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ON POINT

INTELLIGENTLY DIFFERENT THINKING FROM NATWEST MARKETS

Deep Dive:

Release the pressure: Why Europe's power players must now act to ease fiscal constraints

At September's meeting of the European Central Bank (ECB), the call for more fiscal policy was loud and constant. The word 'fiscal' came up again and again. As central banks across the globe run out of ammunition, we expect fiscal policy to be rolled out, especially in Europe – beginning first in the UK. Germany, the economic benchmark for Europe, is key for this sea change in the global policy framework. We believe that Germany can, and must, do more.

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Key takeaways:

- Germany and the Netherlands hold the key to greater investment and fiscal easing across Europe
- The blocks to greater German fiscal easing can be overcome… some more easily than others
- Conditions are gathering to make fiscal easing across Europe attractive; and even inevitable
- Federal efforts are gathering pace, but are too embryonic to make a decisive difference in 2020

The line between fiscal and monetary policy has always been blurred. In short, fiscal policy is done by the government; monetary policy by central banks. And after nine years of austerity's drag on investment and demand, fiscal policy is finally being eased again. But while the past few months' progress is certainly welcome, it has been modest at best. Much more can – and must – be done. Meanwhile, at the federal level within the euro area, efforts to loosen monetary policy and to provide liquidity are still in their early stages, but they are gathering pace.

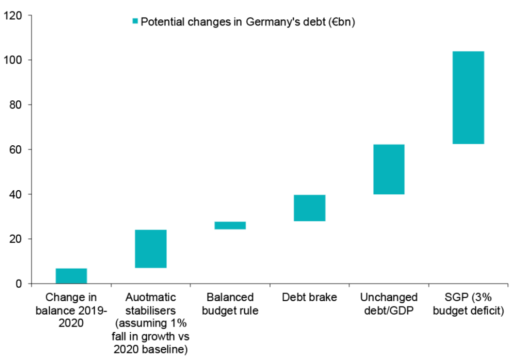
Here we first take a look at why all eyes are on Germany to deliver more fiscal policy, and what that programme might look like. We then shift lenses and ask: how could a Lagarde-led European Central Bank change the status quo?

The question of Germany: They could do a LOT more

Germany has long been seen as resistant to easing. This may partly be a consequence of its own fraught historical relationship with easing and inflation. It is Germany, though, where there is the most fiscal space. But while some easing of fiscal policy has begun, the Germans could do a lot more.

The Germans' famous 'Black Zero' (Schwarze Null) is the clearest manifestation of that. It is the belief and ambition that net borrowing should always be zero. But Germany also has a fiscal rule known as the 'debt brake' written into its constitution, which specifies that the structural deficit should not exceed 0.35% of the previous year's GDP – see chart below.

But just as there is good and bad borrowing, there are good rules and bad rules; and the German debt brake is a bad rule. Fortunately, in the right circumstances, constitutional amendments to reduce its influence (if not to derogate it outright) at last seem possible, and a push in that direction could well gather momentum through 2020.



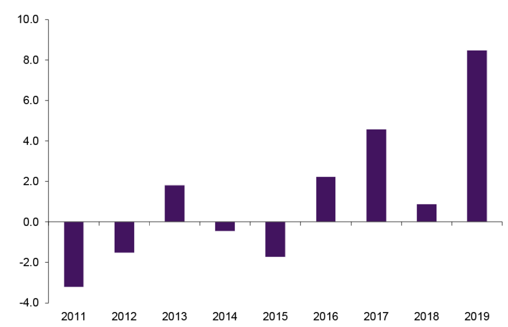
Source: NatWest Markets, European commission

The slowdown in Germany

The slowdown in Germany in particular has given it a fresh set of incentives. The fall in bond yields has also changed the economics: simply, it is now much easier to explain why fiscal expansion makes sense. It is, after all, clear that deficit-financed investment can be expansionary, and can drive long-term debt/GDP ratios down. Indeed, the reports now emerging of a Dutch investment initiative along just these lines should not come as a surprise.

There has been progress. German fiscal policy turned decisively expansive this year, reversing 2018's tightening.

German federal expenditure, cumulative Jan-Jun, % y/y



Source: NatWest Markets, Haver

Some amendments to the German constitution's provision for tax law may be possible. These should add further impetus to investment spending, by granting the Federal government additional powers. These include providing financial support for the investments of different state and local authorities in education infrastructure, social housing, and local public rail transport.

But despite that easing, Germany still has plenty of fiscal room to manoeuvre and the case for fiscal easing is overwhelming. Let's look at the incentives.

The case for German fiscal easing

Most commentary focuses on the case for boosting investment – and indeed, this looks solid. Quite simply, the government's hurdle rate is currently so low that borrowing to invest in nearly any viable project (that is, with an expected real rate of return of more than about -1.5%) should reduce Germany's long-term debt/GDP. And this at a time when political will for increased investment in green policies especially is very strong,

More broadly there is also consensus that Germany has worked up an infrastructure gap in recent years. Elsewhere, strategists are urging preparation for a future in which the world may not want Germany's specialties to quite the same extent. Politicians have previously rationalised Germany's enormous overseas investment (its current account balance is 7% of GDP) on the basis that it is a country "saving for its retirement". A more active policy of investment-at-home should not be politically unpopular.

Investment is hard to rush, but economic slowdown is here.

German 'Spanification'… but without the feet of clay.

Useful comparisons exist between present-day Germany and Spain's position, pre-2008.

Pre-crisis Spain's funding costs were lower than its return on investment (GDP growth). The government ran surpluses, conveying the perception of a restrictive fiscal stance. Yet its fiscal policy was not restrictive; it was loose. This drove Spain into a spiral of growth and investment.

Unlikely though it sounds, Germany's current position is similar. Spending more would have little or no impact on the country's deficit.

But it is also much stronger.

Spain lost competitiveness quickly, and relied on enormous amounts of foreign investment. By contrast, Germany has – so far – largely preserved its competitiveness within Europe, and runs an enormous current account surplus.

Still, Germany can also easily afford to accommodate a downturn via tax cuts and work credits. This has already started, as we have seen in the recent debate on the elimination of the 'solidarity tax'. The sensitivity of public finances to output in Germany suggests that automatic stabilisers may soften a little less than half of an economic shock.

The question is, why be so timid?

Germany can easily afford to do more, and it might find the bill is less than expected anyway. Fiscal multipliers in recession are sometimes estimated to be above one. Where debt is largely held by foreigners, as in Germany, those fiscal multipliers may be greater.

So just how much 'fiscal space' does Germany really have?

The 2020 budget draft now projects a healthy 0.75% of fiscal loosening next year.. This assumes growth returns to 1.5%.

In a slowdown, automatic stabilisers may add to any easing. Beyond that, though, there are two constraints, in the Black Zero and the constitutional debt brake. And while the former may run deeper as credo, the latter is more restrictive, especially in cases of economic slowdown.

The watchword, and the mindset, is prudence. But prudence could still be much more ambitious. Beyond the existing constraints of the Black Zero and debt brake, there may be two alternatives. Namely, a deficit level that would keep debt/GDP unchanged; and the 3% ceiling specified by the Stability and Growth Pact.

Climbing the easing ladder: How quickly, how far?

Let's be clear. Major changes to the 2020 plan are unlikely now – and the larger fiscal stimulus expected in 2020 is mostly a consequence of the non-delivery of the stimulus initially planned for this year. Current plans are reportedly seen to embed sufficient flexibility already. Besides, there probably isn't time for the sense of pressing necessity to develop far enough for further action.

In the short term, then, the likeliest reason for fiscal stimulus is simple automatic stabilisers in a downturn. In a severe downturn, this even might challenge the Black Zero. There are already whispers that it might be dropped if it comes under pressure. In reality, this is something of which one can be reasonably certain.

The debt brake, however, is a different matter. It remains a major constraint. The brake requires a constitutional amendment that would be both much more complicated to breach, and require a two-thirds majority in the both houses of the German parliament.

But a bad rule it remains. And constitutional change is possible.

Indeed, this may be a subject that comes to dominate the year ahead. In the same way that the debt-brake responded to a sense of emergency around public finances in 2009, so it could be revisited in 2020. Clearly to get there would require a significant change of political mood, but there are some early signs of movement in this direction.

Crucially, it is also possible to amend, rather than remove, the debt brake. This would allow scope for certain types of spending or investment.

To get there, though, we may need a combination of circumstances.

1. recession (near),
2. academic consensus (growing),
3. a potential new government (the next elections are in 2021).

This is very unlikely to be a narrative that characterises 2020, in other words; but that does not mean that expectations around this theme won't be seen to drive markets.

All in all, easing could gather incremental momentum; especially if a slowdown puts pressure on the debt brake.

Not Germany alone: Spotlight on the Netherlands

The Netherlands – the other country in the euro area with significant fiscal space – is also accepting the logic of more active fiscal policy.

The Netherlands have also announced a planned 3/4pp easing for 2020. A government investment fund is being studied, that should target up to €50bn (6.5% of GDP).

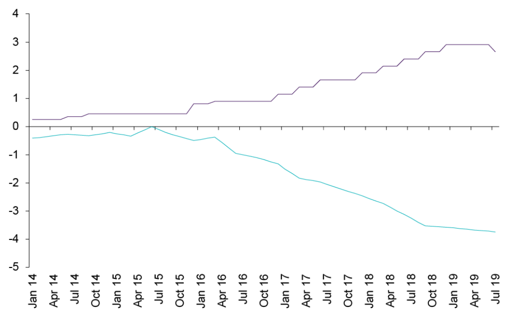
What is not clear at this stage is how the fund might be structured; or the period over which the €50bn figure might apply.

Still, even the existence of such a fund is a clear sign that the logic of investment stimulus is finally gathering the momentum it deserves.

So will Federal Europe step up?

Federal capacity to help is still in its embryonic stages. Still, that capacity is growing fast, and may prove important over time. And as we can see in the chart below, Europe has plenty of fiscal policy space.

US has monetary policy space, Europe has fiscal policy space



Source: NatWest Markets, Bloomberg

The need for a European fiscal capacity has been hotly disputed, with the battle lines drawn broadly along the north/south divide. While it would make economic – and political – sense to build a specific euro-area fiscal capacity of “several points of GDP”, as French President Macron proposed in his Sorbonne speech, euro area members still appear very far from reaching any agreement to bring that prospect closer to reality.

Help is at hand… the BICC

Only one genuine, albeit decaffeinated, fiscal capacity has been agreed so far: the budgetary instrument for “competitiveness and convergence”, or BICC. European governments agreed in June on the creation of this. But the new instrument is a starting point at best. At worst, it may even become a hinderance to any real future progress in fiscal federalism.

…or is it?

But let’s not get too excited. The BICC is small, its purpose is still unclear. Even as a crisis stabilisation tool, the BICC falls short, at least for now.

First, its budget is likely to be small, more in line with Merkel’s “low tens of billions” than with Macron’s “several points of GDP”, i.e. hundreds of billions.

Second, the word “stabilization”, which was included in the Franco-German Meseberg declaration last year (itself already a diluted version of Macron’s vision), was dropped amid protests from the Hanseatic League (a group of eight EU countries, including the Netherlands, Ireland and Sweden, opposed to fiscal federalism).

Furthermore, the BICC itself may have inbuilt resistance to becoming anything more ambitious. There was no clarity on the potential for topping up resources via additional European taxes or contribution at the national level, condemning the new tool to remain small…and as such probably useless in a crisis.

And yet. the fact remains that the BICC is after all a budget that provides grants. It also represents recurring funding, which is better than a one-off “rainy-day fund”, it provides a welcome means for support to come in the form of grants, not loans (as for example ESM support).

The BICC is not the end product, but a starting gun

But the BICC may also be a step to something greater. France, in particular, remains ambitious on its behalf.

In July, France’s Finance Minister Bruno le Maire stuck to the view that the BICC should be seen as a starting point. He stressed that the architecture of the budget is more important than its size at the moment; and that the “stabilisation function” would be revisited, He also said that France would work on finding additional resources.

One has some sympathy with the arguments in favour of a central fiscal capacity with the aim of stabilising significant asymmetric shocks. In a currency area, Member States are deprived from the main traditional tool to cope with a shock: devaluation.

Structural reforms and healthy budgets are essential, but they are not always enough, as Ireland and Spain – both of whom ran substantial budgetary surpluses before the financial crisis – show. As for Banking Union, resistance will be very high and the road to a significant development will be long.

… and not the only idea in town

Still the BICC is not the only initiative out there. Some additional ideas for a stabilisation tool are emerging, giving cause for hope.

Instead of – or in addition to – a generic euro area budget, a specific euro-area ‘unemployment re-insurance scheme’ would be a sensible tool. It would help members dealing with one of the key negative social and political developments of a financial crisis.

Several countries currently support this idea. Interestingly, this has seen it move from being an almost heretical proposal to the centre stage of European politics in just a few months. Indeed, it was part of the programme proposed by of Ursula von der Leyen, the new president of the European Commission.

We should expect more on this front in the coming months. Von der Leyen also proposed new green funds, including turning part of EIB into a ‘climate bank’ to unlock €1trillion of investment over 10 years. There are also whispers of a substantial tech investment vehicle.

But Von der Leyen is not the only high-profile appointee to whom eyes are looking as a possible trigger for advances at the euro area fiscal level.

What will a Largarde-led ECB look like?

The European Central Bank president looks set to herald a change in outlook. A Christine Lagarde-led ECB is expected to be far more active in encouraging fiscal, and quasi-fiscal efforts to boost investment at the national and euro-area level. We believe that Largarde is well-positioned to coordinate collaborative fiscal policy successfully, and that this will be a key objective for her in this new role.

Support green investment

Outside of bringing everyone together, we expect Lagarde's second option to be focussed on the ECB supporting the stimulation of green investment. The ECB would have difficulty targeting purely government-sponsored investment schemes. But supranationally led schemes, and the credit it crowds in, may be possible for the ECB to target, both directly (EIB) and indirectly (CSPP).

So what does that mean for the future? For one thing, ECB support for Ursula von der Leyen's quasi-fiscal investment schemes and green investment funds may well become a feature of policy.

Green bond investment may gain increased traction too. In Lagarde's written answers to European Parliament questions, she speaks openly of the 'priority' need to investigate ways in which central banks can contribute to mitigating climate change. She also says that that this includes such essential background work as simply how to classify bonds as 'green'.

And when all else fails? Implicit helicopter money

Quantitative easing (QE) which essentially means increasing the supply of money into the economy, still has some headroom. And this is is another tool in the box for a Lagarde-led ECB. This is especially the case if some of the self-imposed asset-buying limitations are removed. But clearly the ability of the ECB to act independently from other policies – notably fiscal policy – is increasingly in question.

In addition to QE, which already incorporates quasi-fiscal elements, there are other ways through which central banks could provide support to fiscal authorities.

The ECB is highly unlikely to engage in any unconventional measures to stimulate the economy (such as a monetised tax rebate). But as Angela Merkel would say, when there is a will there is a way. Governments and the ECB could act independently, though each with a mutual understanding of what the other would do, given the state of the economy.

The challenges of low inflation and finishing departing ECB president Mario Draghi's job of 'saving the euro' may force Christine Lagarde to reflect on those differences between fiscal and monetary policy.

It will also take all of her skills as a political mediator, crisis manager, and effective communicator to steer the euro area boat towards a proper policy mix. And despite all the improvements since the crisis, this is a policy mix that still needs a significant amount of work.

Is this the end of the way it's always been?

Whatever comes next, it seems pretty clear that change is in the air.

It may be that Germany is at a turning point in terms of its fiscal policy and its relationship with the Black Zero, constitutional change and all; or it may just be a small modulation. Macron's ambitions for far more ambitious federal firepower might be the start of a concerted long-term effort; or they might be words. Will the ECB lead, or follow? New European Central Bank president Christine Lagarde may prove to be the right person at the right time to involve the ECB in a push to make sure these federal fiscal efforts are as effective as possible.

But whatever else is in doubt, the mood music is certainly turning from austerity to investment across Europe. Fiscal relaxation, if not immediate or far-reaching loosening and revision, is in the air already. Will that be enough to head off the expected bumps? Only time – and policymakers – will tell.

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