Exchanges at Goldman Sachs

Europe at a Crossroads

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Allison Nathan: This is Exchanges at Goldman Sachs and I'm Allison Nathan, a Senior Strategist in Goldman Sachs Research and creature and editor of the firm's Top of Mind report.

In this episode, we're focusing on the implications of a potential shift in the fiscal mindset in Europe. In response to the pandemic, Europe embarked on an unprecedented program of fiscal risk sharing in the form of an 800-billion-euro next generation EU fund and it's recovery fund, which for the first time in the history of the EU, provides large-scale grants and loans to weaker economies backed by the issuance of common debt.

At the same time, Germany is about to get a new ruling coalition that's likely to break from the fiscal conservativism of the Merkel era. Whether these shifts in fiscal policy towards a more expansionary mindset mark a turning point for European growth and integration is top of mind.

We first sit down with our Chief European Economist Jari Stehn to get his take on the importance of the recent fiscal developments for the evolution of the European union.

Jari Stehn: Well, I think we have seen an important shift in European fiscal policy, really, over the last 18 months. At the national level, countries were very quick to provide fiscal support. And that was really aided by the suspension of the EU-wide fiscal rules. So, they were quite quick in suspending those and really making room for national governments to respond.

And then, of course, at the EU-wide level, the Recovery Fund, we think, was a real milestone and a real turning point for the crisis. And of course, that agreement to issue joint debt, which was a real step forward. And it involves large-scale grants basically from the stronger to the weaker economies. And I think that's a very important step forward.

I think the German election outcome is likely to cement that shift that we've seen. Of course, there is still quite a lot of uncertainty around what exactly will happen. But it's very clear that it's not going to be a center right coalition that would have pushed for a return to fiscal prudence soon. So, I think the fact that the Green party is going to be part of the next government, I think that's pretty clear, that is really going to cement the shift towards more public investment and more expansionary fiscal policy. And I think, really, underscores the shift that we've seen.

It's important to add that we’ve not just seen the shift on fiscal policy, but also of course the ECB played a very important role, essentially, in buying time with the pandemic QE program, the PEPP, until that EU-wide fiscal response had been put together because that, of course, took some time. And I think it's notable how the ECB did this and how they really stepped up those purchases in a really big scale and much more flexible way despite the concerns that had been voiced from the German Constitutional Court not so long before that. And so, I think it was a really clear sign that the ECB is also willing to do what's needed to protect the monetary union and really kick started a much more coordinated policy response between fiscal and monetary policies.

So, I think bottom line is that it is an important shift. And I think it is positive from an economic perspective because the missing part in the monetary union, of course, is the fiscal risk sharing. And these are all steps that provide some of that risk sharing. And so, from an economic point of view, I think those are quite clearly desirable.

Allison Nathan: But so many of these initiatives and these steps are actually ultimately temporary. Isn't that somewhat concerning?

Jari Stehn: That's a good point. And of course, it's true that a lot of the institutional shifts that I just talked about are temporary in one form or another. So, the fiscal rules are only suspended temporarily. They will come back. And I think the hurdle for formal treaty change is very high. And it is possible, of course, that we are going to see a turn back to austerity once these rules bite again, which is probably going to be 2023.

And then on the Recovery Fund, you're also right, that is a temporary tool. It's not Euro bonds. It's not joined in several guaranteed debt. And there are plans to wind it down starting from 2027 all the way to 2058. So, this is kind of a pretty long timespan, but you know, it is designed to be temporary.

But nonetheless, I think there is progress. On the fiscal rules, we think there is going to be more flexibility in how those will be interpreted. So, formal adjustment of the rules is probably unlikely because it requires treaty change. But there are lots of parts where you can reinterpret the fiscal rules and give countries more time to do fiscal adjustment. And we also think there's going to be an effort to shield public investment from the rules and to make more room for that. And so, that's a more informal change, but I think that is something that will be important in practice.

And then on the Recovery Fund, yes, it's planned to be temporary. But first of all, important to realize, it really sets a precedent for an EU-wide response. And effectively cuts out the very left tail in terms of the sort of macro distribution in Europe. And so, I think it's quite reasonable to assume that if we were to get another shock like this some time down the road, hopefully not but maybe, then there is going to be another one of those responses. And I think Europe has shown that when it matters it really can come together.

And then we think there's a decent likelihood that some elements of the Recovery Fund will stay. So, for example, the loan facility could stay. The bottom line is progress is more incremental. I think that's often the case in Europe. But I do think it's real progress.

Allison Nathan: But Otmar Issing, former Chief Economist and member of the Executive Board of the European Central Bank is more concerned about the precedent of fiscal burden sharing in the Euro area. That's because he believes it violates the Maastricht Treaty and because he's not convinced that countries will channel their newfound funds towards productive investments rather than consumption.

Otmar Issing: I think fiscal policy in the Euro area and all within the European union is at the crossroads. On the national level, all countries have spent huge amounts to mitigate the economic consequences of the pandemic. Finding back to a sustainable path for fiscal policy without endangering the recovery is a huge challenge, especially for those countries with a high level of debt.

On the European level, I think two questions are imminent. First, the stability in [UNINTEL] is under severe pressure. A number of countries from the south argue that investments should be excluded from the deficits limit. Whereas countries from the north, the so called [UNINTEL], resist those requests. The credit financing of the huge Next Generation program is an exemption of the law that the EU is not allowed to take credit. The program was presented as a unique measure to tackle the challenges of the unique events of the pandemic. For me, this declaration of the uniqueness was hardly credible. Uniqueness of a fiscal policy situation, not the pandemic. Now, not surprising, there is strong pressure from many sides to continue with further credit financing at the EU level. Investments to fight against climate change are the most prominent arguments for that.

Behind those considerations is also the idea to develop the Euro area in the direction of a fiscal union. But if one wants to go further in the direction of fiscal union, which in the end can be only done in the context of a broader political union. Then we need to change the treaty. But within the limits of the Maastricht Treaty, not just step of Europeanizing of fiscal policies is undemocratic. It's not legally justified. Fiscal policy still remains and must remain in the domain of national governments which are responsible to their voters. And the credit financing was already an exemption and quite a number of lawyers say a violation of the treaty. So, this cannot be continued without putting the whole institutional arrangement in question.

And unfortunately, many countries will spend the additional funds coming from the EU level not for investment in digitalization, the fight against climate change, et cetera, in innovative activities. But spending it on public consumption. Spending it on pension schemes. Et cetera. Some countries, I'm afraid, might waste this opportunity.

The experience of the past tells me to be at least cautious. I think Italy, as long as Mario Draghi will be Prime Minister, should go in the right direction. But as soon as he's out of office, and this might happen sooner than later, if you become president of the republic next year, for example, and elections, anyway, are not so far away. So, behind the scenes, behind the strong position of Mario Draghi, parties have already their long list of wishes how money should be spent.

Even for my country Germany, over the past years public investment has been very weak. But this was not due to fiscal austerity, but because there was a high priority for public consumption, for pension schemes, et cetera. And I've still to be convinced that countries can really get out of their behavior of the past. But this is difficult with the voters who are now used to getting benefits from government spending.

It's a huge challenge for our democracies that governments will take a longer-term view and not just look for the next election. This is a permanent problem of democracy. But in the Euro area, it's even more pressing because of disappointing growth so far.

Allison Nathan: I've asked Stehn for his thoughts on whether the bending of fiscal rules and increased fiscal risk sharing across the European union go against the EU's treaty framework and risk moral hazard in the region.

Jari Stehn: The world has changed since the Maastricht Treaty was put together. One of the key developments has been the decline in interest rates and in the equilibrium interest rate that has fallen over time, which I think makes it much harder to defend the structure that was put into place when the EU was constructed, where the idea was, of course, that monetary policy does the stabilization. And fiscal policy, basically, looks after debt sustainability. But all the cyclical stabilization is done on the monetary policy side.

And of course, we've learned that this, first of all, it isn't possible to the same extent when there is a lower bound to interest rates. And that, of course, is a global thing. But certainly, it's true in Europe. And then secondly, I think it means that running public debt is much cheaper than it used to be. And for 60 percent debt constraint and 3 percent constraint for the deficit, which is the original Maastricht criteria, those were calculated on interest rates that were much higher. And so, if you recalculated those numbers, you would get very different numbers because you can sustain higher debt with bigger deficits today.

And so, I think there's a strong economic case for revisiting that interaction between fiscal and monetary and understanding that you can't constrain both monetary and fiscal policy very much because then you end up not having enough room for stabilization when it's needed.

Broadly speaking, fiscal sustainability is obviously important. But what we've learned is that the fiscal rules are not very helpful if there isn't buy in into the rules. So, in other words, the fiscal rules are quite ineffective in shifting incentives at the country level. Just because you have a rule, it doesn't mean that people will follow the rule. And there really needs to be buy in, political buy in, in the countries that are supposed to follow the rules. And I think that's been pretty clear the rules have been broken, both by Germany in the early 2000s when it was convenient, and then obviously later on in southern European countries and so on.

And so, I think that's really the issue with fiscal rules. That you can't just ensure fiscal sustainability by writing down these rules. You need them to be incentive compatible, basically.

The way forward with that might be, and this is where the Recovery Fund comes in, is to have a system of sticks and carrots at the EU level where, essentially, the fiscal rules currently, that's only a stick. There is no carrot. And I think potentially the way forward is to use the EU-wide resources, basically in exchange for more fiscal responsibility. And so, you're seeing this already with the Recovery Fund now that the grants are basically allocated in return for commitment on structure reform and certain things that need to be fulfilled in terms of conditionality for countries to be able to access those grants.

And you can imagine a system where you move away from just these pure constraints where the evidence is that they haven't worked that well towards a system where you combine grants or loans from the central level with, basically, a commitment in return. That's the route that the Recovery Fund has taken. And I think that is, to me, a promising road.

Allison Nathan: Beyond these shifts towards fiscal risk sharing, the larger question is whether the cooperation between EU members that resulted in a decisive response to the pandemic can persist after the crisis and push the EU towards a stronger and more effective union.

Romano Prodi, former Prime Minister of Italy and President of the European Commission believes the EU is headed for further integration, but the requirement of unanimity around big EU decisions means integration will likely be very slow and, ultimately, incomplete.

Romano Prodi: Proper integration means total agreement. But if you talk with an Italian or French or German bankers they understand that the degree of control and the degree of necessarily dialogue with the European Central Bank or with Brussels is increasing every day. Now, it’s taken given for granted that there are not any more national banking authorities who harmonized the main decision of the banking system. Now when a great decision is taken in the banking system, the first question is what Frankfurt or Brussels is thinking, not what Rome or Paris is thinking. This is a process that cannot be reversed.

I think that there could be or should be more engaged role of the southern countries concerning African politics. What I mean is that Spain, France, and Italy, but especially Spain and Italy, but even France, all of the Mediterranean countries, they're very, very worried with what is happening in Africa. And this preoccupation was not shared 10 or 15 years ago by the northern European countries. Now it's becoming a common European preoccupation. And because of that I do think that we should have a more close policy among France, Italy, Spain, and Greece concerning the southern border of

Europe.

There is one obstacle, one problem. That is unanimity. This is the real disaster for Europe. You know? I don't see the possibility of adopting a majority rule in rule in all the major decisions. But this is the really stumbling block.

And so, I see the possibility of progress of Europe. But starting from, I'd say, a restrictive number of cooperation. All the problems become more evident like fiscal progress, like foreign policy decisions. They are blocked by the need of unanimity. So, I do see some progress. But very slow. And starting from partial agreement that do not involve all the countries.

Allison Nathan: That said, Prodi believes that the European parliamentary elections in 2019 kicked off a new wave of pro-European sentiment and that the EU no longer faces existential danger from populous forces.

Romano Prodi: The European election had started a new wave. They demonstrated that people want Europe. The British case is different because in Britain there was always the idea of an alternative and their relation with the United States has been different from any other country. But look, in all of the most recent elections, the so-called populist parties have lost ground. Think to Germany. Germany…the danger of the parties going out of Europe went away and even Italian local elections, 12 million people voted. Clearly, the political parties close to Europe gained votes. And so, I do think that in people's mind, Europe is a reality with all the limits that I've depicted before.

Allison Nathan: But Timothy Garton Ash, professor at the University of Oxford, cautions that Europe has seldom missed an opportunity to miss an opportunity over the past decade. And is not convinced that peak populism in Europe is behind us.

Timothy Garton Ash: I've worked on a history of contemporary Europe. And what you see is that since 2005, but particularly since 2009/10, it has been crisis after crisis after crisis. And like with someone who's had a series of health issues, they take their toll. So, this is in many ways a more weak and a more divided Europe, and one in which both the politics and the opinion polls show that forces of nationalist populism and of Europe skepticism are still quite strong. In round numbers, a third of citizens of EU member states, slightly less, say, "I think our country would be better off outside the EU." So, those forces are very strong.

However, after a very weak beginning, there has been a decisive EU response to the COVID pandemic. There is a strong green agenda coming out of the EU. So, I would say those forces are finally balanced. But Europe has never missed an opportunity to miss an opportunity over the last ten years, of which the most important, I think, but Angela Merkel's greatest single mistake was her failure to take the initiative at the beginning of the Eurozone crisis and say what Helmut Kohl would have said, namely, "We must do whatever it takes." As a result of which, it would taken much less than it did.

But let's be fair. European Recovery Fund is a very big step. So, in response to this big crisis, there has been a big response. And I think as a historian, what one sees is that a great deal will now depend on the consequence of that crisis in the sense that it's entirely possible that we will get more inflation, for one. We might even get stagflation, i.e., we might have a very difficult economic time. The pandemic itself has been a bad time for populists. But the consequence of the pandemic might be a very good time for populists. And in France, the populists, be it Marine Le Pen or Eric Zemmour or the combination of the two, are running neck and neck with Emmanuel Macron. So, elsewhere in Europe we have a very different political landscape.

And I think if populists came back to power in Italy or came to power in France, as well as already being power in countries like Poland and Hungry, then the politics obviously look very different.

Allison Nathan: How likely do you think it is that the populists see a resurgence, again, post this difficult period for the world, but certainly for Europe as well?

Timothy Garton Ash: So, anyone who talks about peak populism being past should just forget it. Populists are still in government in several EU member states like Poland

and Hungary. But clearly, the two key places to watch, particularly after Brexit, which is itself an example of a successful populism, are self evidently France and Italy.

In the French case, we all say, and thank heaven France has such an intelligent electoral system for the presidential elections for the second round. But you know, if it turns out that in the end French voters reject a Le Pen in favor of a centrist candidate like Macron, that will be the third time that French voters have had to do that. They did it for Chirac against father Le Pen. They did it for Macron against Marine Le Pen. If they have to do it again, that's not a very good system where people are having to hold their noses in the second round to vote against rather than for a candidate.

France has been hit by terrorist attack after terrorist attack. One of the worst hit countries in Europe. If there were a terrorist attack the day before the second round, who knows?

The other one to watch is Italy. We're fine so long as Super Mario is there. But if Super Mario did decide to move across to the presidency, then the political game is once again open. And if not Salvini, another populist might well come storming through the door.

Allison Nathan: Given the risks and opportunities Europe is currently facing, we'll continue to watch whether this moment will go down as a seized or another missed opportunity for the European union.

I'll leave it there for now. If you enjoyed this show, we hope you subscribe on Apple Podcasts and leave a rating and comment. I'm Allison Nathan. Thanks for listening to Exchanges at Goldman Sachs. And I'll see you next time.

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