capitals. To put things straight, in normal times fiscal policy should focus on enhancing potential growth rather than trying to micromanage the economic cycle. However, today's times are anything but normal. Interest rates up to long-term maturities are in negative territory, and the ECB has restarted quantitative easing.

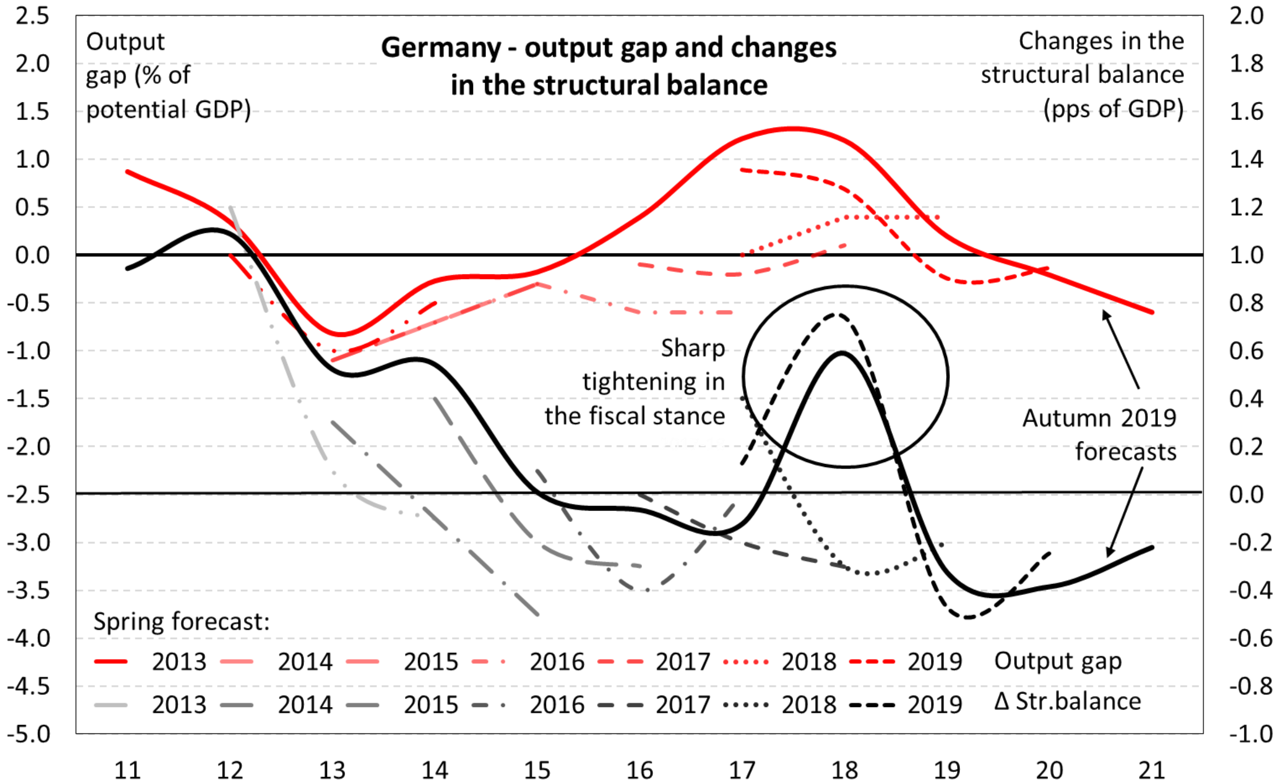
Lorenzo Codogno is Visiting Professor in Practice at the LSE's European Institute and founder and chief economist of his own consulting vehicle, Lorenzo Codogno Macro Advisors Ltd. Prior to joining LSE, he was chief economist and director general at the Treasury Department of the Italian Ministry of Economy and Finance (May 2006-February 2015). Throughout this period, he was head of the Italian delegation at the Economic Policy Committee of the European Union, which he chaired from Jan 2010 to Dec 2011, thus attending Ecofin/Eurogroup meetings with Ministers. He joined the Ministry from Bank of America where he had worked over the previous 11 years. He was managing director, senior economist and co-head of European Economics based in London. Before that, he worked at the research department of Unicredit in Milan.

Figure 1 and 2: Commission Autumn forecasts: the Eurozone fiscal stance



Source: European Commission, AMECO, Thomson Reuters Datastream, own calculations.

Figure 2: Commission Autumn forecasts: the German fiscal stance



Source: European Commission, AMECO, Thomson Reuters Datastream, own calculations.

The only chance to gradually 'normalise' its current policies, bring interest rates back into positive territory and allow proper monetary transmission through the banking channel, without the risk of hindering the ability of banks to expand credit, is through support to aggregate demand from the fiscal side. Besides some official statements and some still very tentative announcements, the impression is that of a deadlock. European countries seem unable to build any form of consensus in favour of the view that fiscal stabilisation is a collective responsibility within the Eurozone.

The controversial decision of the Governing Council of the European Central Bank to introduce another package of easing measures on 12 September generated substantial debate. The recent plea to use fiscal policy by ECB President Mario Draghi was not well received by certain observers in many European capitals. For instance, six prominent former central bankers published a memorandum criticising ECB monetary policies, saying they have been unsuccessful, intended probably to bankroll indebted governments. They said:

"There is broad consensus that, after years of quantitative easing, continued securities purchases by the ECB will hardly yield any positive effects on growth. This makes it difficult to understand the monetary policy logic of resuming net asset purchases. In contrast, the suspicion that behind this measure lies an intent to protect heavily indebted governments from a rise in interest rates is becoming increasingly well-founded. From an economic point of view, the ECB has already entered the territory of monetary financing of government spending, which is strictly prohibited by the Treaty."

On 7 November, the European Commission published its Autumn Forecasts, which do not show any significant fiscal expansion. The Commission fully backs the call for fiscal expansion, but it is somewhat constrained in what it can suggest in its report. Please note that the European Commission is better positioned than any other observer/institution to assess the policy stance of European countries and the stance for the Eurozone overall. In fact, Commission staff look at all the Draft Budgetary Plans submitted by all the EU/Eurozone countries, they discuss them with governments and national officials, and finally, they provide comprehensive estimates.

Figure 1 presents the Commission forecasts on the Eurozone output gap and the change in the structural balance (a proxy for the overall Eurozone fiscal stance) published on 7 November. It is interesting to look at the vintage of the forecasts. Despite having such privileged inside information on fiscal policies, since 2017 the Commission has consistently shown an expansionary bias in its projections. In other words, over the past three years, fiscal policy has turned out to be much tighter than what the Commission had projected. This is especially true for Germany (Figure 2).

First option: moral suasion, i.e. policy coordination

First, without changing the existing Treaties or any substantial variation in the current policy framework, the Commission, with the support of European leaders, could try to achieve a better policy mix through policy coordination. This would imply exploiting all possible fiscal space currently available at the national level and using the maximum flexibility allowed by the rules.

Given that Germany is de-facto the only big country with fiscal space, this would inevitably put any such initiative on a collision course with the country's internal debt brake policy, the ***Schuldenbremse***, and budget policy, the ***Schwarze Null***. More likely, Germany, the Netherlands, and possibly others will introduce separate policy initiatives to make room for additional fiscal expansion, such as funds dedicated to infrastructure or green investment, instead of going for outright fiscal expansion. At any rate, it is not even clear whether moving within the boundaries of existing rules would provide a material contribution to the policy mix in the Eurozone as the potential leeway is limited.

In Germany, there have been calls for the introduction of a fund supporting investments related to climate policies, mainly supported by the Green party, or alternative requests for investing in softening the impact of the ageing population (***Deutchlandsfonds***). At the present moment, this does not appear to have led to any concrete policy action. Moreover, the ***Klimapaket***, a broad-based policy package announced after the summer, introduced a number of environmental initiatives, but no significant new funds have substituted the old climate fund ('EKF' established in 2010) that contained €4.5bn (about 0.1% of German GDP) at the end of 2018, a fund that will be used for the financing of some of the measures in the package.

In September 2019, Dutch King Willem-Alexander confirmed in a speech to both Houses of Parliament that the government would set up a national investment fund early in 2020. The fund will aim to help the economy expand in a sustainable way for the next 20-30 years by strengthening the country's earning capacity, focusing investments on specific projects meeting tightly formulated criteria in the sphere of knowledge development, innovation and infrastructure. Finance Minister Hoekstra said that the fund might involve "tens of billions of euros over the longer term" and press releases later suggested about €50 billion. Projects for this "future fund" will be detailed in early 2020. Both projects are potentially positive developments for addressing supply-side challenges, but they are unlikely to provide any meaningful support to aggregate Eurozone demand.

The so-called Budgetary Instruments for Convergence and Competitiveness (BICC), which recently got the green light from Ecofin, are not a solution. The instrument will support both structural reforms and public investment in the form of grants, i.e. direct financial contributions, with funds taken from the Multiannual Financial Framework, which is not truly a European budget. European funds will require a minimum national co-financing rate set at 25% of the total cost of the investment. The allocation of funds within the EU budget is supposed to be only about 0.1% of GDP. BICC will become useful devices for structural reforms and investments, but they are a false dawn for Eurozone fiscal capacity or fiscal expansion, as they are not designed to play any role as countercyclical tools.

Second option: a suspension of the rules

European leaders and the Commission could agree on a suspension of the rules. The existing Regulation provides for a possible "waiver" from any adjustment in case of an "unusual event outside the control of member States [...] which has a major impact on the financial position of the general government or in periods of severe economic downturn for the euro area or the Union as a whole".

This is a sort of nuclear option, which could be activated only in extreme situations. It would probably take another severe recession or a substantial external shock (US trade sanctions?) to move in that direction. In any case, there would be no guarantee that the Member States faced with the opportunity to go for fiscal expansion would take advantage of that possibility, as the trade-off between stabilisation policies and debt sustainability (correctly so) would become an important issue, especially in high-debt countries (Italy).

Third option: truly centralised fiscal capacity

Finally, Eurozone leaders may decide to introduce a Euro-wide central fiscal capacity, together with a safe asset, to allow the economic area to activate counter-cyclical policies and alleviate the zero-lower bound constraints on monetary policy. This would be the most controversial and politically difficult move. It could only be achieved as part of a grand bargaining that makes a significant step towards economic and fiscal integration. Building up any form of fiscal capacity remains the most controversial step. For now, it is only part of a big dream book.

The bottom line is that no fiscal expansion appears to be in sight. Despite the call by many economists and the backing of the Commission and the European Central Bank, European leaders are not going to take any of the above-mentioned routes that may lead to a more accommodative fiscal stance in the Eurozone. Leaving aside structural issues, which may well prolong the current economic weakness into the medium term, the policy mix is also a negative that will most likely contribute to withdrawing oxygen from the Eurozone economy over the near term.