Berlin Debates, 3 March 2015:
'Europe Needs Fiscal Stimulus'
At the European Commission, Berlin

Keynote speech from Jean-Claude Trichet:

In his opening remarks preceding the debate, **Jean-Claude Trichet**, former ECB President, provided an overview of current conditions within the Euro Area economy and assessment of the policy measures required to deliver a more sustained economic and labour market recovery during the next several years. Mr Trichet also outlined that despite several years of very weak underlying activity, consensus forecasts point towards a continued disappointing regional recovery relative to other developing economies, notably the US, over the short and medium term horizon.

In assessing factors behind this diverging performance versus the US, Mr Trichet highlighted ageing demographics, structural economic rigidities (notably within the labour market), and lasting damage inflicted by the Euro Area's sovereign debt crisis. He also noted that the region's sharp external account adjustment has led to much weaker domestic demand relative to the US economy, where a balance of payments surplus has supported business investment and household consumption.

Regarding the policy response to the crisis, the additional powers granted to the European Commission through a bolstered Stability and Growth Pact and the Macroeconomic Imbalance Procedure were mentioned by Mr Trichet as particularly significant developments. Following the ambitious measures already taken by the ECB, he stressed that the burden of responsibility now lies with national governments to implement further growth enhancing structural economic reforms.

Mr Trichet welcomed the Juncker investment plan as a means of boosting domestic demand, but warned that outright fiscal stimulus would pose a threat to investor confidence in countries with elevated government debt levels. While some economies, notably Germany, may have some capacity to boost public expenditure, in his view current conditions do not call for an outright stimulus, with fiscal expansion a policy tool to be employed only as a final resort. However, a crucial step towards intra-regional economic rebalancing must include an improved dialogue between social partners, and Mr Trichet outlined the importance of a more sustained increase in nominal wages and inflation within the region's largest economy, Germany.

The Debate:

Jan Vincent-Rostowski, finance minister of Poland from 2007-13, opened the case in support of the motion by stressing how the region's ongoing economic downturn and elevated levels of unemployment poses a fundamental threat to social and political cohesion with the EU, and must be urgently addressed to stem future catastrophe.

Mr Rostowski stressed his period at the helm of Poland's economy as evidence of the benefits of applying counter cyclical fiscal stimulus, in conjunction with structural reforms, in generating a solid economic and labour market recovery. While acknowledging that fiscal retrenchment alongside structural reforms may be sufficient to generate growth within small, open economies, such as Ireland, in his opinion it is not an appropriate policy tool within larger countries where trade represents a smaller share of economic output, not least following a deep financial crisis.

Mr Rostowski outlined a radical proposal to commandeer the ECB balance sheet to directly finance an increase in government spending, as the optimum way to directly target fiscal stimulus to appropriate areas of the economy. He added that issues of moral hazard could be avoided by enabling only 'virtuous' economies, where structural reforms have taken place, to access central bank debt financing.

Also speaking in support of the motion, **Natacha Valla,** Deputy Director of CEPII in Paris, highlighted the increase in political and social risks associated with the Euro Area's dismal economic performance and elevated levels of unemployment. Failure to generate a sustained economic recovery will elevate the chances of future sovereign debt restructurings, according to Dr Valla. In presenting the case for targeting fiscal stimulus towards increased public investment, she also outlined the worrying stagnation in productivity growth. In her view, fiscal stimulus would also enhance the capacity of national governments to successfully implement much-needed structural reforms, with the boost to growth provided by investment resulting in a more cohesive social environment in which to ratify politically controversial legislation. Dr Valla outlined concern that the use of guarantees rather than outright public spending within the Juncker investment may reduce private sector appetite to participate.

Jürgen Stark, former member of the ECB executive board, opened the case against the motion, providing the example of Japan as evidence of the ineffectiveness of fiscal (and monetary) stimulus in generating economic growth rather than merely driving a rapid increase in government debt. In his view, solid government finances represent a pre-requisite for robust economic growth. Dr Stark highlighted inadequate private sector deleveraging and banking sector consolidation as a primary factor behind the Euro Area's dismal economic performance in recent years. He also stressed that weak implementation of structural economic reforms (particularly those targeting the labour market), alongside disincentives to reform following excessively loose monetary policy, as further factors behind the region's stagnating economy. Dr Stark presented diverging intra-Euro Area economic performance, as evidence of the fundamental importance of structural reforms. He added that historical precedent suggests that the Juncker investment plan will be poorly targeted and ineffectual.

In opposition to the motion, **Ruta Arumäe,** economic advisor to the Estonian Prime Minister, outlined how adding to the stock of public debt will not solve the European debt crisis. In her view, the example of Estonia is evidence that wholesale fiscal stimulus is unnecessary to generate economic expansion. Ms Arumäe added that rather than an outright increase in public expenditure, members of the Euro Area should use budgetary tools to enhance the effectiveness of public investment as a means of driving future growth. In outlining her views on the paramount importance of deeper structural reform, Ms Arumäe spoke of the need to improve the private sector business environment as a more effective policymaker tool than fiscal stimulus.

A pre-debate vote revealed a sizeable majority of the audience in favour of the motion 'Europe Needs Fiscal Stimulus' – with 55% voting for, 18% against and 27% abstaining. In the post-debate vote, the size of the majority had declined, with 48% in favour, 33% against and 19% abstaining.