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BEYOND BANKING

Flash Economics

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What would the ECB and euro-zone countries' governments do if euro-zone growth fell sharply?

As a result of rising oil prices, mounting uncertainty and recruitment difficulties, it is possible that euro-zone growth will fall sharply. What could be the economic policy response in that case?

- The ECB could obviously not cut its interest rates;
- The only possibility would be an increase in fiscal deficits financed by money creation, to prevent a marked rise in long-term interest rates due to the high level of public debt;
- The euro zone would therefore - like Japan - enter a process of a simultaneous and continuous increase in the public debt and in the size of the central bank's balance sheet. We would expect this development to lead to a financial crisis (rejection of money and currency crisis), but we must recognise that it has not yet taken place in Japan.

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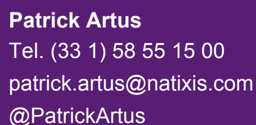

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ECONOMIC RESEARCH

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It is possible that euro-zone growth will fall sharply

The euro zone will suffer from:

- **The rise in the oil price,** which is leading to inflation and slowing real wages **(Chart 1A)** and therefore consumption **(Chart 1B);**

Chart 1A
Euro zone: Inflation and nominal per capita wage (Y/Y as %)

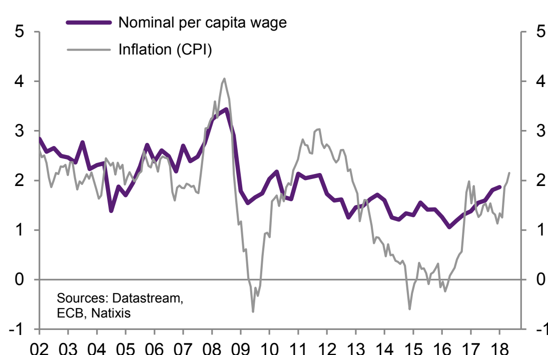
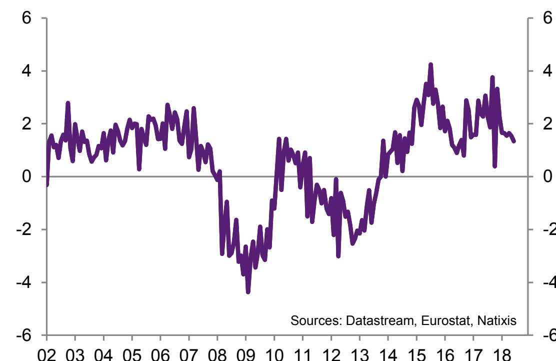
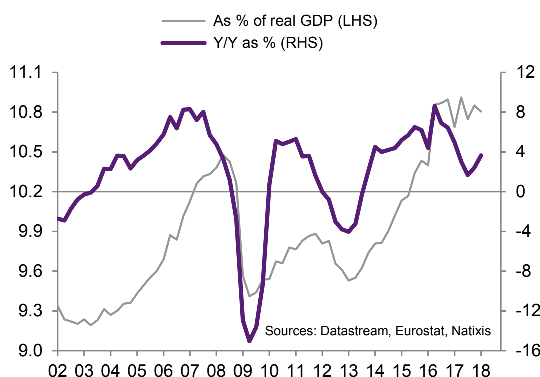


Chart 1B
Euro zone: Retail sales (in volume terms, Y/Y as %)



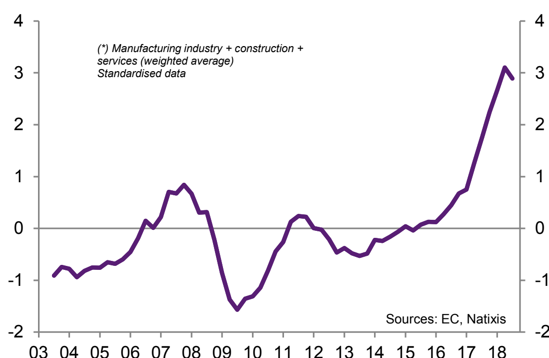
- **The mounting uncertainty** (protectionism, sanctions against Iran and Russia, Italian crisis) that may discourage corporate investment **(Chart 2);**

Chart 2
Euro zone: Real productive investment



- **Companies' recruitment difficulties (Chart 3),** which may curb employment.

Chart 3
Euro zone: Proportion of companies experiencing recruitment difficulties* (as %)



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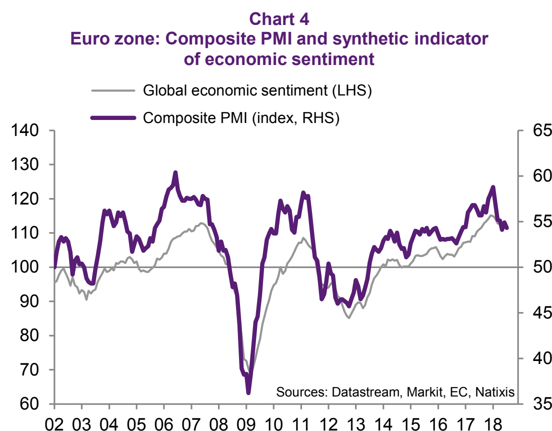
These developments may lead to a marked slowdown in euro-zone growth, consistent with the trend in cyclical indicators **(Chart 4).**

Chart 4
Euro zone: Composite PMI and synthetic indicator of economic sentiment

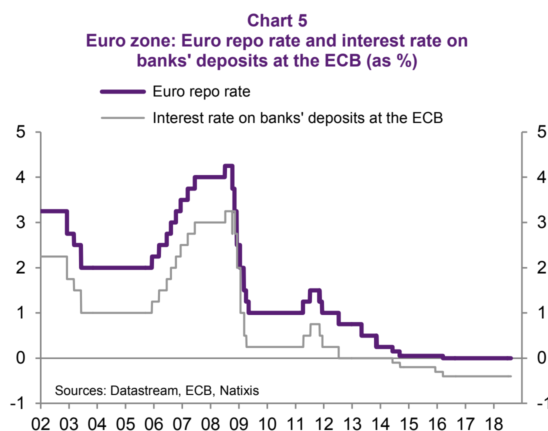


So what could be the euro zone's economic policy response if its growth slowed down markedly?

If euro-zone growth slowed down markedly in 2018-2019:

- **The ECB could not cut its interest rates (Chart 5);**

Chart 5
Euro zone: Euro repo rate and interest rate on banks' deposits at the ECB (as %)



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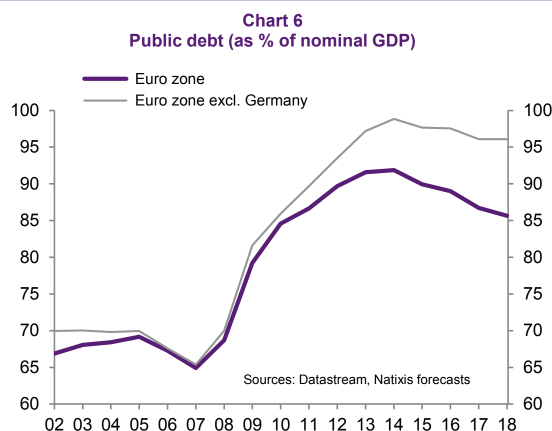
- Given the high level of public debt (excluding Germany, **Chart 6**), **an expansionary fiscal policy may push up long-term interest rates sharply;**

Chart 6
Public debt (as % of nominal GDP)



- **The only solution would then probably be:**
  - **An expansionary fiscal policy;**
  - **Financed by the ECB, i.e. with monetisation of fiscal deficits** to keep interest rates from rising.

The result would therefore be a **return of considerable fiscal deficits (Chart 7A) and a resumption of a large-scale quantitative easing programme (Chart 7B).**

Chart 7A
Fiscal deficit (as % of nominal GDP)

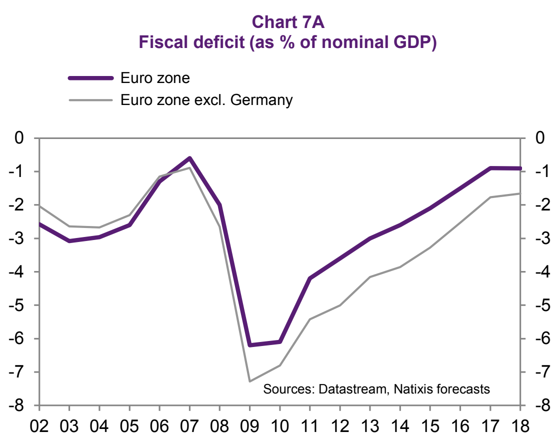
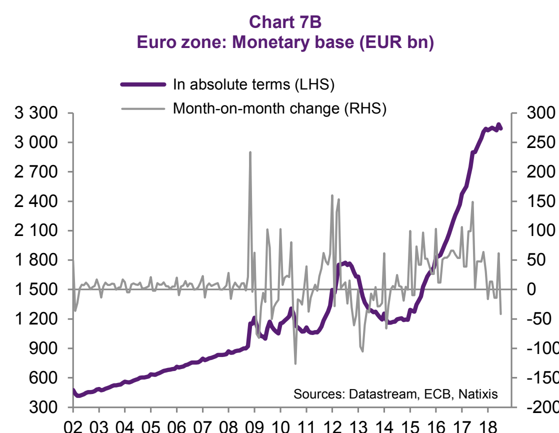


Chart 7B
Euro zone: Monetary base (EUR bn)



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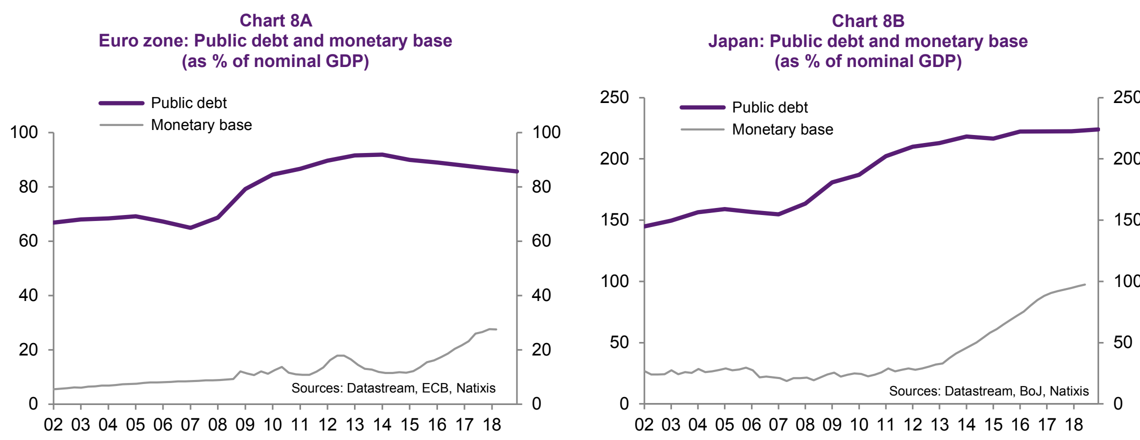
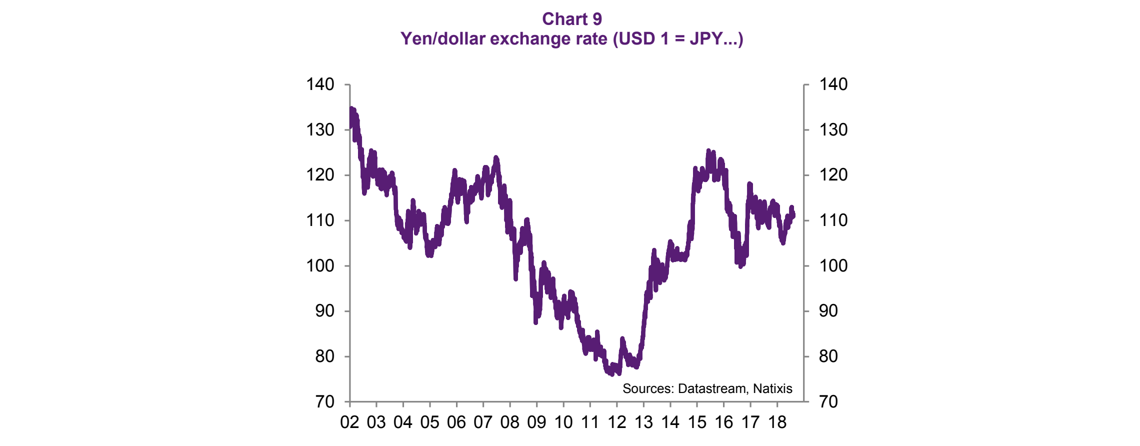
Conclusion: What are the risks?

If euro-zone growth fell markedly, the economic policy response would therefore probably be **an expansionary fiscal policy financed by money creation.**

This means that, **like in Japan, there would be a simultaneous rise in the public debt ratio and in the size of the central bank's balance sheet in the euro zone (Charts 8A** and **B).**



We would expect this configuration to lead to a financial crisis, a currency crisis in particular, due to the excess money creation financing low-productivity public spending. **But it has to be admitted that this currency crisis has not yet taken place in Japan (Chart 9).**



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