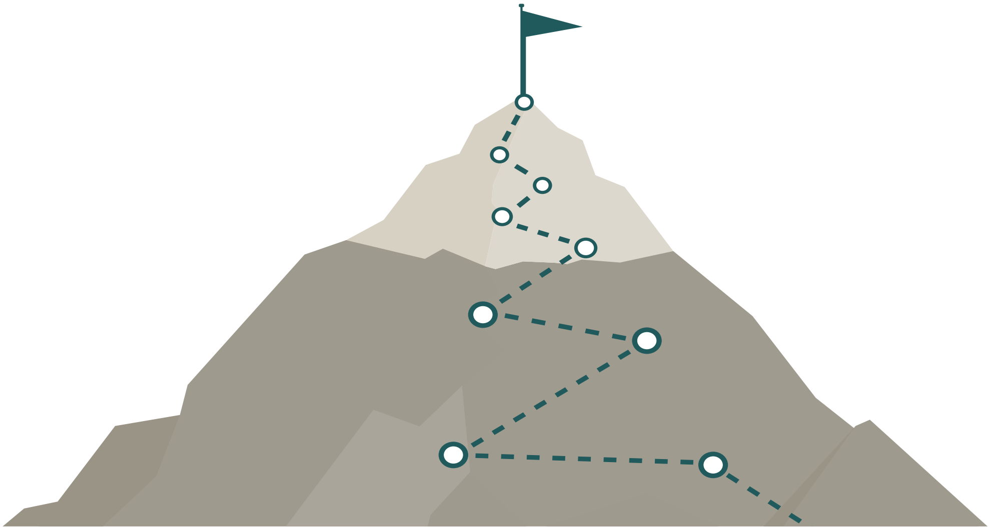


Don’t waste the crisis: How to address Europe’s challenges for the next decade

Peter Sidorov, Francis Yared

While the continuing health and economic crisis caused by the pandemic remains an immediate challenge for European policy, it also presents an opportunity to address the continent’s underlying strategic weaknesses and put it on a more positive trajectory. Much of the change will have to be driven by fiscal policy. Thus, it is encouraging to see governments during the current crisis begin to play a larger role in addressing Europe’s challenges. This has opened the door to pursuing even more decisive action. With fiscal policy as an anchor, other policy areas should complement to create lasting, positive change.

The cost to rebuild from covid will be substantial. In fact, at least €300bn of extra investment is needed per year. However, we should not question whether Europe can afford to pay for a growth-enhancing investment agenda, but if it can afford not to. Indeed, if the euro area can return to its pre-GFC pace of capital deepening and boost productivity growth to the levels seen in the US, the region can boost annual GDP by €1tn after 10 years.

Why governments have a larger role to play

Recent intra-European policy debate has often reflected tensions between those calling for a more proactive EU industrial strategy versus the proponents of free market functions. However, government influence and market competition are not mutually exclusive tools. This is best exemplified by the East Asian growth miracle in the 1970s-80s, which was driven by the combination of improved market functioning – free trade, protection of property rights, lower taxes – and proactive industrial strategies and state influence.

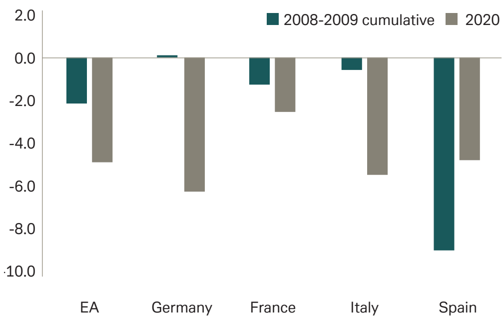
Indeed, many of the areas that present strategic challenges for Europe are ones where market failure has undermined the functioning of free markets in recent years and where governments have a role in fostering effective competition. Climate change is the most crucial area where negative externalities demand a role for government action. Other challenges to effective competition include multi-national tax avoidance and highly concentrated digital markets. At the same time, at the global level there has been a move away from free trade, with geopolitical considerations playing an increasing influence in countries' economic strategies.

Don't waste the crisis

This year, the pandemic has caused a systemic reset in the willingness of European governments to pull the fiscal policy lever, as the crisis removed political and moral hazard barriers to an aggressive policy response. Compared with other crises through history, the scale of the policy response to covid has been extraordinary. Fiscal rules have been suspended and those countries with the most room to provide stimulus have been the most aggressive in using it. The EU made a big leap forward towards fiscal union with the Recovery Fund (NextGenerationEU). At the same time, low inflation has allowed the ECB to aggressively lean against the risk of high fiscal deficits leading to tighter financial conditions.

Discretionary fiscal response far greater than post-GFC in most countries

'Fiscal Stance' (change in the structural primary budget balance), pp of GDP positive numbers = tightening, negative numbers = loosening



Source: European Commission, Deutsche Bank. Updated as of September 2020. Final outturns may be higher given new stimulus in response to second wave of covid in Q4.

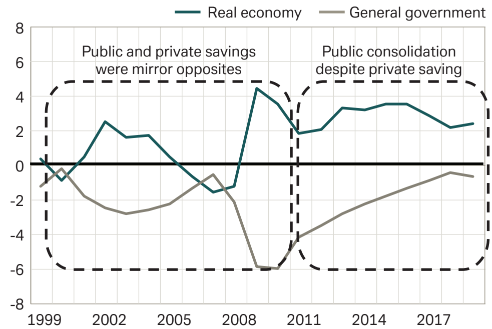
Fiscal support must continue – shifting from cyclical crisis support to structural (investment)

The near-term focus of the fiscal response must remain on supporting affected sectors of the economy and avoiding cliff edge effects while the covid shock persists. With the sharp rise in private saving, fiscal stimulus must not be removed too early as it will risk persistently lower aggregate demand.

As we move beyond the crisis phase, the need for income replacement policies and sectoral support will ease. However, a structurally easier fiscal stance needs to be maintained. This is a key lesson from the last euro crisis where high private savings, coupled with fiscal policy tightening, left the euro area with excess savings. This detracted from the dynamism of the European recovery and placed downward pressure on inflation.

Public consolidation despite high private saving has dragged on euro area growth over the past decade

Net lending/borrowing by sector, % of GDP



Source: Eurostat, Deutsche Bank

Three strategic goals for public investment: Green, Digital, Levelling up

It is critical that Europe does not allow a repeat of the demand-side drag of the past 10+ years. To avoid this, Europe must increase public investment to address the issue of weak demand. This will also provide lasting supply-side benefits that are necessary to offset the impact of the covid shock on potential growth.

Public investment in the euro area remains weak (% of GDP)

Source: Haver Analytics, Eurostat, Deutsche Bank

As new public investment is deployed, there are three key areas that should be the focus points.

Green: Europe should become a global leader

Arguably the most critical area for investment is in climate projects and green energy. Europe has led the world in the growth of green finance and emissions trading, and market-based solutions should be used where possible. However, markets fail to accurately internalise the costs of climate change, with current carbon prices well below those necessary to limit global warming trends.

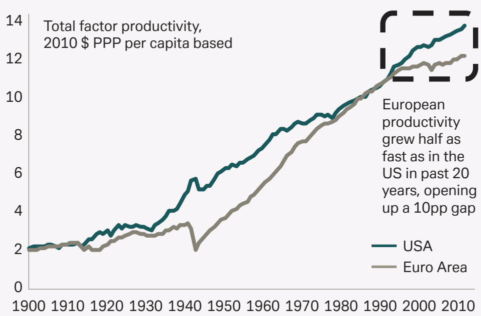
We must be careful. A much higher effective price of emissions – whether achieved through regulatory restrictions or market-based instruments – will represent a sharp negative energy supply shock and weigh on an already vulnerable post-covid recovery. To avoid this, large state-backed green energy investment is required. Such investment would both smooth the costs of transition and support the technological progress required to achieve carbon-light economic growth in the long run.

Digital: Catching up to the US and China

The importance of the digital agenda has been made all the clearer by the covid shock, with more digitally advanced countries better able to adapt to the new realities of work-from-home, online shopping and more.

Europe must therefore start closing its digital gap with the US and China and this must be a focus of new investment. While the EU has become a global rule setter for the digital economy, as exemplified by its GDPR standards, it lags far behind on digital innovation. Indeed, as the digital age as hit full stride over the last 20 years, total factor productivity in the euro area has grown half as fast as that in the US.

European productivity underperformance

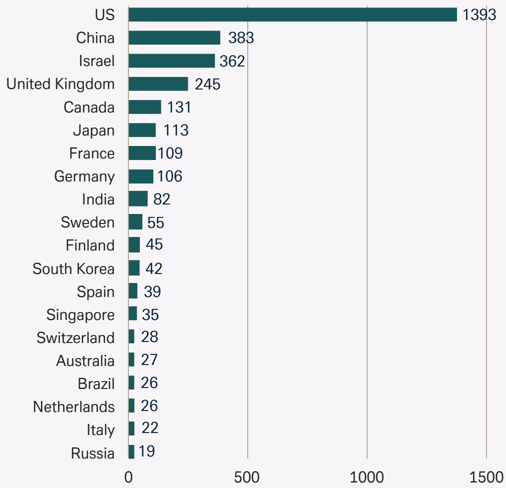


Source: Long Term Productivity Database; A. Bergeaud, G. Cette and R. Lecat

While the EU has talked up the need for a digital transformation, its efforts to date have been disappointing. The digital agenda has been underfunded, accounting for only one per cent of the upcoming EU budget. This is being addressed with the Recovery Fund, which targets 20 per cent of its spending on the digital agenda, but implementation questions remain and larger support is still needed to help Europe narrow the gap in R&D spending in the digital sphere.

The EU lags far behind the US on digital innovation

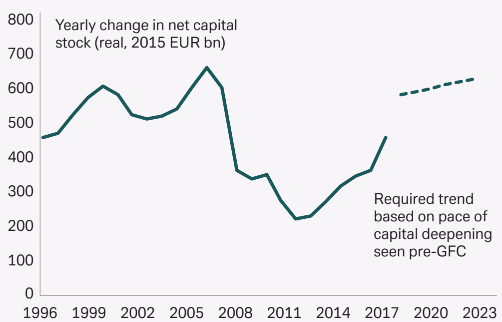
Number of AI startups per country (2018)



Source: Crunchbase retrieved from Center For Data Innovation (2019). Who Is Winning the AI Race: China, the EU or the United States?

In addition to greater R&D funding, the green and digital challenges require increased spending on infrastructure. Since 2008, the pace of capital deepening in the euro area has run at half that seen in the prior decade.

Europe's underinvestment in infrastructure since the GFC



Source: Eurostat

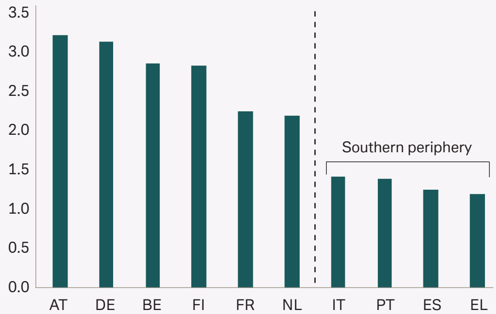
Merely returning to the pre-2008 pace of capital deepening requires an increase of €175bn in annual investments compared to 2019, with an even larger gap now after the covid shock. Coupled with the need to boost R&D and other investment by around one percentage point of GDP, we see extra investment needs of around €300bn a year. This would total €2tn over the next seven years in the euro area alone compared to the €750bn size of the Recovery Fund for the EU as a whole. And this does not account for specific covid-related investment.

While the costs of investment will be substantial, the potential benefits of closing the investment gap and boosting productivity should not be underestimated. For example, if the euro area caught up to the US in terms of the pace of total factor productivity growth and the pace of capital deepening returned to its pre-GFC pace, this would boost annual GDP by €1tn after 10 years. The question is not whether Europe can afford to pay for a growth-enhancing investment agenda, but how can it afford not to.

Levelling up: A successful investment agenda to boost intra-EU convergence

The public investment agenda is not only about improving the prospects for the EU as a whole but also about creating inclusive growth that facilitates economic convergence. Infrastructure investment is a challenge across the euro area – with Germany among countries with lower-than-average spending on this – but the post-2008 decline has been most severe in the periphery. The Southern periphery also performs poorly when it comes to R&D spending and digitalisation in contrast to Northern peers.

Southern Europe underperforms dramatically on R&D spending (% of GDP, 2018)



Source: Eurostat

A levelling up of economic wellbeing was a key selling point of the European project. Indeed, the promise of inclusive growth is required for political buy-in for common EU projects. The Recovery Fund is a crucial step in the right direction, with funds weighted towards countries with lower incomes and higher unemployment. By providing joint funds, it can overcome the political incentives that favour current spending over longer-term projects. By linking public investment and the structural reform agenda, it can offset the short-term costs of reform. At the same time, by directing funds to specific growth-enhancing areas, it addresses moral hazard concerns about EU spending.

The Recovery Fund is not by itself enough. Attracting private co-investments can magnify its impact but overreliance on this could result in only 'low hanging fruit' projects being funded. Maximising private investment requires a strong strategic commitment and progress toward common fiscal capacity – the Recovery Fund cannot be merely a one-off. In the long term, joint revenue-generation will be needed to ensure sustainability of common fiscal tools.

Reforming EU fiscal rules

The much-needed public investment agenda must be credible. It must ensure that fiscal policy can sustainably enhance growth without risking fiscal profligacy. For this to happen, the EU must reform its fiscal rules and simplify them to move away from the situation where testing the flexibilities of the system has become an annual negotiating game between the European Commission and some member states.

Most importantly, the rules need to be made economically relevant. This requires moving away from the 3% deficit and 60% debt limit criteria of the 1992 Maastricht treaty. These levels never had a fundamental economic justification and their rule-of-thumb relevance for fiscal sustainability is based on long-outdated realities of growth, inflation and interest rates.

Going forward, the EU should consider debt sustainability from the perspective of gross financing needs and debt stabilisation. The deficit criteria should move towards a 'golden rule' framework that reflects the importance of growth-enhancing public investment. More explicit allowances for countercyclical stimulus would be also welcome.

While the fiscal rules are suspended for 2020 and 2021, reform is still an urgent matter. The major changes outlined above would require

Treaty change, a multi-year process. The reform process should be started without delay as uncertainty frequently undermines the effective allocation of resources. Indeed, countries' budgetary plans show signs of reluctance to use Recovery Fund loans until there is clarity on fiscal rules.

Competition and tax policies to complement public spending in supporting the EU strategic agenda

Some will argue that the aggressive use of fiscal policy to further Europe's strategic agenda will distort the functioning of the free market. However, state influence and market competition are somewhat different dimensions on which to judge the structure of the economy. Instead, government action must be well tailored and limited to areas where effective market functioning is at risk of failing, rather than simply be indiscriminate or politically-driven intervention. A fiscally-driven investment agenda, as well as competitive markets, can then complement each other and foster growth.

One way for the EU to create complementarity is to complete the Capital Markets Union. This will facilitate the growth of green financial instruments and support the climate agenda. Deeper equity markets would direct additional funding to early stage innovation, which is key if the EU is to challenge the US dominance in the digital space. Developing deeper equity markets would also require reforming the savings system and reducing the tax advantages of debt funding.

Competition policy – an area where the EU has achieved much success in the past 20 years – faces two key challenges. The top anti-trust priority will be facilitating the EU's digital agenda by ensuring effective competition in the digital space. The emergence of platform monopolies in which entire marketplaces are controlled by individual corporations is an unusual challenge for free markets. The other challenge is to adapt state aid rules in areas where strategic support is needed to address market failures (climate change, geopolitical challenges to free trade).

Enhancing competition will also require progress on tax reform and digital taxes to address multinational tax avoidance. Unified support for the OECD's corporate taxation proposals will speed these reforms. Of course, some member states that benefit from the status quo will push back, but their support could be garnered as part of a larger grand bargain that includes the creation of common fiscal tools.

To support inclusive growth, shifting the tax burden from earned income towards unearned income and wealth should be explored. Popular concern over inequality is likely to grow worse post-covid, particularly among the young and lower-earning workers who have suffered the most in the crisis. The increase in private savings has largely accrued to those at the higher end of the income spectrum, who have also seen their wealth protected by monetary stimulus.

External policy: Combining multilateral efforts and strategic autonomy to support the EU agenda

Many of the policy challenges above are most effectively addressed at the global level, particularly climate and corporate taxation issues. This highlights the importance of the EU's external policy. A push for greater multilateral co-operation – which should include reform of multi-lateral institutions – will be more achievable under a Biden administration. However, the transatlantic relationship will still have key challenges. Areas of tension such as lower defense spending are likely to remain on Washington's radar, while a divided Congress would make it less likely that the US can match EU ambitions on climate change.

Recent experience highlights that Europe cannot be over-reliant on the US in geopolitical matters. So while multilateral efforts should be pursued where possible, Europe must also maintain the push for greater 'strategic autonomy'. This also applies to defence, with the need for a deeper EU common defence policy becoming more pertinent after Brexit, with France now the only nuclear power and UN Security Council member in the EU. Meanwhile, a stronger common migration policy would boost the levelling up agenda and provide greater support for exposed Mediterranean countries.

Conclusions

As we rebuild from the pandemic, Europe must not return to a status quo of national interests that lead to paralysis. Worryingly, this could become a 'Japanisation minus' scenario of secular stagnation with excess savings as well as low growth, inflation, and real rates; but with a less cohesive and stable internal environment.

Europe has already taken one big step forward by allowing common and more proactive fiscal policy to go mainstream. Post-covid, we have a unique opportunity to make greater use of fiscal policy to support the strategic goals of the EU with public investment. For this to work, fiscal expansion must be sustained. We must rewrite the fiscal rules and create common fiscal capacity. 'Core' country concerns over fiscal union can be mitigated if the EU fiscal remit is well defined and is accompanied by complementary growth-enhancing policies. Europe cannot afford to waste this opportunity.

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