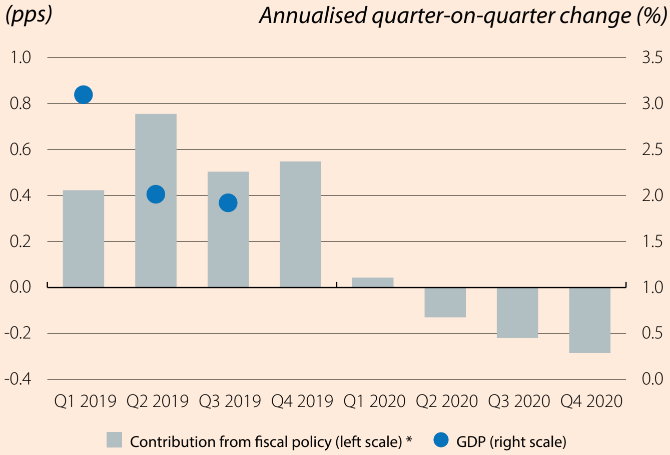
What margin for manoeuvre does economic policy have?

After several years of expansion, the global economy has slowed down in recent quarters and the risks of recession have begun to generate concern. All eyes have now focused on how monetary and fiscal policies could help to spur the economy. Monetary policy has already made a move: the Fed has cut interest rates three times and the ECB has issued a new stimulus package.

Monetary policy: still the only game in town?

In the last decade, the bulk of the responsibility for stabilising the economy has fallen on the central banks, to the point that monetary policy has become known as «the only game in town». However, **both the intensity of the turbulence experienced since 2008 and the strong latent structural dynamics[1] have reduced the central banks' scope for future action**. As an example, in 2007 the Fed started from an interest rate of 5.25% (which allowed for 20 cuts of 25 bps before hitting 0%). In contrast, in the last hiking cycle (between 2015 and 2018) the Fed only managed to raise rates up to 2.50%.

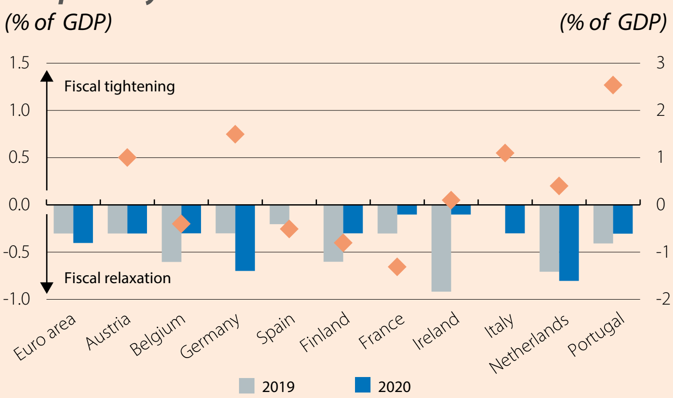
US: contribution of fiscal policy to GDP



Note: ** According to the methodology of the Hutchins Center, a positive contribution indicates that fiscal policy pushes GDP growth above its potential (and vice-versa).*
Source: *CaixaBank Research, based on the estimates from the Hutchins Center Fiscal Impact Measure.*

Despite their lower margin for action, in 2019 the **central banks have already exhausted much of the available space**. In the US, the three 25-bp cuts implemented by the Fed have consumed one third of the 225-bp margin it had available for reducing reference rates. In Europe, meanwhile, the ECB could run out of space to purchase more public debt securities towards the end of 2020, if it maintains the current limits under which it cannot buy more than 33% of each issue. On the other hand, with the latest rate cut, the ECB could be approaching the so-called «reversal rate»: the level at which a further reduction in the reference rates would have contractionary effects on the economy (estimates place this rate at around –1.0%, relatively close to the –0.50% at which the depo rate currently stands).[2] This proximity shows that the margin for monetary policy stimulus is more limited than in the past.

*Euro area: position of fiscal policy * and primary structural balance ***



Notes: ** The position of fiscal policy (left scale, columns) provides an approximation of the change in the primary structural fiscal balance. ** The primary structural balance forecast for 2020 (right scale) is represented with diamond-shaped markers.*
Source: *CaixaBank Research, based on the European Commission's assessment of the 2020 Draft budgetary plans.*

Furthermore, a growing number of voices are warning of the costs of a long period of negative rates. In fact, in Sweden, despite a reduction in the outlook for growth and inflation, the Riksbank has decided to wind back its policy of negative rates.[3]

In the US, unlike in the euro area, **the Fed still has a margin of 150 bps in its reference rates**, and in the event of a significant deterioration in the economy, it would still have the option of reactivating asset purchases. **However, fears that monetary policy is approaching its limits have resonated strongly in the euro area** and calls have intensified for fiscal policy to step forward in 2020.

The struggle of fiscal policy

In the US, although **the estimates presented in the first chart suggest that fiscal policy will deduct some growth** (after having contributed substantially in 2018-2019), the indicators point towards a reasonably favourable performance from economic activity. In addition, the Fed still has room for manoeuvre. Moreover, with the presidential elections looming (to be held in November 2020), the Trump administration could renew the fiscal stimulus in the event of a more marked slowdown in the economy.

In the euro area, on the other hand, some form of fiscal stimulus is expected. As shown in the second chart, according to the budgetary plans presented before the European Commission, in 2020 a fiscal stimulus of 0.4 pps of GDP is expected across the euro area as a whole.[4] The main drivers are, essentially, Germany (0.7 pps) and the Netherlands (0.8 pps), while a more modest

1. That is, the fall in the natural rate of interest. See the various articles of the Dossier «The future of financial conditions: a paradigm shift?» in the MR02/2019.
2. See the article «The farewell of (Super) Mario Draghi» in the MR11/2019.
3. The Riksbank raised rates from –0.50% to –0.25% in December 2018 and, last October, sent a clear message of its intention to raise them to 0% in December 2019. This is despite the analysts' consensus revising the forecast for GDP growth in 2020 from 1.8% to 1.2% over the last few quarters (as well as revising the inflation forecast from 2.0% to 1.7%).
4. Projected change in the structural primary balance between 2019 and 2020, according to the European Commission's analysis of the 2020 Budget Plans.

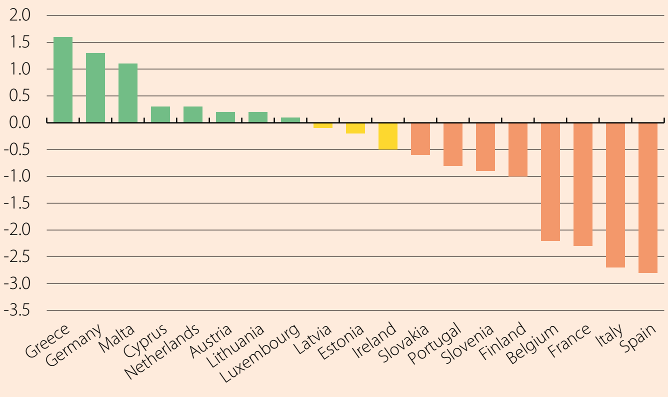
stimulus is anticipated in Italy (0.3 pps) and France (0.1 pps). In Spain, a relatively neutral fiscal policy is expected.

To estimate the impact of this fiscal stimulus, we must take into account how it affects the other components of the economy. We can obtain this information from the so-called «fiscal multipliers», which estimate the net effect that an increase in public expenditure has on GDP. **According to the consensus in the economic literature, the multipliers for public expenditure stand between 0.6 and 0.8,[5] meaning that the budgetary plans would boost growth by around 0.3 pps in 2020.**

The third chart shows that **the space for an additional fiscal push in the euro area is somewhat limited and unevely distributed**. In this context, the following items take on an important role. Firstly, the **fiscal multipliers are higher in a low interest rate environment**, so it is possible that the multipliers of the euro area are actually higher than those mentioned. For instance, using data for the US, Ramey and Zubairy (2018)[6] found that the multiplier for public spending rises to 1.7 when the reference rates stand at 0%.

Euro area: fiscal space *

(% of potential GDP)



Note: ** Difference between the structural fiscal balance projected by the 2020 Budget Plans and the target structural balance per the medium-term budgetary framework (MTBF).*
Source: *CaixaBank Research, based on the European Commission's assessment of the 2020 Draft budgetary plans.*

On the other hand, fiscal stimuli generate externalities which, in a union like the euro area (i.e. with a fixed exchange rate and a common monetary policy), **are essentially channelled through trade**. In particular, according to the multipliers estimated by Dabla-Norris *et al.* (2017),[7] which we reproduce in the fourth chart, the spillover from the aforementioned fiscal stimulus in Germany or the Netherlands could add 0.1 pp to the growth of the euro area periphery.

The importance of smart fiscal policy

The causes of the slowdown (especially uncertainty and the maturity of the business cycle) generate doubts over the effectiveness of classical fiscal policies. It should be borne in mind that fiscal multipliers are higher when the use of an economy's productive capacity is low, and they are lower in economies with higher levels of debt (due to a potential tightening of the financial conditions if the sustainability of the debt is called into question). However, in the euro area, greater fiscal space is to be found in economies with a high degree of resource utilisation, while those economies that have higher unemployment also have limited fiscal space and higher debt.

Euro area: fiscal multipliers and externalities

Ratio between the cumulative change in GDP and the cumulative change in public expenditure

Recipient country of the stimulus	Country of origin of the stimulus					
	Germany	France	Netherlands	Italy	Spain	Portugal
Germany	**0.71** (0.63-0.82)	0.22 (0.14-0.31)	0.21 (0.15-0.26)	0.11 (0.07-0.15)	0.08 (0.05-0.11)	0.06 (0.03-0.08)
France	0.09 (0.06-0.12)	**0.53** (0.45-0.61)	0.07 (0.05-0.10)	0.06 (0.04-0.10)	0.04 (0.02-0.06)	0.03 (0.02-0.04)
Netherlands	0.17 (0.13-0.20)	0.14 (0.09-0.20)	**0.52** (0.46-0.58)	0.07 (0.04-0.10)	0.05 (0.03-0.07)	0.03 (0.01-0.05)
Italy	0.13 (0.09-0.17)	0.16 (0.11-0.23)	0.11 (0.07-0.14)	**0.50** (0.46-0.54)	0.06 (0.04-0.09)	0.04 (0.02-0.06)
Spain	0.12 (0.08-0.16)	0.14 (0.10-0.20)	0.09 (0.06-0.13)	0.08 (0.05-0.11)	**0.31** (0.27-0.35)	0.06 (0.04-0.08)
Portugal	0.12 (0.08-0.16)	0.15 (0.09-0.20)	0.08 (0.04-0.12)	0.07 (0.03-0.10)	0.07 (0.05-0.10)	**0.29** (0.25-0.33)

Note: *The ratios shown in the diagonal path (in blue) are the fiscal multipliers, while all other values show the externalities, or spillovers, in the other countries. The figures in brackets indicate the confidence intervals at 68%.*
Source: *M.E. Dabla-Norris et al. (2017). «Fiscal Spillovers in the Euro Area: Letting the Data Speak». IMF Working Paper.*

The complexity of the current environment requires the design of fiscal policy to be refined. In this regard, **a boost to investment focused on infrastructure, new technologies and the energy transition would have the virtue of providing a fiscal stimulus** to combat the cyclical slowdown, while at the same time **reducing the uncertainty** surrounding the structural transformations affecting the major economies **and boosting potential growth.**

With all this, what can we expect to see? On the one hand, although Germany and the Netherlands have a considerable fiscal space, both countries have traditionally ended up implementing a policy that is less expansionary than expected. On the other hand, **the presence of positive externalities between euro area countries and the differing margin for fiscal policy highlight the importance of developing a supranational fiscal authority**, with the ability to implement a coordinated fiscal policy.[8] Will the euro area be capable of giving itself capacity to implement fiscal policy before the next recession?

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5. V.A. Ramey (2019). «Ten years after the financial crisis: What have we learned from the renaissance in fiscal research?» Journal of Economic Perspectives, 33(2), 89-114.
6. V.A. Ramey and S. Zubairy (2018). «Government spending multipliers in good times and in bad: evidence from U.S. Historical data». Journal of Political Economy, 126(2), 850-901.
7. M.E. Dabla-Norris *et al.* (2017). «Fiscal spillovers in the Euro Area: letting the data speak». International Monetary Fund.
8. The EU budget being discussed for the period 2021-2027 is of a modest size: around 2% of total public spending and 1% of the EU's gross domestic income.