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Fiscal policy in Europe: An unloaded weapon?

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At the end, under the pressure of stock markets "thirsty of good news" (Solow), leading world governments have resorted to big fiscal plans to take their countries and the world economy out of the muddle. There is in fact large agreement among operators and economists that the persistent pessimism of stock markets is now mainly dictated by awful perspectives of the real economy. And there are very good reasons indeed for pessimism; for there is no bail-out programme of any sort that can create prospects of prosperity for banks or businesses as long as their final clients have no such prospects.

For those who also like to keep track of economic thinking *vis-à-vis* the evolution of the crisis, it may be interesting to note that this request for active fiscal policy is nothing but another step into the Keynes-Minsky view that this crisis is resurrecting. Following over-investment and over-leveraging with asset price bubbles, the bubbles burst, sharp deleveraging and debt deflation, and liquidity entrapment of intermediaries, the last-resort weapon is fiscal policy. The aim of which is twofold. First, stop the Keynesian de-multiplicative process. Second, recreate sales and profit prospects in the business sector in such a way that outstanding debt-backed positions turn out to be sustainable. Since failure on this grounds means that some amount of production capacity (physical and human) is destroyed, the issue at stake is not routine *cyclical* stabilization around a given "potential output", but *structural* stabilization *of* "potential output".

What even old-fashioned Keynesians have learned is that success of fiscal policy cannot be taken for granted. It is of course first of all a matter of entity. This should be neither too small nor too large. In either case, a waste of resources would result, with no tangible effet on the economy (if fiscal stimulus is too little) or possibily negative medium-term effects (if it is too much). The Paulson Plan amounted to $700 bn. Latest news say that Obama's plan (which sours day after day) may add $500 bn. If taken together, they will reach about 8.6% of GDP. The EU package agreed upon under the Sarkozy-Merkel initiative and the Commission (the so-called "European Economic Recovery Plan" (ERP, like the Marshall Plan!), http://ec.europa.eu/economy_finance/publications/publication13504_en.pdf) indicates about Î200 bn (1.5% of GDP of EU27), *mostly to be implemented through national policies*. It should be added that China is undertaking a massive infrastructural plan for about $1500 bn. (7% of GDP).

Figures seem extraordinarily large in the US (and China), not so much in Europe. As to the ERP, announcements sound like those of a national government engaging in a vast fiscal programme. Substance is quite different. In the first place, this is not a coordinated mandatory fiscal plan, but it simply "*proposes* that member states coordinate national budgetary sitmulus packages", giving an aggregate figure and a list of recommeded items. *Proposes* here means that the plan will be submitted to the next meetings of Ecofin and Heads of Governments for their approval, *and* that the implementation of the plan at national levels will be under their total discretion. The problems that will likely surface at that stage will be reconsidered below. Second, the ERP substantially reflects by 85% (Î170 bn) fiscal measures that have already been budgeted by major countries (namely Germany, UK and France) or that are still on paper; the genuine new resources are just the Î30 bn. coming from the EU and the BEI.

Secondly, "micro" quality is as important as "macro" magnitude. However, the "micro" level is probably more difficult to gauge and implement. Recipients of fiscal measures are not passive, in the sense that they can change their economic behaviour as a consequence. Typically, households under financial distress may first of all direct fiscal aids towards saving rather than consumption, which may possibly help restore consumption over the medium run but not immediately. Another example in point is that recapitalization (or nationalization) of banks may be necessary to stabilize the financial system and redirect funds towards final recipients who will eventually spend them, but these actions also freeze a large amount of resources while they have no immediate impact on the real economy. Experience suggests that it is quite hard to take these deep under-the-skin effects of fiscal measures into due account. Yet it seems generally the case that self-

defeating effects of fiscal measures are more likely the more the latter are small, dispersed, and short-lived. On the contrary, fiscal plans commensurate to the gravity of the crisis should be large, concentrated on well-selected targets, and structural (structural does not mean irreversibile, but that recipients should expect them to last as long as necessary to stabilize their medium term budgeting).

Available information does not allow accurate assessment of these issues. Fiscal plans in the US and Europe are similar in that they range from some “micro” interventions directed to specific subjects or sectors (under-capitalized banks, collapsing industrial companies, households under financial distress) to conventional “macro” measures (more investment and social expenditures, less taxes). The Paulson Plan is largely aimed at the banking sector only, hence it has been criticized as not suited to take care of the real economy. Obama and his staff seem better aware of the real issues at stake, and daily news indicate that they are aiming at both the “micro” and the “macro” levels. But stock and goods markets do not yet seem in the mood to bet that these measures will determine the decisive U-turn of the crisis. The ERP has an Obamian flavour in that it recommends that public expenses today should ensure better (not only more) growth tomorrow, and to this effect it indicates hi-tech and green-tech investments. However, the EU national plans not only are rather limited in amount; to date, they are still opaque, and, as is usual the case, sparse and uncoordinated. The possibility that this state of affairs is radically improved by the ERP should not be overstated, as argued below.

Thirdly, the financial side of fiscal policy is another well-known critical element. In this respect, the problem lies not so much in the textbook “crowding-out” of government borrowing to the expense of private investment. That *may* be a relevant problem close to full capacity of the economy. In the downturn of the Keynes-Minsky parable, when private borrowing and lending are frozen, and when the few lenders around are hunting for safe securities, it is not a major problem for Treasuries to sell bonds. As is testified by recent extremely successful, largely overbought, issuances of Italy’s bonds - a sovereign debtor which is not top-ranked. Nonetheless, the spread with the German *bund* remains relatively large, which reminds the Italian government that each borrowed euro increases a huge public debt which sets a tight budget constraint in the future. Hence, the ability of governments to implement large deficit spending for structural stabilization has to take into account not so much the extent of the deficit as the initial debt position.

From this point of view, the US President elect (after an electoral campaign tuned towards fiscal prudency) seems determined to go ahead with a lot of “bening neglect” towards public finances like his predecessor. The problem is whether lenders will keep on sharing that same attitude. US deficit is expected to reach about 5% of GDP in 2008, while public debt is already at its heights (about 70% of GDP, though the same figure was reached in the early ‘90s), and, what is more important, it is by *more than half* (54%) in foreign hands (20% in 1990). This entails that the future path of the dollar will also be a crucial variable in the picture, and that it will pose a formidable dilemma: to sustain the US economy the dollar should depreciate, to sustain the US debt it should appreciate.

The euro zone as a whole on paper displays better figures for 2008: 1.5% of deficit/GDP and 64% for debt/GDP. A strong currency and a less damaged financial system may also make euro denominated debt quite attractive. It may be noted that, by chance or by design, the ERP aggregate fiscal input of would be consistent with the SGP deficit ceiling of 3% of GDP for the euro zone as a whole. Nontheless *each* country in the euro zone is constrained by the SGP. As integral part of the ERP, the Commission has announced that the escape clauses introduced into the new SGP in 2005 will apply. However, Mr. Almunia has also used words of caution warning that the SGP is still in place. In practice, member states may reckon on suspension of the SGP procedures only for 2009, and only for a "a few points" (?) above 3%. Afterwards, member states will be required to submit consistent consolidation plans. In my view, given the entity of the crisis, this is a restrictive interpretation of the new SGP escape clauses.

Within this framework, euro-zone endemic fiscal policy un-coordination will be a major stumbling block than ever. Replicating time and again a notorious game, everyone in Europe wants Germany to expand first in order to gain from its demand spillovers with less fiscal effort. Actually, Germany now has a favourable public finance condition close to balance. However, Chancellor Merkel seems much inward oriented, and President Sarkozy's moral suasion to obtain more fiscal coordination has so far obtained little success. The French-German joint initiative underlying the ERP should not be overstated (see e.g. http://www.euractive.com). The full half of the glass is that the EU has for the first time produced a common

framework at the level of macro-policies. The empty half is that the ERP is no more than "soft" coordination, a menu from where each country *may* pick (or has already picked) the most preferred combination of fiscal items as well as the overall entity of its interventions.

The empty half of the glass may give rise to two major problems that play against coordination and efficacy. The first is that the menu chosen by each country will most likely differ from the others. For instance, UK has already chosen VAT cuts that Germany dislikes, while it is not yet clear what Germany likes in addition to rescue banks (and perhaps carmakers). On the one hand, this is reasonable since economic structures are different, and, as explained above, the "micro" level matters in the choice of the best-suited fiscal measures. On the other hand, the ERP may turn out to hamper the already slow and painful process of fiscal harmonization in the EU.

The second problem is that, if the 1.5%-GDP fiscal stimulus of the ERP were mechanically transferred at the level of each EMU member state, the result, in terms of euros, would be the one reported in the following table, 3rd column.

The telling data are those concerning the expected fiscal imbalances relative to GDP (i.e. the simple sum between the expected imbalance for 2008 plus the ERP, 4th column). The first information we get is that not all countries can afford full use of their ERP equiproportional allocation because this would lead to deficit/GDP exceeding "a few points" above 3%. If the limit is say 3.5%, this may be the case of Portugal, Italy, France, and Greece. Italy, as an example, has already announced that *it will not breach the pre-ERP SGP commitment* for next year which means not to exceed Î6 bn (0.4% of GDP) of additional deficit. France is already at 3% of deficit/GDP. Hence, unless the low deficit countries spend *much more* than their ERP share, there exists a concrete chance that the overall impact of national fiscal plans will be *less* than the ERP provision. However, as can be seen from the table, low deficit countries are mostly small countries, with negligible spillover demand effects. Except Germany: so we are back to the "Germany first" game. But Berlin has announced a Î30 bn plan, which is even less than its ERP share.

EMU member states	Fiscal imbalances 2008 (% of GDP)	ERP (1.5% of GDP) (bn. euros)	Expected fiscal imbalances (% of GDP)	Additional deficit up to 3% of GDP (bn. of euros)
Malta	-1.6	0.1	-3.1	0.7
Cyprus	1.7	0.2	0.2	0.1
Slovenia	-0.6	0.5	-2.1	0.8
Luxembourg	2.4	0.5	0.9	1.8
Portugal	-2.2	2.5	-3.7	1.3
Ireland	-1.4	2.6	-2.9	2.8
Finland	4.9	2.7	3.4	14.1
Greece	-2.0	3.2	-3.5	2.2
Austria	-0.7	4.1	-2.2	6.4
Belgium	-0.4	5.0	-1.9	8.7
Netherlands	1.4	8.5	-0.1	25.0
Spain	0.6	14.7	-0.9	35.4
Italy	-2.3	23.8	-3.8	11.1
France	-2.9	28.7	-4.4	1.9
Germany	-0.5	38.6	-2.0	64.3
Total euro zone	-1.5	135.8	-3.0	176.5

Baseline: GDP at current market prices 2008
Source: elaborations on Eurostat, *Euro Economy 2008, online database*

` Mr. Almunia has anticipated that governments will have to negotiate their ERP resources taking into account these constraints. On the other hand, it is puzzling to see that if each country sought to spend up to the *normal* 3% deficit/GDP ceiling, given its own fiscal imbalance as of 2008, the resulting mobilization of additional resources would exceed the ERP total figure (5th column) (the reason is that some countries now have a deficit below the average or a surplus). Which of the two constraints will bind? The aggregate ERP or the 3% deficit/GDP for each country, which is in their own right?

Given this foggy picture, the result of negotiations is totally unpredictable as it is what the European fiscal policy will look like. Yet with Germany in the back lines, France and Italy with little room of manouvre, and the SGP constrictions behind the corner, Europe seems badly armed to fight the fiscal battle in the war against the global recession.

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