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ON POINT

INTELLIGENTLY DIFFERENT THINKING FROM NATWEST MARKETS

Easing: The pressure is on

Fiscal easing in Europe is cause for cheer. But far more must be done, and soon. We're expecting government spending of 0.5% across the Eurozone in 2020, much more than the consensus.

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Conditions are gathering to make fiscal easing across Europe attractive; even inevitable.

At September's meeting of the European Central Bank, the call for more fiscal policy was loud and constant. As central banks across the globe run out of ammunition, we expect fiscal policy to be rolled out, especially in Europe, and beginning in the UK.

Federal Europe is already doing what it can. The Federal 'budgetary instrument for competitiveness and convergence' (BICC) is a fund, but a tiny one. Other quasi-fiscal initiatives are in their infancy.

That leaves Germany and the Netherlands holding the key to greater short-term investment and fiscal easing across the eurozone. And Germany – Europe's economic benchmark – is key.

Germany must now step up

Germany has the most fiscal space. Limited easing has begun; but it should go further.

Germany has long been resistant. And while obstacles to greater fiscal easing can be overcome, some are easier than others. The famous 'Black Zero' (Schwarze Null) – Germany's ambition that net borrowing should always be zero – and a 'debt brake' written into its constitution specifying that the structural deficit should not exceed 0.35% of the previous year's GDP, loom large.

Still, there has been progress. German fiscal policy turned expansive this year, reversing 2018's tightening. And the 2020 draft budget suggests a fiscal step up in 2020.

The watchword? It continues to be 'prudence'. But prudence could still be more ambitious.

Why should Germany change its tune?

The case for greater fiscal easing and investment is overwhelming.

Germany's slowdown has changed the incentives, while the fall in bond yields has changed the economics. It is now easier to explain why fiscal expansion makes sense. Deficit-financed investment can be expansionary, and drive long-term debt/GDP ratios down.

The government's hurdle rate is currently so low that borrowing to invest in nearly any project with an expected real rate of return of more than about -1.5% should reduce Germany's long-term debt/GDP. Political will for more investment, especially in green policies, is strong.

Germany also has an infrastructure gap, and wants to prepare for a future in which the world may not want Germany's specialties quite as much. Politicians rationalise Germany's enormous overseas investment as a country "saving for retirement". A more active policy of investment-at-home should not be politically unpopular.

But investment is hard to rush. And economic slowdown is here.

How fast, and how far?

Two alternatives exist to the debt brake or Black Zero: a deficit level that would keep debt/GDP unchanged; or the 3% ceiling specified by the Stability and Growth Pact.

Yet major changes to the 2020 plan are unlikely. Current plans are seen to embed sufficient flexibility already. Besides, there probably isn't time for a sense of urgency to develop into action.

In the short term, the likeliest reason for fiscal stimulus is a downturn. But to challenge the debt brake and Black Zero require a combination of recession (near); academic consensus (growing); and a potential new government (the next elections are in 2021). These are unlikely to combine fully in 2020, but the latest 2020 budget draft shows decent fiscal expansion projection (see table below). . Reasonable expectations for fiscal expansion, especially if added to by 'automatic stabilisers' in a downturn should also drive markets.

2020 draft budget table for the euro area

	2018	2019	2020
France			
Deficit (-) / surplus (+)	-2.5	-2.3	-2.2
Structural balance	-2.3	-2.2	-2.2
Change in the structural balance	0.1	0.1	0.0
Change in the structural primary balance	0.1	0.0	-0.1
Italy			
Deficit (-) / surplus (+)	-2.4	-2.2	-2.2
Structural balance	-1.5	-1.2	-1.4
Change in the structural balance	-0.1	0.3	-0.2
Change in the structural primary balance	-0.3	0.1	-0.3
Netherlands			
Deficit (-) / surplus (+)	1.5	1.2	0.3
Structural balance	0.7	0.3	-0.4
Change in the structural balance	0.2	-0.4	-0.7
Change in the structural primary balance	0.1	-0.5	-0.8
Germany			
Deficit (-) / surplus (+)	1.9	1.3	0.8
Structural balance	1.5	1.2	0.5
Change in the structural balance	0.6	-0.3	-0.7
Change in the structural primary balance	0.5	-0.4	-0.8
Spain			
Deficit (-) / surplus (+)	-2.5	-2.0	-1.7
Structural balance	-2.5	-2.6	-2.6
Change in the structural balance	0.0	-0.1	-0.1
Change in the structural primary balance	-0.3	-0.2	-0.2
Euro area aggregate			
Deficit (-) / surplus (+)	-0.6	-0.7	-0.9
Structural balance	-0.6	-0.6	-1.0
Change in the structural balance	0.2	-0.1	-0.4
Change in the structural primary balance	0.1	-0.2	-0.5

Change is in the air

Elsewhere, momentum is gathering behind increased easing.

New European Commission president Ursula Von der Leyen is a supporter. A Christine Lagarde-led European Central Bank will be far more active in encouraging fiscal efforts to boost investment. Meanwhile, France sees the BICC as a starting point for greater federal firepower.

Whatever else is in doubt, the mood is turning from austerity to investment across Europe. Fiscal relaxation, if not immediate or far-reaching revision, is in the air.

But it must go further. And there is no time to lose.

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