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Euro Area Fiscal Policy: The Factual, the Possible and the Surprising*

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With monetary policy now being more constrained, it's a fact that fiscal policy is gradually becoming more expansionary. 2020 should see a bigger fiscal impulse, doubling to ~0.4% of GDP. Most euro area countries will likely contribute, led by Germany. This stimulus could possibly get bigger, but mostly in reaction to weak growth. Depending on the macro-political situation, the fiscal impulse could increase to ~1.5% of GDP, with some relaxation in the budget rules. We regard this as an upper bound for now. A proactive, large boost would surprise us. But we can see how economic weakness eventually 'forces' additional stimulus. We believe that core Europe is getting more open to this scenario. However, we think that policy-makers will mostly react to economic underperformance. Political and policy shifts in Germany at some point, and perhaps also within the European institutions, are the catalysts we're watching to gauge whether fiscal policy shifts a gear or two.

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Summary: How fiscal policy is now and how it could turn out to be

We expect a moderate fiscal impulse in 2020. A weak economic outlook, combined with an already very accommodative monetary stance, calls for extra fiscal stimulus. But, rather than proactive and in one go, we think that any further boost is likely to be reactive and gradual. One of the major constraints is Germany's debt brake, along with the EU fiscal rules and debt sustainability in the periphery. While difficult in the near term, over time a shifting political landscape could make core Europe's fiscal approach more expansionary. Rules for national economies could change and common budgetary tools be finalised.

These are the main implications:

- **A moderate fiscal boost**: The latest budgetary plans show that fiscal policy will likely get more expansionary next year. However, while this should support economic growth to some extent, the size of the boost still looks set to remain moderate and, as such, mostly about cushioning the downside of the global slowdown and trade tensions rather than triggering a significant domestic recovery.

- **Bigger budgetary plans likely in reaction to weak growth**: In Germany and the Netherlands – the euro area economies with the most fiscal space – our expectation for a larger fiscal boost would probably increase if growth was to slow more than we forecast. But, rather than proactive and swift, we believe that any additional stimulus will likely be reactive and gradual, mostly in response to recessionary conditions.

- **Budget rules and workarounds**: Germany's constitution requires a nearly balanced structural budget. A two-thirds majority in both chambers of parliament is needed to change this. Only in the case of a severe recession is a deficit possible, provided there's a binding amortisation plan to reduce the extra borrowing and only with an absolute majority in parliament. Severe recessions do qualify for exceptions also in the context of the EU fiscal rules. For the periphery, debt sustainability is a fiscal constraint.

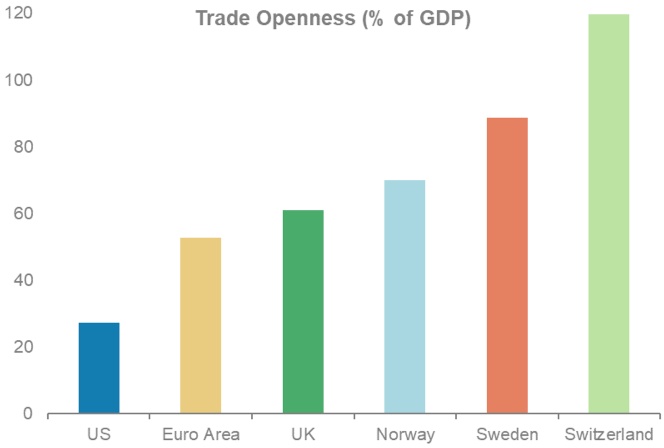
- **Calling on fiscal**: In Germany, the Greens, a pro-fiscal boost party like growing parts of CDU junior coalition partner SPD, are polling well – as in other core countries. A hypothetical election could perhaps deliver a German coalition that's more willing to cut the fiscal surplus and/or revisit the debt brake. And work on an (admittedly rather small and limited) euro area budget is progressing. Over time, it may grow in size and scope.

1. Why policy stimulus is needed

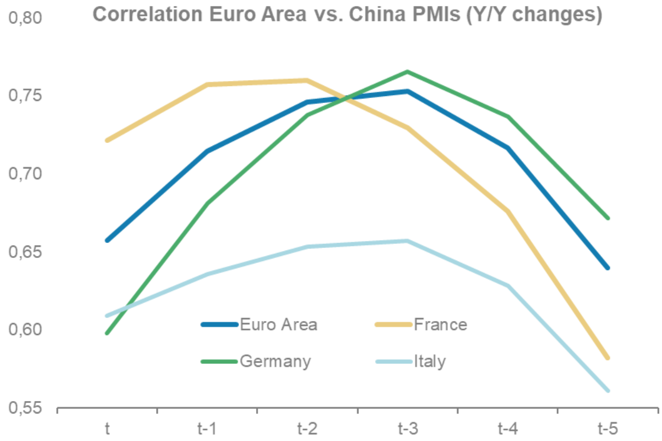
The euro area is a large, open economy. Relative to other economies in its peer group, such as the US, its trade openness is higher. Relative to economies of similar trade openness, such as the UK, it's bigger. So it's more exposed to external shocks, i.e., what happens in the rest of the world matters a great deal, which is why it's been impacted more than other economies from the global slowdown and developments in trade policy.

We don't believe that 'what happens in China stays in China'. To us, either the domestic stimulus works, thus lifting domestic and foreign demand, or it doesn't work. The correlation between changes in China's PMI and the euro area PMI is fairly high – especially with a three-month lag. A pick-up in China/global growth, therefore, would be good news for the euro area. But, conversely, if trade tensions were to slow China's economy further, then the euro area would likely be affected too.

China's cycle and trade tensions matter a great deal for the euro area



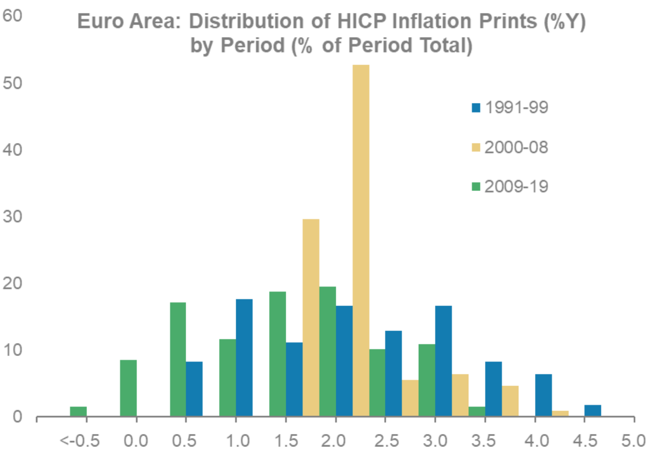
Source: OECD, Morgan Stanley Research estimates;
Note: Exports plus imports.



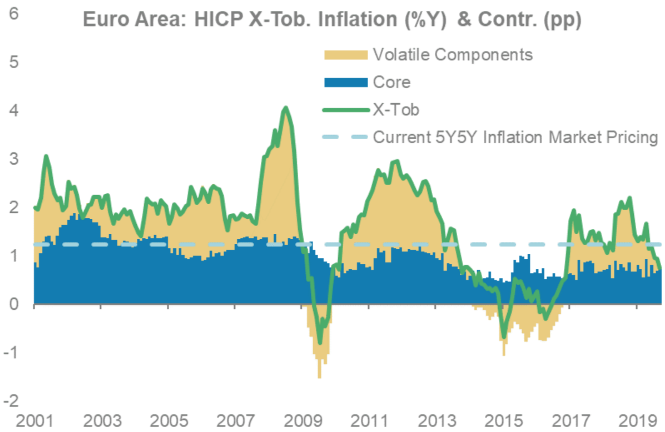
Source: Morgan Stanley Research calculations

In the decade before the global financial crisis, episodes of disinflation or significantly above-target inflation were uncommon in the euro area. HICP printed within 50bp of 2%Y over 80% of the time, never fell below 1.5%Y, and was only rarely >3%Y. That's a big contrast from what we've seen in the years since 2009. The distribution of inflation prints has 'moved to the left' and the average level of HICP is significantly lower. While inflation has been above 3%Y in only two months this decade, it's been below zero more than 10% of the time. We expect core HICP to remain subdued. With growth below trend, we don't see a near-term catalyst for significantly higher underlying inflation.

Post-crisis period skewed towards lower inflation



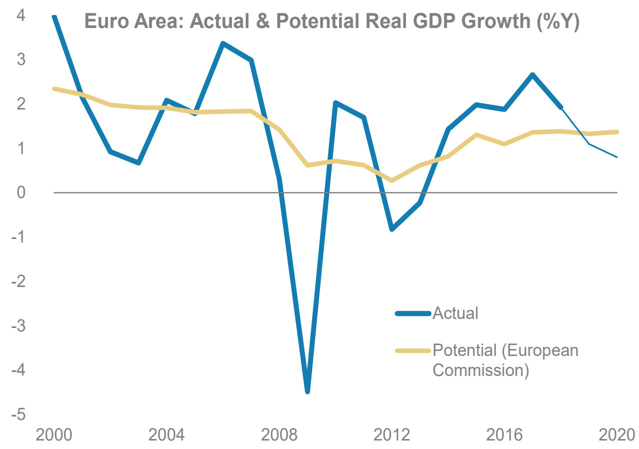
Source: Eurostat, Morgan Stanley Research



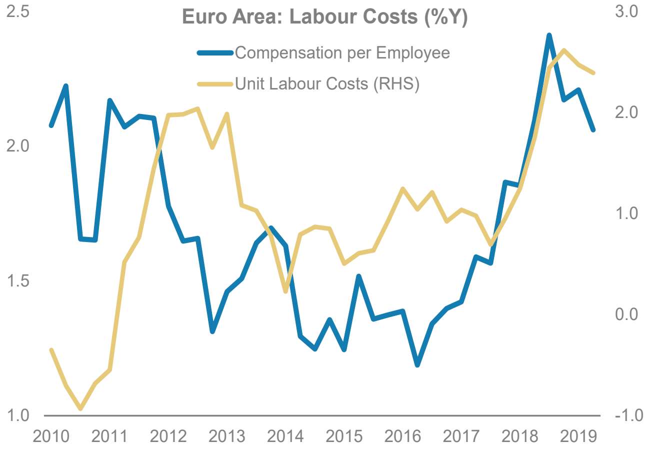
Source: Eurostat, Morgan Stanley Research;
Note: Volatile components = Energy + food.

When the economy was growing above its potential rate, wage inflation started to accelerate, thus squeezing firms' profit margins. If this had continued, they would have had no choice other than to raise prices. In the context of strong demand, the consumer would have been able to withstand the hit to its real purchasing power. But we never got to that point. Now that growth is undershooting its trend pace, it's even less likely that firms raise prices.

Growth below potential, inflationary pressures reduced



Source: Eurostat, European Commission, Morgan Stanley Research; Note: Thin line = Morgan Stanley Research forecast.



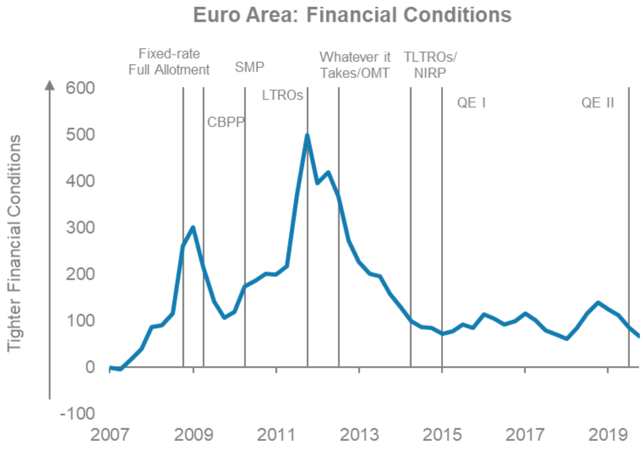
Source: Eurostat, Morgan Stanley Research

2. Pivoting from monetary to fiscal

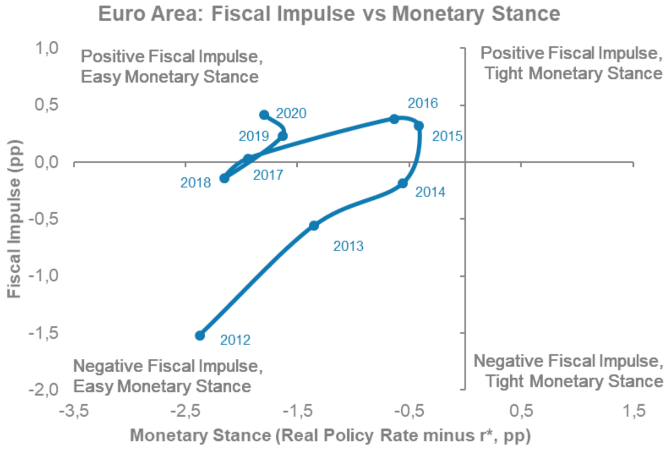
ECB net asset purchases have restarted in November. The central bank has also cut the depo rate by 10bp to -0.50% and introduced a tiering mechanism to mitigate its negative side-effects, a more generous TLTRO bank funding scheme and dovish forward guidance. Because of low inflation, these measures are warranted, in our view.

But we think that monetary policy may be approaching the point where QE becomes less effective – given that financial conditions are already very expansionary. And further rate cuts in negative territory could have bigger side-effects. This backdrop suggests that the policy mix will likely change, with fiscal policy probably playing a bigger role going forward.

The fiscal-monetary policy mix will likely shift over time



Source: ECB, Morgan Stanley Research estimates



Source: National governments, Morgan Stanley Research estimates

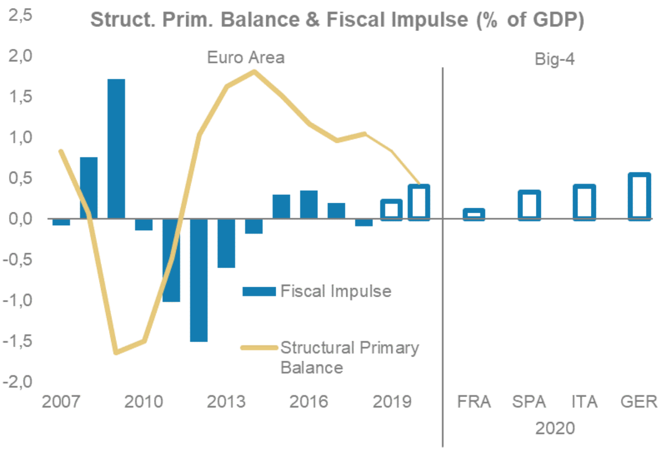
We see three paths:

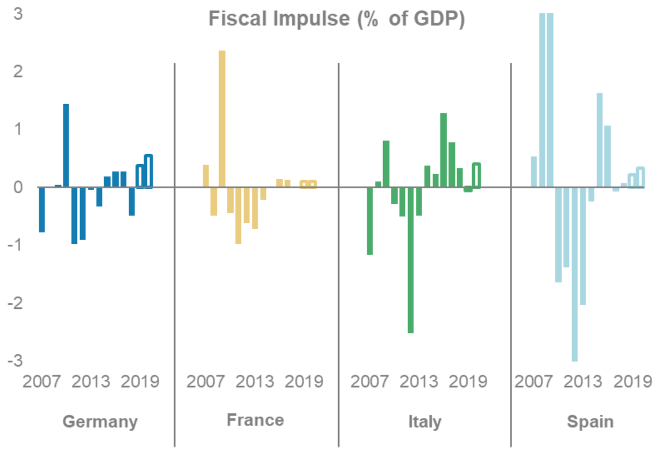
i. The factual

We define fiscal stimulus as the change in the structural primary balance. Imagine that growth slowed further. Governments would collect fewer taxes and pay extra unemployment benefits. The budget would deteriorate. It would be the same if rates started to rise. But that's not really fiscal stimulus. And asset sales (or, equally, acquisitions) have little to do with *discretionary* fiscal policy. So we look at changes in the budget ex interest spending and one-offs, and adjust for the cycle.

This shift from monetary to fiscal policy is already happening. Factually, this year has seen a moderate fiscal boost after a couple of years of just a neutral impulse or even some budget retrenchment. This fiscal impulse is likely to get bigger next year, with all the euro area countries we cover – led by Germany – loosening the belt. Based on the latest draft budgetary plans, we're now projecting a somewhat bigger fiscal stimulus in 2020 (though from a smaller-than-expected one this year). This is positive but, at ~0.4% of GDP, not that large. We believe that risks are skewed towards a bigger stimulus. But, on the whole, fiscal policy is likely to remain reactive to weak growth. Rather than a large, US-style fiscal package in one go, any extra fiscal response in Europe is likely to come in the form of gradual policy measures country by country.

We expect a somewhat bigger fiscal stimulus in 2020 across the largest four economies

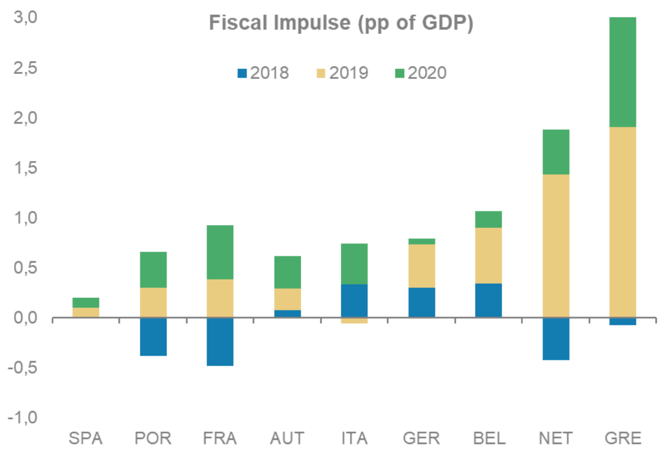




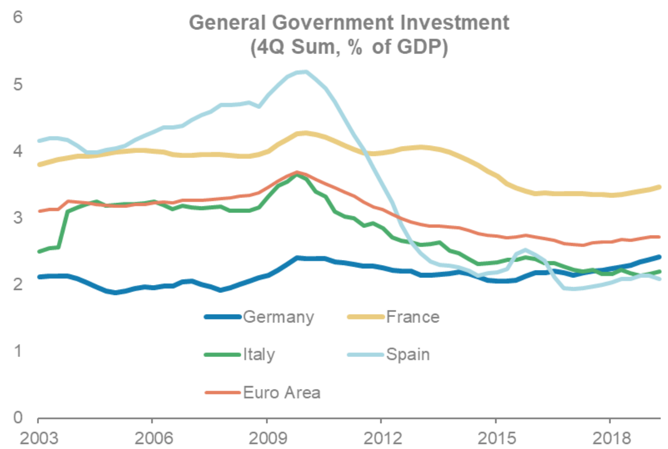
Source: European Commission, Morgan Stanley Research; Note: Empty bars, thin line = Morgan Stanley forecast; Structural primary balance = cyclically adjusted primary balance ex one-offs; Fiscal impulse = change in structural primary balance; +/- = fiscal boost/drag.

Albeit to various degrees, almost every euro area country has eased fiscal policy in 2019, apart from Italy – which still managed to tighten somewhat (though marginally). This reinforces the idea that fiscal policy is gradually turning more supportive of growth. For 2020 we are projecting a somewhat bigger fiscal boost, coming primarily from the core economies – Germany, the Netherlands and Belgium. That governments are no longer tightening the fiscal belt but, rather, are stimulating, is positive from a growth perspective. But we're not seeing much evidence just yet that public investment, which tends to have a large multiplier effect on the economy, is rising.

Some extra spending and tax cuts, but public investment remains low



Source: European Commission, Morgan Stanley Research forecasts



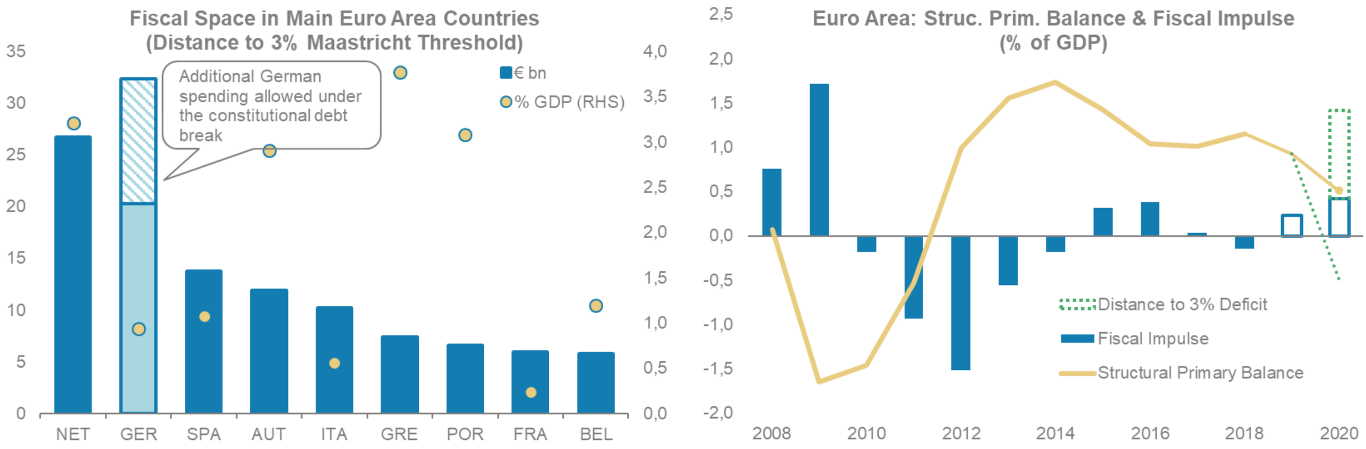
Source: Eurostat, Destatis, Insee, INE, Morgan Stanley Research

ii. The possible

Fiscal space is very unevenly distributed across the euro area. Germany and the Netherlands have the greatest leeway, while most other countries have much more limited room for manoeuvre. Based on the latest draft budgetary plans for 2020, the current and projected fiscal impulse, while getting bigger, is still relatively moderate. However, should the economy continue to underperform, we'd expect Germany to react with a bigger boost over time.

While other constraints do apply in practice, if only the 3% of GDP deficit threshold was applied, perhaps as a temporary relaxation of the rules while the economy is weak, the fiscal boost could rise from 0.4% of GDP currently to ~1.5%. For Germany, which is currently meeting the EU deficit and debt rules, the calculation is based on reducing the surplus to zero plus the maximum spending that would be in line with the debt brake (which allows structural deficits of up to 0.35% of GDP).

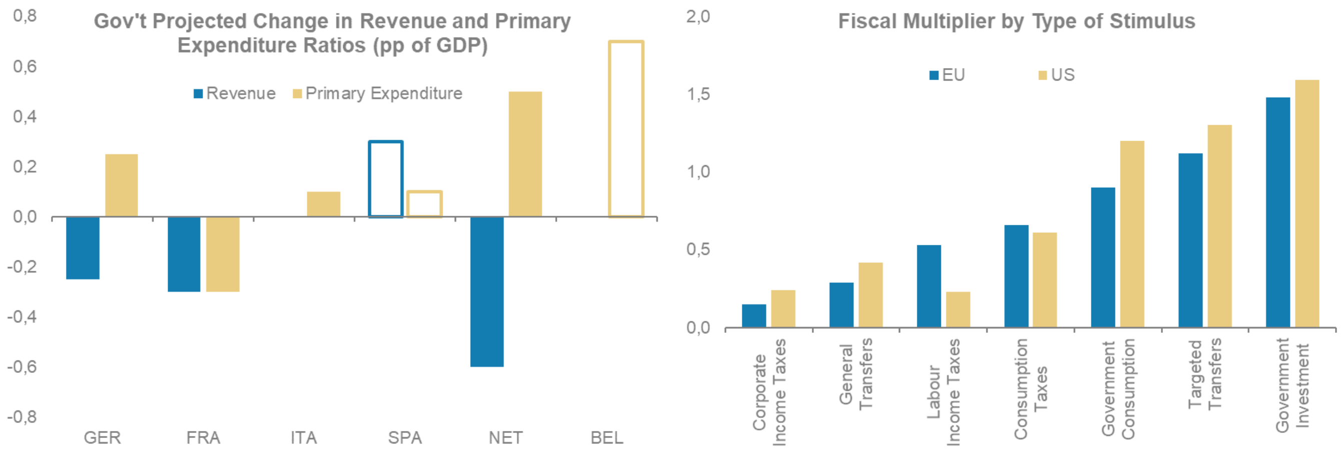
Potential for additional fiscal stimulus



Source: National governments, European Commission, Morgan Stanley Research estimates; Note: For Germany, we use the debt-brake rule, not a deficit of 3% of GDP; Greece's targets are agreed with the official creditors, and currently they demand a 3.5% of GDP primary surplus.

One way to increase the fiscal impact is to shift the *composition* of the budget towards policy actions with higher multiplier effects. Based on their own budgetary plans, most governments expect only small changes in spending and revenue ratios next year, with mainly moderate reductions in tax burdens. Empirical analysis shows that the most productive ways of lifting the economy with fiscal policy are by increasing public investment and, while the impact is somewhat smaller, also targeted transfers and government consumption. Lowering consumption taxes, such as VAT, has a more moderate impact, just like bigger general transfers. Lowering corporate and labour income taxes, while perhaps important to shape investment decisions over the long run, tends to have a more limited impact in the near term.

Little public investment means that the fiscal multiplier is likely to be small



Source: National governments, Morgan Stanley Research; Note: Chart shows 2019 vs. 2020 changes; Given the current political situation in Spain and Belgium, the fiscal trajectory remains unclear, so estimates for these two countries as based on the assumption of no policy change.

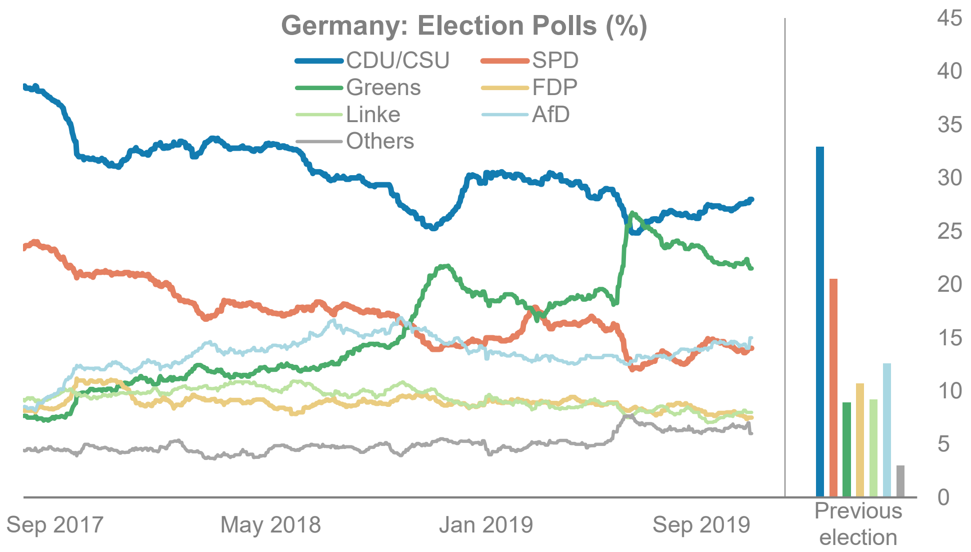
Source: Coenen et al. (2012), Morgan Stanley Research

iii. The surprising

Hypothetically, a different German government possibly including the Greens, which are polling well and have a pro-fiscal boost stance, may result in a larger fiscal impulse. This political shift may perhaps facilitate attempts to modify the German constitution and allow for more flexibility on the debt brake – which requires two-thirds majorities in both chambers of parliament. We could see more flexibility at the EU level too, e.g., with a more coordinated approach and a rethink of some aspects of the EU fiscal rules.

Green parties have recently risen in popularity across the euro area, as illustrated by the polling success of the German Greens, but also in other core countries, such as Belgium and Austria at their respective elections. Like many of their European counterparts, the Greens are generally in favour of more expansionary fiscal policies and tend to be lukewarm towards the current balanced budget policy in Germany. They'd prefer more flexible budget rules. Already part of several state governments, the Greens could become key at the national level if the SPD, hypothetically, decided to quit the coalition at year-end – following upcoming leadership changes. This may result in a more supportive fiscal stance.

The political dimension of budgetary policy



Source: Opinion polls, Morgan Stanley Research

What's more, work on a centralised euro area budget could explore options to increase its size and/or scope. The most basic degree of fiscal integration is one where there's just coordination. That's what we have now. This essentially is a mechanism to restrain fiscal expansions and ensure sound public finances via a variety of fiscal rules the EU countries have committed to. At the other end of the spectrum, there are very ambitious options, such as a complete fiscal union with a euro area finance minister and centralised policy decisions, and/or joint debt issuance via Eurobonds. These options, for now, have failed to materialise.

The intermediate options, such as the idea of pooling funds for, e.g., a common unemployment insurance scheme, require a lesser degree of fiscal integration, and so they're more likely. Work on a 'federal' budget for the euro area is now ongoing, which will likely take a few years. Rather than a macro stabilisation fund, this looks more like a tool to disburse cash-for-reform and co-finance investment. And it will likely be small at first. But, just like the various rescue funds (EFSM, EFSF, ESM) have evolved into something bigger and with extra capabilities, one could envisage the evolution of this tool into some sort of 'European Monetary Fund' over time.

A budget for the euro area?

	Degrees of Fiscal Integration	
Now	**Fiscal Policy Coordination**	Control size of national budget, e.g., 3% deficit limit
Tomorrow	**Common Unemployment Insurance Scheme**	Borrow funds with specific purpose, with repayment obligations
	'Federal' Budget	Joint euro area budget as part of overall EU budget
	'European Monetary Fund'	European rescue fund with macro stabilisation function
	Large Fiscal Capacity & Joint Debt Issuance	Common 'safe asset', e.g., Eurobond
	Complete Fiscal Union	Euro area finance minister to centralise fiscal policy

Source: Morgan Stanley Research

3. Putting it all together

While it's not yet obvious how far the shift from monetary to fiscal will go, we think that it's likely to be facilitated by very favourable borrowing conditions, which allow core European countries to tap the bond markets at negative rates. What's more, we suspect that the recent calls from several ECB speakers for fiscal policy to play a bigger role will likely intensify, especially given that room to ease monetary policy much more, at least in the near term, is limited.

Even though a tiering mechanism is now in place and does allow to mitigate the negative impact of a further small cut or two, we think that scope to reduce the depo rate much further is rather limited. And, even if the central bank was to cut, e.g., a couple of times, we don't envisage much of an impact on the real economy, while possible negative side-effects may increase. While positive for growth and inflation, the effects of QE too will likely be relatively small. That's partly because it's harder to ease financial conditions further, given how expansionary they already are, and partly because the purchases, after all, are quite small.

Whether the fiscal impulse increases significantly will likely depend also on how much pressure for a bigger boost there is. In turn, this is likely to increase in a situation where the economy continues to underperform. Put differently, we think that fiscal policy in the euro area will be reactive to poor economic conditions, rather than proactively preventing the slowdown from getting worse. It's precisely the downward pressure on growth that may make governments more open to considering bigger fiscal packages. Until then, we think that any extra stimulus will continue to come gradually rather than in one go.

About the author

Daniele Antonucci is a Managing Director of Morgan Stanley and Chief Euro Area Economist. Based in London, he is responsible for the region's economic and policy outlook. Daniele is the Firm's ECB watcher and manages a team of economists covering developed and emerging Europe, the Middle East and Africa. Before joining the Firm in 2009 from Merrill Lynch, he worked at Moody's KMV in the United States and at Confindustria, Italy's main business association. Daniele holds a master's degree in economics from Duke University and graduated from the Sapienza University of Rome, having also studied at EHSAL in Brussels.

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