Flash Economics

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Euro zone: The distribution of the effort between fiscal and monetary policy has not been optimal

We defend the following theory: in the euro zone it would have been better if:

- Fiscal policy had been more expansionary from 2010;
- Monetary policy had been less expansionary from 2014-2015.

This preference is explained by the following facts:

- Fiscal policy seems to be more effective than monetary policy in boosting activity;
- Zero interest rates have well-known drawbacks: weakening of banks, asset price bubbles.

If interest rates were partially normalised as in the United States, these drawbacks of zero interest rates would have been avoided while making an expansionary fiscal policy possible.

Since 2010 the euro zone has, on the contrary, made an extreme choice: restrictive fiscal policy, ultra-expansionary monetary policy.

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ECONOMIC RESEARCH

Two findings

The first finding is that monetary policy has not been very effective in the euro zone.

The switch to a very expansionary monetary policy in 2014-2015 (Charts 1A and **B) did not restore potential growth, did not prevent growth from being quite modest (Chart 2A), and did not drive up core inflation (Chart 2B).**

Chart 1A
Euro zone: Nominal GDP, euro repo rate and interest rate on 10-year government bonds

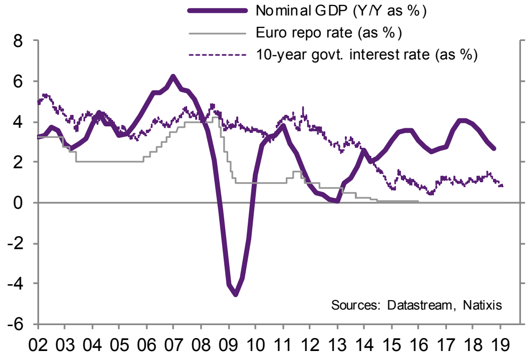


Chart 1B
Euro zone: Monetary base (as % of nominal GDP)

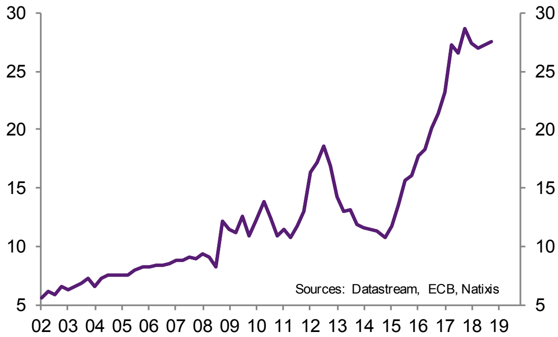


Chart 2A
Euro zone: Real GDP and potential growth (Y/Y as %)

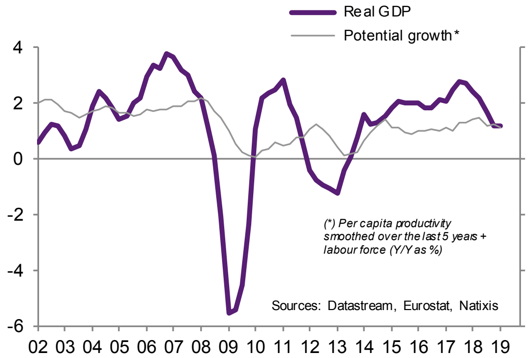
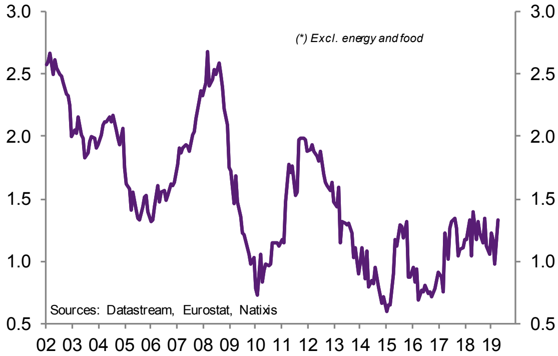


Chart 2B
Euro zone: Core inflation* (core CPI, Y/Y as %)



The second finding is that zero interest rates have significant drawbacks: weakening of banks (Chart 3A) that are faced with a very low level of interest rates on loans **(Chart 3B), real estate price bubble (Chart 3C)**.

Chart 3A
Euro zone: RoE and banks' profits

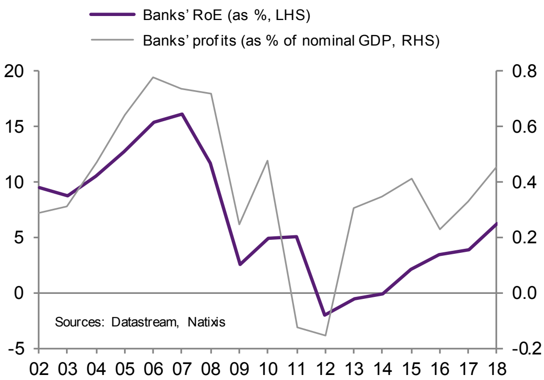


Chart 3B
Euro zone: Interest rate on fixed-rate loans to households and companies (as %)

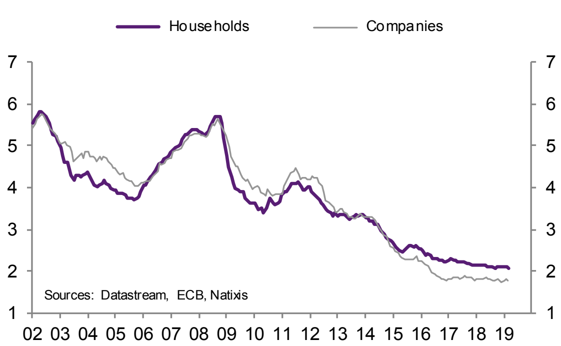
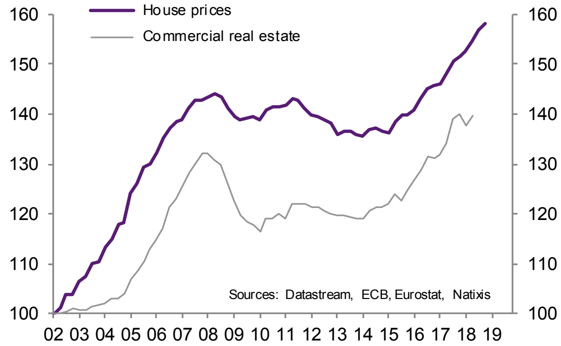


Chart 3C
Euro zone: House prices and commercial real estate prices (2002:1 = 100)

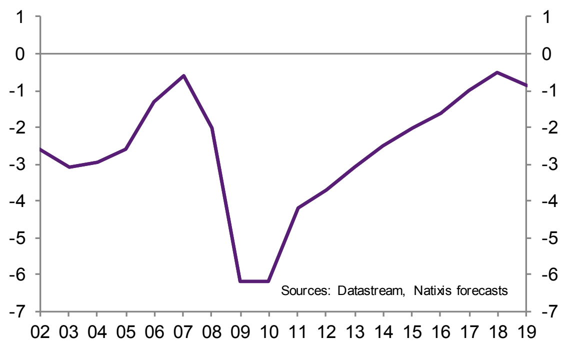


Hence our suggestion

If monetary policy is not very effective in boosting activity and if zero interest rates have significant drawbacks, it **would have been better for the euro zone if:**

- **Fiscal policy had remained more expansionary from 2010 to 2015 (Chart 4);**

Chart 4
Euro zone: Fiscal deficit (as % of nominal GDP)



- **Monetary policy (Charts 1A** and **B** above) **had become less expansionary from 2014-2015**.

All things considered, **the choice made in the United States** (semi-normalisation of interest rates and no major fiscal policy contraction, **Charts 5A** and **B**) seems better than the choice made in the euro zone.

Chart 5A
United States: Nominal GDP, Fed Funds rate and interest rate on 10-year Treasuries

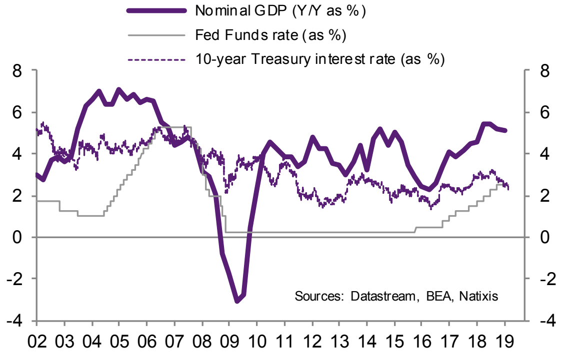
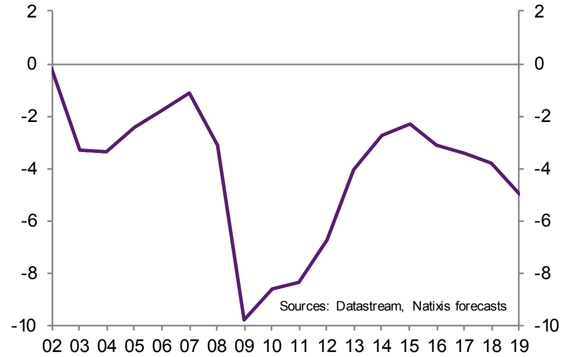


Chart 5B
United States: Fiscal deficit (as % of nominal GDP)



Conclusion: Why this extreme choice in the euro zone?

Since 2010, the euro zone has made an extreme choice:

- Fiscal policy that became restrictive again;
- Ultra-expansionary monetary policy.

This extreme choice is odd, when we see that monetary policy is less effective than fiscal policy in boosting activity and that zero interest rates have serious drawbacks.

Disclaimer