How to jumpstart the Eurozone economy

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The stagnating Eurozone economy requires policy action. This column argues that EZ leaders should agree a coordinated 5% tax cut, extension of budget deficit targets by 3 or 4 years, and issuance of long-term public debt to be purchased by the ECB without sterilisation.

The mantra is that once again it is up to the ECB to save the Eurozone. Quantitative easing is the last policy tool available to jumpstart the Eurozone economy. The longer the ECB waits before starting to buy government bonds, the further away will the recovery be. This analysis, however, overestimates the power of monetary policy.

Quantitative easing should take place, but together with fiscal easing

The main challenge currently faced by the Eurozone is a lack of aggregate demand. This is much more important than internal imbalances or lack of competitiveness in the periphery.

At the end of 2013:
• Private consumption in the Eurozone was 2% below its 2007 level;
• Private investment was 20% below the 2007 level;
• Producers' prices have been decreasing for over a year.
The only bright spot is the rise of exports by almost 10% since late 2013.
• In the US, by contrast, GDP and private consumption are 6–7% above where they were six years ago, and investment too is above its pre-crisis level.

Macroeconomic policy in the Eurozone is no longer a national prerogative

If lack of demand is the problem, then the solution can only be found at the European level. Fiscal policy is bound by the Stability Pact and monetary policy is in the hands of the ECB. Moreover, spillover effects between member states make a coordinated effort to revive aggregate demand much more effective than isolated, country-specific actions.

What can be done to increase aggregate demand in the Eurozone? From a technical point of view, the answer is simple and has few disadvantages.
• All countries should enact a large tax cut, say corresponding to 5% of GDP.
• They should be given several years (say three or four), to reduce the budget deficit created by this tax cut, through a combination of higher growth and lower expenditures.

• To finance the additional deficits, members states should issue long-term public debt with a maturity of say 30 years.
This extra debt should all be bought by the ECB, without any corresponding sterilisation, and the interest on the debt should be returned to the ECB shareholders as seigniorage.

Combining a monetary and a fiscal expansion is key to the success of aggregate demand management, as shown by the recent experience of other advanced countries. Quantitative easing by itself would not do much to revive bank lending and private spending, because credit in Europe flows mostly via banks, rather than financial markets. And fiscal expansion without monetary easing would be almost impossible, because public debt in circulation is already too high in many countries. The combined monetary and fiscal expansion would stimulate aggregate demand both directly and indirectly, through a devalued exchange rate. The resulting temporarily higher inflation would be welcome, as it would reduce the debt overhang problem and it would facilitate achieving the ECB's price stability goal.
Juncker's investment plan is too timid

The new Commission President, Jean-Claude Juncker, hinted that he plans to address the lack of aggregate demand by launching a public investment program worth €300 billion over the next three years. But the plan is much too timid.
• The monetary expansion part is missing, which makes financing problematic and reduces the effectiveness of the stimulus.
• Higher public investment has several disadvantages compared to tax cuts, as the experience of Japan has shown.
• Critically, it would take much longer to be implemented, and action is needed now, not in two years.
Moreover, in some countries it is likely to lead to corruption and misallocation of resources. Some investment in European infrastructure is welcome and should be financed by the European Investment Bank, but not on the scale that is needed to overcome the aggregate demand failure that is sinking the Eurozone.

Political obstacles

The main objection to the combined monetary and fiscal stimulus described above is not economic, but political. It would be opposed by Germany, and perhaps a few other member states, because it runs counter to the principle of monetary and fiscal policy separation that is enshrined in the Treaty, and because the idea that taxes are too high in Europe does not go down well with the principles of a social market economy.

If political concerns were to prevent a coordinated action to revive aggregate demand, six months down the road the ECB would be forced to engage in quantitative easing anyway, to try and fight deflation. But this will not work. And the Eurozone will remain depressed, fuelling anti-European sentiment among its citizens.