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The potential for euro fiscal stimulus

- **The call for fiscal stimulus in the eurozone is becoming louder …**
- **… but the room for stimulus is limited by EU rules and national political choices**
- **We have calculated the potential room for stimulus from different perspectives, with the resulting amounts varying from around EUR65bn to around EUR160bn**
- **This could potentially lift eurozone GDP growth by between 0.25 and 0.75 pps**
- **Current indications are that any stimulus would be at the lower end of the range**

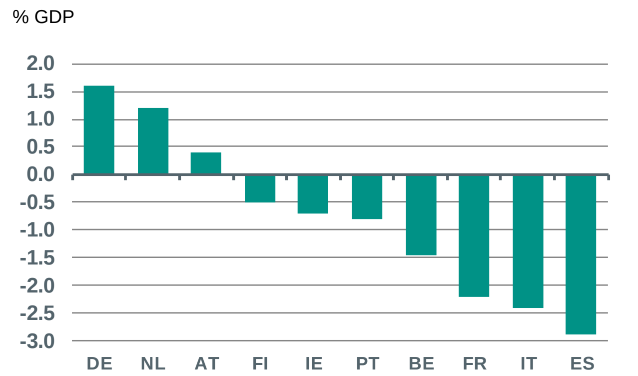
1. Room within the limits of the European Commission's MTOs

The fiscal policy rules of the European Commission (EC) state that all countries have to reduce their structural government deficit (the deficit corrected for the impact of the business cycle and one-off measures) to 0.5% of GDP. Moreover, countries that have a debt ratio above 60% need to 'reduce the excess by at least 5% on average during the next three years'.

Based on these rules an MTO (Medium-Term Objective) is set by the Commission for fiscal policy in each country. As the graphs shows, some countries will have met or passed their MTOs in 2019 (e.g. Germany, the Netherlands and Austria), while others still have a long way to go (Spain, Italy and France).

If all countries that have met the MTO were to use the available room and reduce the structural balance to -0.5%, around EUR 65bn of fiscal stimulus would be feasible. The bulk by Germany (EUR 54bn) and the Netherlands (EUR 9bn).

Fiscal room according to divergence from MTOs



Source: European Commission, ECB, ABN Amro Group Economics

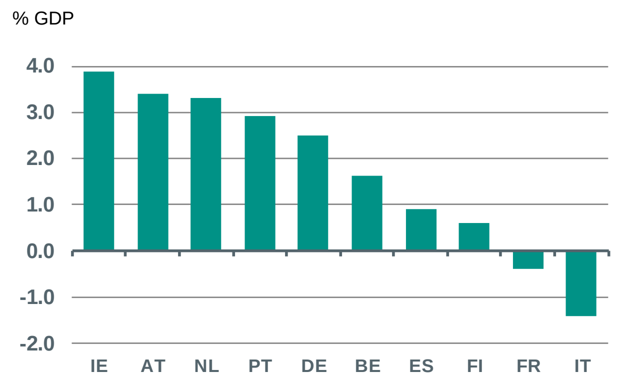
2. Room within the limits of a debt stabilisation

Another possible way to assess the room for fiscal stimulus is to ignore the rules of the EC, and look at the level of stimulus that would result in stabilisation of the debt ratio at its current level.

A simple rule of thumb is that the debt ratio of a country stabilises when the primary budget balance (the balance excluding interest payments) is equal to the difference between nominal GDP growth and the interest payment ratio.

Taking the estimated primary budget balance for 2019 as a starting point and using our estimates for GDP growth and interest payments, a total stimulus of EUR 160bn would be possible. Again, the bulk by Germany (EUR 85bn) and the Netherlands (EUR 25bn). Our calculations show that France and Italy actually would have to implement austerity to achieve debt stabilisation (around EUR 60bn in total). Still, we think this is unlikely to happen as it would seriously aggravate the economic downturn.

Fiscal room according to debt stabilisation



Source: European Commission, ABN Amro Group Economics

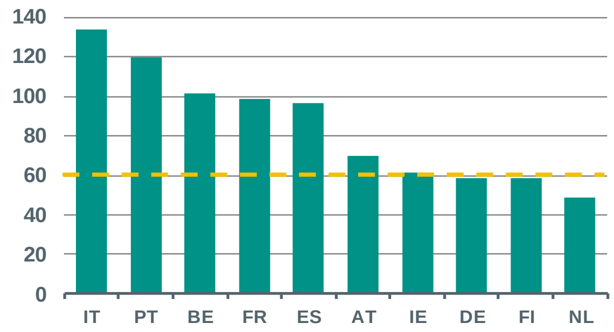
3. Grey area and flexibility

In January 2015, the EC published new guidance (see here) explaining how it would apply the existing rules of the Stability and Growth Pact to 'strengthen the link between structural reform, investment and fiscal responsibility in support of jobs and growth'. This guidance allows countries to deviate temporarily from their MTOs in order to accommodate investment when their economies are contracting or growing well below their potential. Still, a strict set of conditions will be applied (e.g. co-funding by the EU, deviation needs to be compensated within the timeframe of the MTO, deviation does not lead to deficit above 3% and 'an appropriate safety margin is preserved').

Although it is difficult to translate this guidance into exact numbers, we think that extra investment would be allowed in any case in the five countries that have already met or are close to meeting the 60% debt ceiling (see graph). Assuming that these countries would want to prevent their debt ratios from rising, extra government investment of around EUR 140bn would be possible in total.

Government debt ratios

2019, % GDP



Source: European Commission, ABN Amro Group Economics

4. The potential impact on eurozone GDP growth

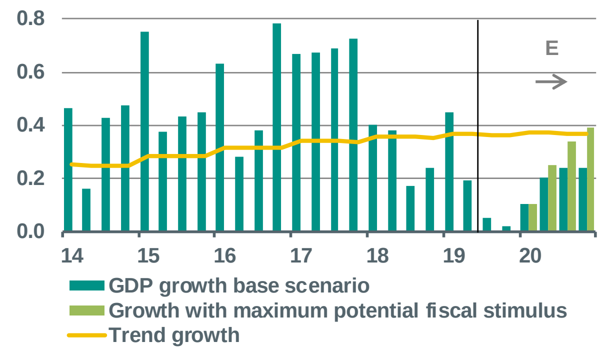
The impact on GDP growth of any fiscal stimulus always is less than one-on-one, as part of the stimulus leaks away via higher imports, higher cyclical government tax income and higher private sector savings. Moreover, the shape of the stimulus is also relevant for its impact, with direct government spending or investment having a more direct and often stronger impact on growth than indirect stimulus such as tax cuts.

As a rule of thumb, a fiscal stimulus equal to 1% of GDP, lifts eurozone GDP by around 0.5-0.7%. This means that our range of estimations of the room for fiscal stimulus could lift eurozone GDP growth by between around 0.25 and 0.75 pps. Depending on the shape and size of the stimulus, it could start having an upward impact on growth in the course of 2020.

Our current base case scenario is that growth will remain stuck at modest levels well below the trend rate throughout 2020. A fiscal stimulus package in line with maximum potential size according to our calculations (around EUR 160bn) could lift growth to close to the trend rate in the course of 2020. Still, governments are not moving very quickly, so we might stay at the lower end of the range of potential stimulus.

GDP growth versus the trend rate

% qoq



Source: Thomson Reuters Datastream, ABN Amro Group Economics