Euro area: How much fiscal boost can we expect?

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- EMU fiscal policy is in the focus due to weak activity and with the ECB reaching its limits. 2020 budget plans point to a fiscal impulse of 0.3 pp of GDP with Germany (2/3), the Netherlands (~20%), and Italy (~10%) the major contributors.
- In case of an adverse scenario, under the Fiscal Compact there is a potential for a further fiscal impulse of 0.8% of GDP in 2020 and the frameworks offers additional flexibility, e.g. in case of a sharp slowdown.
- For an effective policy impulse, core countries, especially Germany, have to take the lead. A strong and sustained increase in German public investment would have beneficial spillover to the rest of the euro area, especially if the ECB policy rate is kept low, as we expect. However, the German government is likely to wait if the situation deteriorates further.
- The potential fiscal backstop will be reassuring to financial markets thereby supporting risky assets while working against a new fall in government bond yields.

Over the course of 2019 the euro area economic situation has deteriorated quite significantly. Quarterly growth has come down below potential and is unlikely to recover soon. The slowdown has been initiated by a global manufacturing weakening. The global manufacturing PMI ex euro area receded from a reading of 51.4 in December to a low of 49.8 in June and was at 50.5 in September. More fundamental factors like the slowing of Chinese growth and the turn of the Asian tech cycle have been exacerbated by the direct as well as indirect effects from the US-Chinese trade war. Also uncertainty related to the Brexit process has been taken its toll. Euro area domestic activity has weathered these headwinds quite well but has recently started to show some cracks. Not only has the domestically-oriented services sector sentiment started to ease but there is also evidence that the buildup of employment has weakened.

Will we see a turn to the better? We think so, but as we discussed in a recent Focal Point the risk of a recession in the euro area has increased, to a 25% probability over the next twelve months. This raises the question about potential policy measures to avoid a recession or, in a worst case, to fight it. In fact, monetary policy has largely exhausted its policy space already. The shadow rate (which accounts also for the effects of unconventional policy measures) is at an all-time low and it is obvious that the ECB will not be able to replicate a stimulus similar to the ones following the GFC or the euro crisis. Moreover, even it were able to do it, it is not sure that this would lead to a rebound in investment, as the sour mood shown by surveys and data on orders is due to political tensions, whereas financing conditions are very loose by historical standards.
Hence, fiscal policy would have to take the lead. Against this backdrop we discuss in this FP the just released 2020 Draft Budgetary Plans (DBPs) of the major euro area economies and explore the potential for additional fiscal action under the conditions of the Stability and Growth Pact (SGP). All in all there is limited scope for some stimulus with would be carried mostly by Germany. This could have meaningful spillovers to the rest of the euro area, provided that there is political will to implement it.

The 2020 Draft Budgetary Plans

On October 15 the EU countries released their DBPs for the year. Notwithstanding a deteriorating growth environment amid lingering risks the key euro area economies did not embark on outright fiscal action but are willing to let their underlying (structural) budget balance slip: Germany still sticks to the idea of an overall balanced budget targeting a surplus of ¾%, down from 1 ½% in 2019. The projected easing is also due to some expansionary measures so that the structural balance will also deteriorate. The German government still sees its debt-to-GDP ratio, that likely fell in 2019 below the 60% threshold for the first time since 2002, receding further to 57 ¾% in 2020. These figures look rather optimistic to us as the assumed 2020 growth rate is at 1.5%. This compares to a consensus expectation of 1.0% to which the government has in the meantime also reduced its expectation and our own forecast of only 0.7%. Hence, we even see the possibility of a small budget deficit.

France projects an improvement of its budget balance, from -3.1% of GDP in 2019 to -2.2% in 2020. However, this largely rests on a reduction in on-off expenses compared to this year. In 2019 the conversion of the Competitiveness and Employment Tax Credit (CICE) into a permanent cut in social security contributions pushed the deficit by 0.8 pp higher. The debt-to-GDP ratio is expected to roughly stay constant (98.7%, from 98.8%). Growth is assumed to be at 1.3% in 2020. This is broadly in line with consensus expectations but below our forecast of 0.9%. The draft budget approved by the Italian government targets a 2.2% deficit to GDP ratio for 2020, in line with the estimated result for 2019. The budget projection is based on a fairly reasonable GDP growth forecast (0.6% against 0.5% expected by the IMF, with which we agree) and hinges on bond yields remaining at the current record low level; Italian long term yields are now projected to average 1.2% in 2020, against the 3.1% expected in Spring.

In the aggregate, the numbers imply that the euro area’s structural balance is expected to ease by 0.3 pp to -1.0%. Stripping out interest payments (i.e. measured by the cyclically adjusted primary balance) this impulse is lower but still at 0.3 pp. All in all, the 2020 budget proposals already imply some kind of fiscal easing on the euro area level.

How much potential for fiscal action?

Looking into next year, a worse than expected macro development would trigger the need for additional support from the fiscal side. A key question also from a financial market perspective is about the remaining fiscal leeway. Within the Fiscal Compact framework there is space for those countries whose structural deficit is below the Minimum Benchmark calculated. It is derived by the European Commission (EC) as the structural balance that is needed in order to comply with the convergence path towards the 60% debt ratio while having a sufficient safety margin to still comply with the 3% deficit criterion. Accordingly, among the eleven largest economies only Germany, the Netherlands, Austria, Ireland and Greece have fiscal leeway in 2020. The potential room for additional measures for the euro area sums up to 0.8 pp based on the DBPs. This is slightly lower than implied by the EC’s spring forecast. Once the EC has assessed the DBPs it will comment on the plans and publish its own country-wise fiscal projections by mid-November. We gauge that the fiscal space might be reduced further.

It has to be kept in mind that in some countries additional national debt brakes might limit fiscal policy action further. In ‘normal’ times, the structural budget deficit shall not exceed 0.35% in Germany and 0.45% in Austria. Currently, Germany exhibits a fiscal buffer that would enable it to even launch a fiscal impulse of about € 70 bn or 2% of nominal GDP under its debt legislation in 2020. That said, in case of unforeseen major events national debt brakes entail flexibility. In Germany, a maximum structural deficit of 1% would then be allowed. Also, the EU fiscal framework still leaves room for further flexibility. Most importantly, this comprises the case of unusual events that are beyond the control of member countries or severe economic downturns and depending on the deterioration of the output gap the fiscal adjustment path is reduced anyway. Also, a higher deficit will be granted in the case of structural reforms and of investment plans albeit there is a cap.
Spillovers make fiscal action more powerful

Bottom line, in a situation of positive but meagre growth that we foresee, the 2020 fiscal leeway is restricted. As a potential 2020 stimulus would largely have to come from Germany, the key question is to what extent other euro area countries would benefit from such unilateral actions. Clearly, this would largely depend on how the stimulus is structured, i.e. tax cuts versus higher expenditures and its mix between government consumption and investment.

In a 2016 paper¹, the EC estimated using its main quantitative model, the impact of a two year long increase of German public investment worth 1% of GDP. Indeed, the EC deems annual public investment of ½ % to 1% of GDP necessary to maintain the quality of transport infrastructure in particular. Assuming no offset from the ECB in the form of higher rates, the bump to GDP would be relevant. In Germany, GDP would be 0.9% higher than without the stimulus and the gradual beneficial impact on potential output would bring the long term impact to 1.2% of GDP. According to the model simulations, the negative impact on Germany’s public finances would be overall manageable; the deficit to GDP ratio would worsen by no more than a half a percentage point and hence still in line with Germany’s national debt brake. The rest of the Eurozone too would also be better off in terms of higher foreign demand. The positive impact on its GDP would peak at around 0.25% of GDP two years after the beginning of the fiscal expansion. Hence, overall euro area growth would be lifted by a significant 0.6%.

How likely is it that Germany finally embarks on fiscal action? For the traditionally very much export-driven German economy the evolution of trade related uncertainties and of the global manufacturing cycle hold the key. Given our below consensus forecast (0.7% vs 1.0% for 2020) for the German economy, we think that the fiscal stimulus discussion within the government will become louder. In case downside risks materialize, the ruling coalition will not want to go to the ballots in 2021 with an economy in recession and fiscal action would then become our base case.

**Overhaul of the fiscal rules ahead?**

As a matter of fact, the ability of a big fiscal push in euro area to a very high degree depends on Germany. However, it cannot be forced to take responsibility for euro area fiscal policy action. This led to frustration in other countries and thoughts to change the fiscal rules. We do not expect action along this line for the nearer future.

First, Germany — and also other Northern European countries — will probably hint at the above mentioned flexibility the current framework offers and reject any change of the legislation. The large and unprecedented lack of consensus on the latest expansionary measures taken by the ECB is a clearer indication that the split between Northern and Southern members is growing again. The lack of mutual trust would be magnified in case of measure requiring core countries to run larger deficits to bail out fiscally constrained partners.

Second, the new President of the European Commission, Ursula Von der Leyen, during her campaign called for a simplification of the Stability and Growth Pact, and for a “golden rule” excluding investment expenditures from the deficit limits. Such a proposal would encounter resistance from more fiscally conservative countries. Moreover the weakness shown by the incoming commission, as the European Parliament blocked the nomination of three commissioners, bodes ill for resolute and quick measures on any front, including the fiscal framework.

Plans for a beefed up common budget are on the table, but their implementation (if any) would take a lot of time. The Budgetary Instrument for Convergence and Competitiveness (BICC), a scheme aimed at co-financing structural reforms and competitiveness-enhancing public investment is being negotiation and should be part of the EU budget by 2021. However, the budgets have not been increased and the funding of the BICC would require derive from a (politically very sensitive) reallocation of resources. Von der Leyen’s idea of a new investment bank with a €1tn budget (around 10% of the euro area GDP) to finance green investment, would be a game changer, but the discussion on that has yet to start.

**Conclusions**

Despite very loose financial conditions, trade frictions are triggering a sharp deceleration in euro area aggregate demand. This increases the risk of a recession next year. The ECB has largely run out of firepower and stemming a recession would be up to fiscal policy. The draft budget plans for 2020 just presented already foresee some loosening. Political frictions within the euro area countries prevent a quick and deep overhaul of existing fiscal rules. Yet, easing by Germany and other euro area countries, potentially coupled with flexibility by the Commission on the budget in more fiscally constrained countries, would provide the resources for a fiscal boost strong enough to prevent a mild downturn from turning into a recession.

Financial markets seem to have grown more confident on the possibility that the euro area cycle is bottoming out and/or on the feasibility of a large enough fiscal help. Since the beginning of September, the yield on the 10 year Bund rebounded from -71 basis points to -40 basis points, mainly due to easing Brexit and trade war fears.

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