

Fiscal policy will remain accommodative, but prudence is not out of the door

How accommodative will eurozone fiscal policy get? In the short run, probably not enough to avoid a marked slowdown or even recession. In the long run, it is likely to remain more expansionary, resulting in tough choices on burden sharing, spending rules or fiscal adjustment



The Ukraine war is adding to fiscal spending needs

The war will change spending through three main channels

At the national level, governments had started 2022 moving away from very expansionary policies toward normalisation as the pandemic had moved into a less impactful phase for the economy. The new geopolitical reality is now adding to fiscal spending needs though, likely reversing the course for eurozone governments. We expect fiscal spending to change in three main ways, resulting in more spending for 2022, but more notably also resulting in higher structural spending beyond 2022.

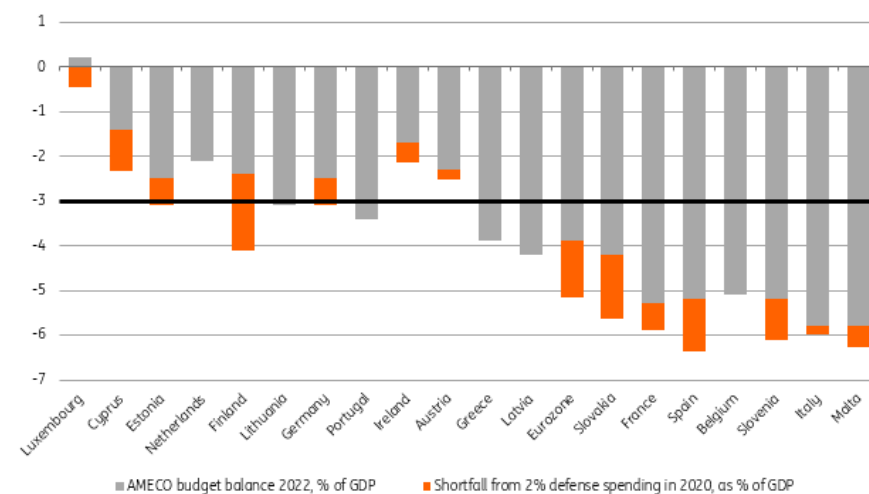
Defence spending is set to see a significant revival. Germany led the way by announcing plans to use €100bn from the 2022 budget on the military and to reach 2% of GDP in annual defence spending in the years to come. The latter is something that many eurozone countries fall short of and, as most are NATO countries, they are therefore not fulfilling their commitment. The EU

summit in Versailles agreed on substantially increasing defence expenditure and investment. Boosting military spending to 2% of GDP would result in the eurozone budget deficit surpassing 4% of GDP – it is currently at just 1.5% of GDP, when all other expenditures remain unchanged.

Energy dependency reduction is set to be a focal point of government policy in the short and medium-term. The Commission’s REPowerEU plan is at the heart of this and has drafted the main pillars for government action, which we have addressed in more detail [here](#). Short-term plans include shifts away from energy dependence on Russia, which is hard to achieve without increasing spending. Looking at the medium-term, plans for the green transition are now going to be done sooner to help achieve energy independence goals. These plans include sizable investments in renewables, but also investing in gas and electricity infrastructure, among others.

Fiscal support for households is being ramped up to counter the negative purchasing power effects of higher energy prices. This already happened at the end of last year to a modest degree when natural gas prices first spiked, but the current situation is causing governments to add new rounds of stimulus. We wouldn’t discount eurozone governments deciding on support schemes for companies in the coming months as business costs are up significantly as well due to higher energy prices.

Additional military spending would add to already significant budget deficits



Source: World Bank, European Commission, ING Research

Note: given the sharp contraction in GDP in 2020, it is likely that this understates the shortfall in military spending for 2022.

Tough choices for European fiscal policy ahead

There are no easy choices on the table here. The structural increase in spending is going to come with either the running up of already high national debt levels (which would mean a further breach of the Stability and Growth Pact [SGP] and realistically demand more far-reaching reform), austerity with other parts of the government budget, or further steps towards a transfer union. Tough choices generally mean delayed decision-making in the EU, but crises can make the EU make groundbreaking decisions at decent speed as the Covid-19 crisis showed. This crisis has the

potential to do something similar, but we do expect this to be in part dependent on how the war in Ukraine develops. We do not expect far-reaching reforms of the SGP that would exclude investments at this point, so if indeed the war results in groundbreaking decisions, we would expect it to be in some form of joint debt issuance.

Fiscal policy will remain accommodative in the years ahead but not excessively accommodative. The age of austerity is over, but prudence is not out of the door. We expect some rebalancing of government spending to happen, but not actually leading to tightened policy stances in the medium-term. And how accommodative fiscal policy can then become depends on whether defence and energy independence spending is funded centrally or not, whether there will be substantial SGP reform and whether the European Central Bank continues to be an important player in the bond market. Our best guess at this point is that a SURE-type lending programme will be introduced. This fudge allows governments to structurally invest at low rates. The fact that this does add to national debt continues to force governments to reform and remain prudent in other spending. This still demands significant SGP reform, but with low interest rates locked in, EU leaders can afford to kick the can down the road with that issue for some time to come.

Authors

Bert Colijn

Senior Economist, Eurozone

bert.colijn@ing.com

Carsten Brzeski

Global Head of Macro

carsten.brzeski@ing.de

Disclaimer

This publication has been prepared by the Economic and Financial Analysis Division of ING Bank N.V. (“ING”) solely for information purposes without regard to any particular user's investment objectives, financial situation, or means. *ING forms part of ING Group (being for this purpose ING Group N.V. and its subsidiary and affiliated companies).* The information in the publication is not an investment recommendation and it is not investment, legal or tax advice or an offer or solicitation to purchase or sell any financial instrument. Reasonable care has been taken to ensure that this publication is not untrue or misleading when published, but ING does not represent that it is accurate or complete. ING does not accept any liability for any direct, indirect or consequential loss arising from any use of this publication. Unless otherwise stated, any views, forecasts, or estimates are solely those of the author(s), as of the date of the publication and are subject to change without notice.

The distribution of this publication may be restricted by law or regulation in different jurisdictions and persons into whose possession this publication comes should inform themselves about, and observe, such restrictions.

Copyright and database rights protection exists in this report and it may not be reproduced, distributed or published by any person for any purpose without the prior express consent of ING. All rights are reserved. ING Bank N.V. is authorised by the Dutch Central Bank and supervised by the European Central Bank (ECB), the Dutch Central Bank (DNB) and the Dutch Authority for the Financial Markets (AFM). ING Bank N.V. is incorporated in the Netherlands (Trade Register no. 33031431 Amsterdam). In the United Kingdom this information is approved and/or communicated by ING Bank N.V., London Branch. ING Bank N.V., London Branch is authorised by the Prudential Regulation Authority and is subject to regulation by the Financial Conduct Authority and limited regulation by the Prudential Regulation Authority. ING Bank N.V., London branch is registered in England (Registration number BR000341) at 8-10 Moorgate, London EC2 6DA. For US Investors: Any person wishing to discuss this report or effect transactions in any security discussed herein should contact ING Financial Markets LLC, which is a member of the NYSE, FINRA and SIPC and part of ING, and which has accepted responsibility for the distribution of this report in the United States under applicable requirements.

Additional information is available on request. For more information about ING Group, please visit <http://www.ing.com>.