Should the Eurozone rely on the US?

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The Covid-19 pandemic has led governments and central banks around the world to implement expansionary fiscal and monetary policies. The United States stands out for its substantial fiscal support, which is much greater than that in the euro area. In a recent paper prepared for the Monetary Dialogue between the European Parliament and the European Central Bank, we review these measures and discuss their international implications. Given the size of the US stimulus packages and the weight of its economy, we can indeed expect significant spillover effects on the euro area. However, the impact will depend not only on the orientation of economic policy but also on the precise nature of the measures adopted (transfers, spending and the articulation between monetary and fiscal policy).

Expansionary monetary policy is generally perceived as a policy based on self-interest, since a fall in the US interest rate should lead to a depreciation of the US dollar that is unfavourable to America's trading partners. However, the literature shows that the exchange rate channel can be dominated by a financial channel and by increased demand from the US economy, both of which generate positive spillovers (see Degasperi, Hong and Ricco, 2021).

The international spillover from US fiscal policy should also be positive, once again *via* demand effects, and also due to an expected appreciation of the dollar (see Ferrara, Metelli, Natoli and Siena, 2020) as well as from expectations of a return to balanced public finances à la Corsetti, Meier and Müller (2010). The favourable impact on the rest of the world might also be attenuated if the US fiscal expansion were to lead to a rise in the global interest rate. Ultimately, the magnitude of the international spillover effects of US fiscal policy will depend on the response of the exchange rate and the interest rate. Faccini, Mumtaz and Surico (2016) confirm the importance of financial effects but nevertheless show that the real interest rate could fall after a US expansionary shock.

In this paper, simulations conducted using a macroeconomic model and empirical analysis confirm the positive effects of US expansionary monetary policy on euro area GDP. There is, however, uncertainty about the timing and duration of these positive effects.

As regards fiscal policy, empirical analysis suggests that the spillover from the US measures implemented since the outbreak of the Covid-19 crisis will be positive, at least in the short term (in the first two years). Given the size of the fiscal impulse, the impact would not be negligible.

The global spillover from US macroeconomic policies is therefore expected to be positive, but there is some uncertainty beyond 2022.

However, it should be borne in mind that the euro area’s growth will depend primarily on the path taken by its own policy mix. The euro area should not therefore rely only on US policy to consolidate and accelerate its recovery. The contrasting fiscal impulses in 2020 and 2021 between the US and the euro area already indicate a risk of increasing divergence between the two regions.

We also briefly discuss that the main repercussions from the US may come not from macroeconomic policies but from financial risks. Asset prices have risen sharply in 2020, sparking fears of a financial bubble, at least in the US. This risk could have a significant impact on the euro area in the medium to long term.