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Fiscal austerity may hamper ECB's path to exit

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Reuters

Frankfurt: The European central bank may have to go slow on withdrawing its support for the economy if euro zone governments come through on promises to start getting budgets into line from 2011.

Over the last month, ECB policymakers have sharpened their tone on shaky public finances, pressing governments to clean up budgets quickly or face the risk of proportionately higher interest rates — bringing higher repayments on public debt.

Economists see little chance of the ECB raising rates as a punishment for slow action but note central bankers cannot ignore the impact of fiscal exits when setting interest rates. European Union members have promised to start deep cuts to budgets by 2011 at the latest and many have a tough job ahead to get deficits back in line with the EU's limit of 3% of gross domestic product (GDP) this year.

The European Commission expects the euro zone budget deficit to more than triple to 6.4% of GDP this year, with countries like Ireland and Spain in double-digits. Public debt is seen at 78% of GDP this year, far above the EU's 60% limit.

Analysts polled by *Reuters* expect the ECB to start raising interest rates from a 1% record low in the fourth quarter of 2010, likely reaching 2.25% by mid-2011.

But if fiscal exit strategies drag on the economy that year, the ECB might find it cannot normalise rates as quickly as it might do in other circumstances, and lag the 2 percentage point tightening in 18 months seen from December 2005.

"If it's a significant budget consolidation with a negative effect on growth of course it will mean that the ECB will raise rates less, or less fast, than otherwise," Bank of America Merrill Lynch economist Holger Schmieding said. "But we would first of all have to see the fiscal tightening."

Think-tank Bruegel, in a paper prepared for EU finance ministers' and central bankers' informal meeting last month, recommended central banks wait to withdraw liquidity and monetary support until after fiscal reforms.

"Simultaneous and vigorous pursuit of all three exit policies might entail a serious risk of a double-dip recession and a renewed crisis in the banking sector," the group said.

The ECB says it will unwind its support measures as soon as the recovery starts and ECB President Jean-Claude Trichet has firmly dismissed any "ex ante coordination" of exits with governments.

But the ECB does not set policy in a vacuum and says it takes all variables into account, including fiscal ones.

Hollow Threats

Economists calculate euro zone governments have announced extra crisis spending worth about 1% of GDP this year, and slightly less in 2010.

The fiscal exit will involve unwinding these steps, as well as wider budget reforms — BNP Paribas calculates it will take 10 years of surpluses worth 2.7% of GDP to cut debt to an acceptable 60% ratio.

Further complicating the ECB's exit path is the uncertain economic benefit of such crisis measures, meaning it is difficult to predict the impact of their withdrawal.

Merrill's Schmieding calculates fiscal stimulus will add about 0.5 percentage points to 2009 growth and slightly less in 2010.

"That of course means that 0.5 will be missing the following year without fiscal stimulus, and if policy goes into reverse, which it should then ... the overall impact will even be bigger," he said.

However, if confidence improved as a result of reforms, the negative growth impact would be blunted, while hiking indirect taxes to fund projects would put upward pressure on inflation and increase the case for higher interest rates.

"Just as not every euro that governments are spending in their stimulus packages is actually good for growth, not every fiscal retrenchment will be bad for growth," Schmieding said.

RBS economist Jacques Cailloux estimates the impact on 2009 growth from fiscal stimulus at a scant "couple of tenths" of a percentage point.

"If it's pure spending, you would say it's one for one. But if it's an infrastructure investment which is spread over a couple of years, gauging the impact on GDP is far more difficult," he said, pointing also to geographic differences.

"A typical case is that German fiscal stimulus ends up being saved, while in other countries it goes into spending."

Goethe University of Frankfurt professor Volker Wieland said the impact of fiscal stimulus was often muted by government spending crowding out consumer spending.

"Consumers may already cut back their purchases and save more now, because they realize that as taxpayers they will have to pay the bill later," he said.

Such forecasting difficulties partly explain why economists set little store in the ECB's warnings on budget discipline, which have gone up a notch in the last month.

Finland's Erkki Liikanen urged a timely withdrawal of stimulus, saying this would give the ECB more room to support growth without fanning inflation.

Executive Board member Juergen Stark wielded a stick to Liikanen's carrot, saying fiscal excess could have "severe consequences" for the economy and ECB policy.

Analysts said politicians would not pay too much attention.

"It would be very difficult to get a consensus within the (ECB) Council to say that because x country or the euro area as a whole has not done its job on the fiscal side, that they should raise rates by x amount more to offset this, and vice versa," Cailloux said.

But markets, which have already pushed up the cost of Greek and Irish debt compared to German, might be more effective.

"I don't think the European Commission can do much and neither can the ECB. But

the market can. If you are a government and your borrowing costs have increased by x basis points relative to two years ago, you think twice before you go to the market," Cailloux said.

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