



# **THE ANALYSIS OF EURO AREA FISCAL STANCE**

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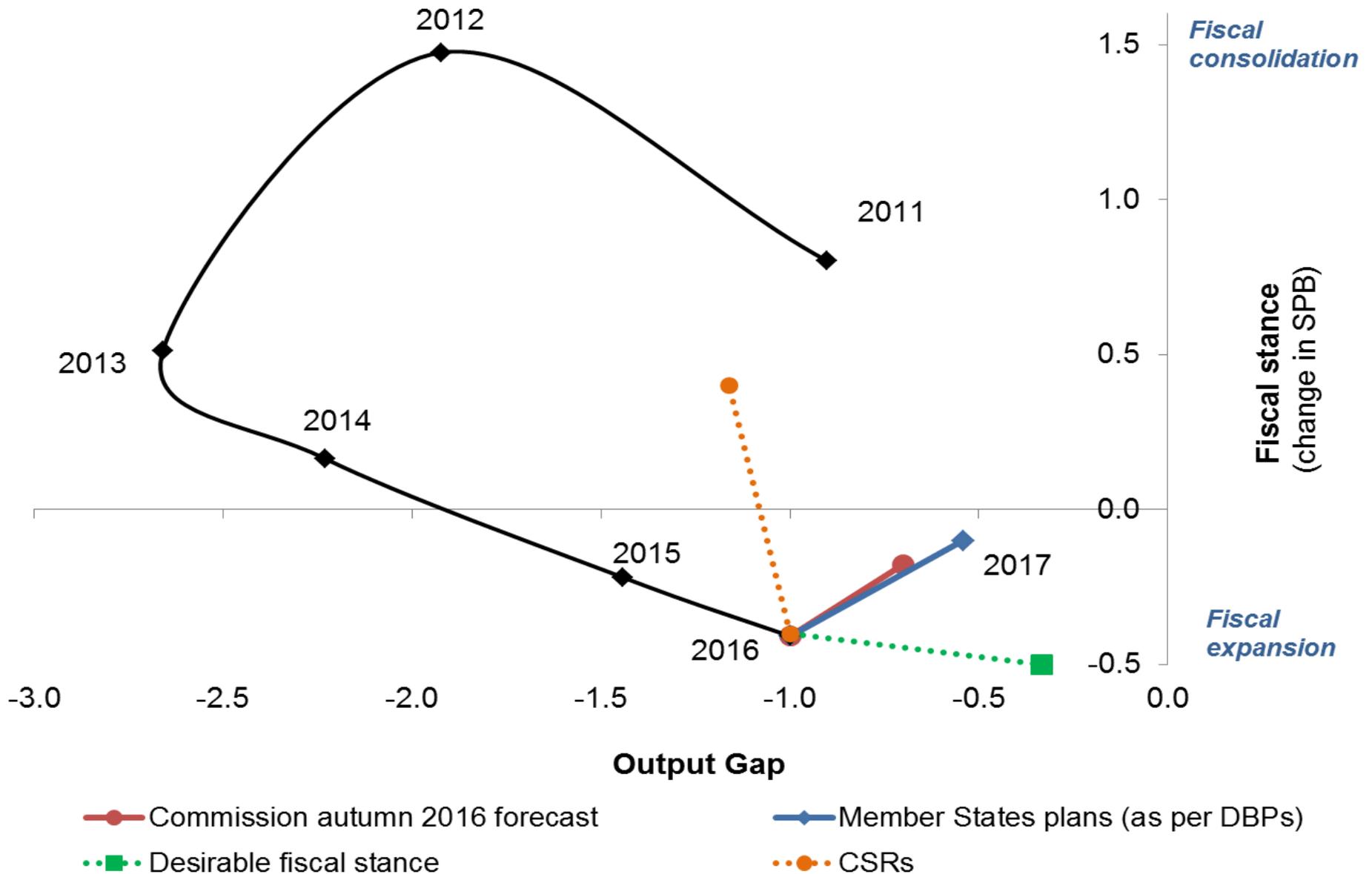
**MACRO-ECONOMIC DIALOGUE AT TECHNICAL LEVEL**

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# The need for a moderately expansionary fiscal stance

- A "positive fiscal stance" is advocated by the Commission for the euro area in its November Communication reflects and unprecedented economic and policy situation
- This is also reflected in the proposal by the Commission to the Council for the euro area recommendation ("moderately expansionary", "fiscal expansion of up to 0.5% of GDP")
- Note that the Council is changing it

# Fiscal policy lever: which direction?



# Meticulous analysis of methodological issues: the Commission's 2016 Report on Public Finances in EMU

## *Two normative questions*

- What is the **optimal fiscal stance** for the euro area as a whole?
- What is the **optimal configuration** across countries?

## *Major methodological issues*

- **Quantify consistently stabilisation and sustainability needs**

1. Stabilise the economy under budget constraint
2. Define the needs
3. Quantify the needs into targets

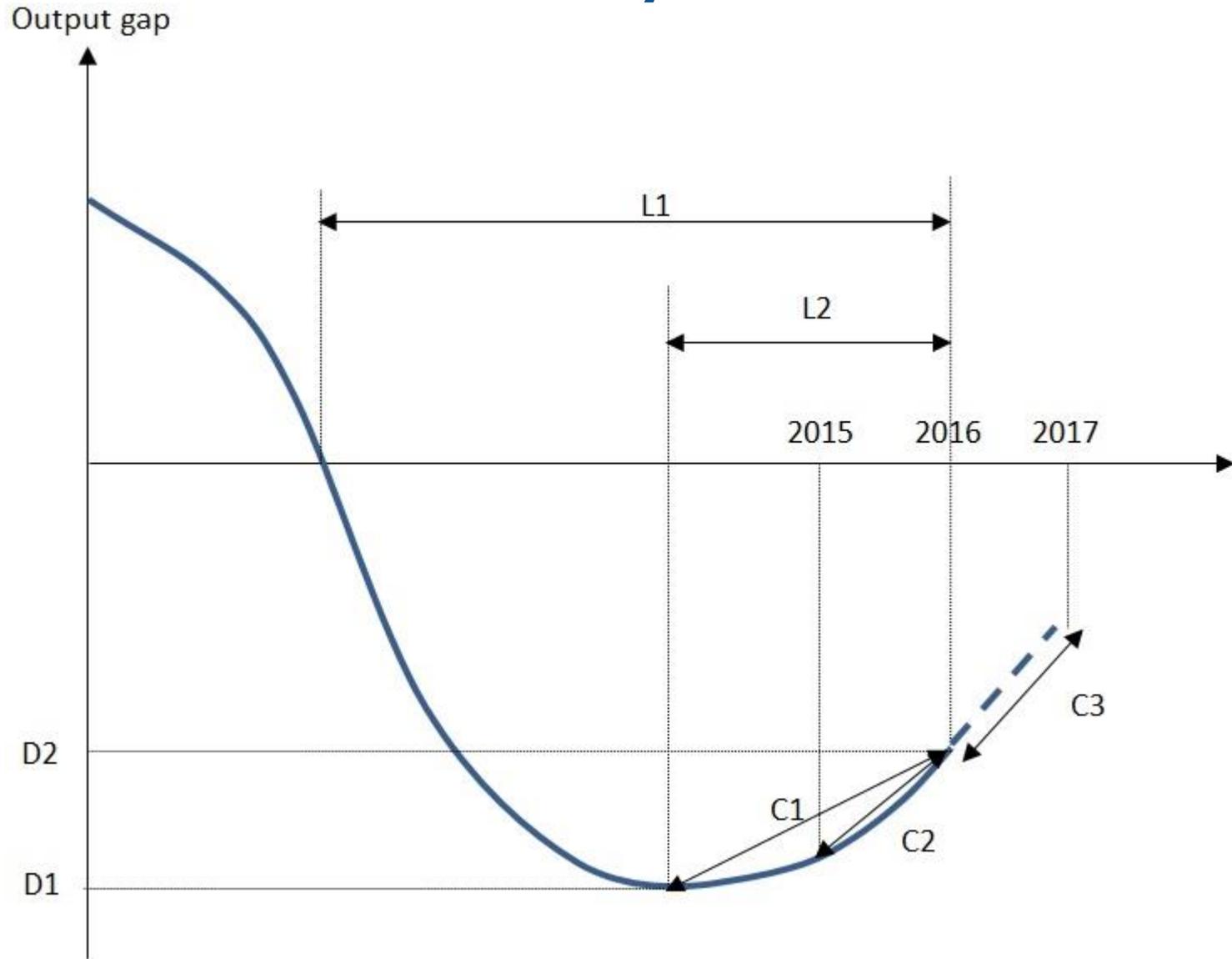
- **Weighing the stabilisation against the sustainability objective**

1. Derive a desired fiscal stance

- **Aggregation**

1. Aggregate the needs of individual Member States or defining a desired fiscal stance for the euro area as a whole ?

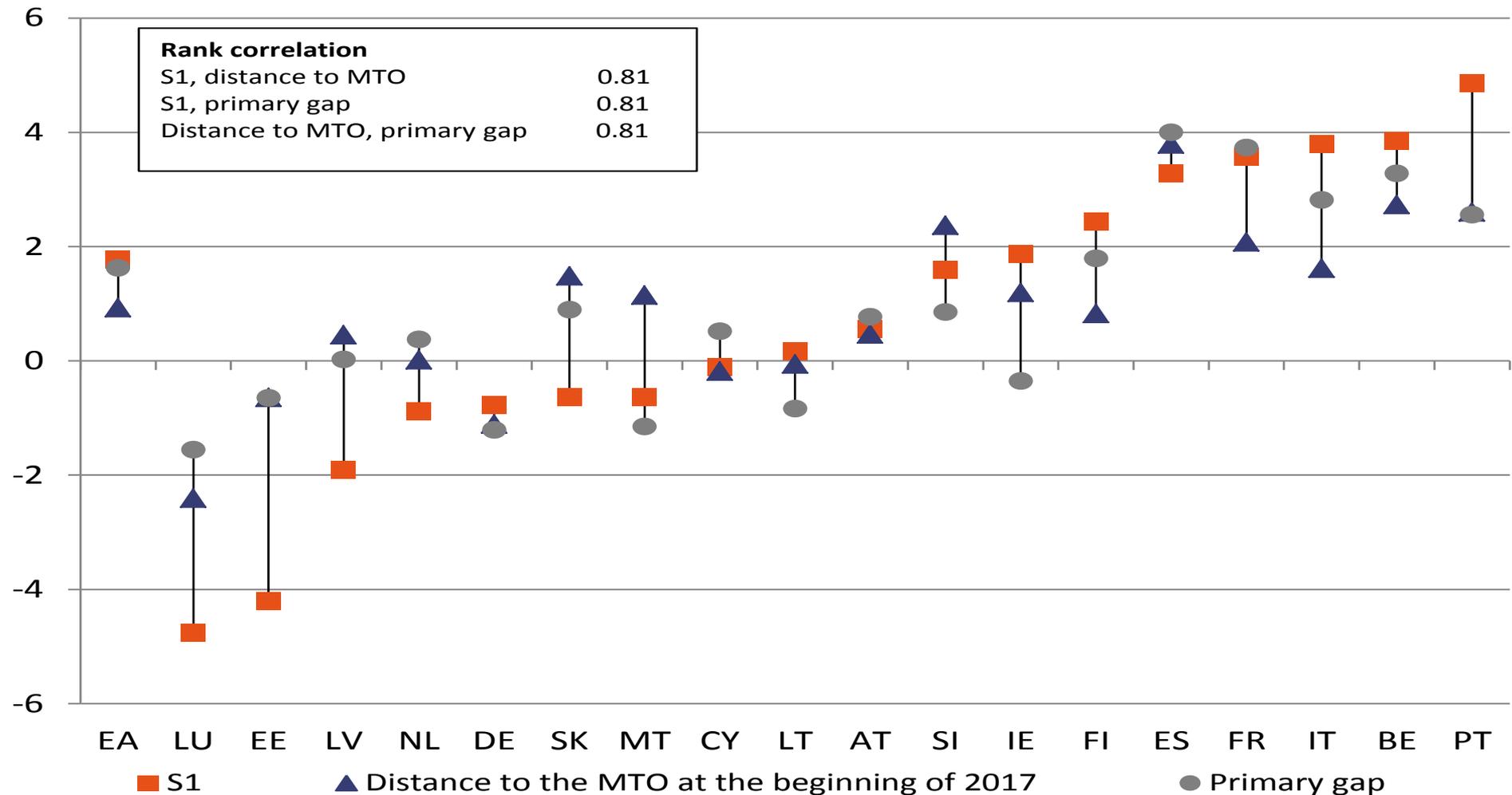
# Stabilization needs: Indicators of severity and depth of the cycle



## High stabilization needs in the euro area

- *Length: 9 years of negative output gap; 3 years since through*
- *Depth: through -2.9% of Potential GDP*
- *Speed of closure: 20% per year, 35% last year*

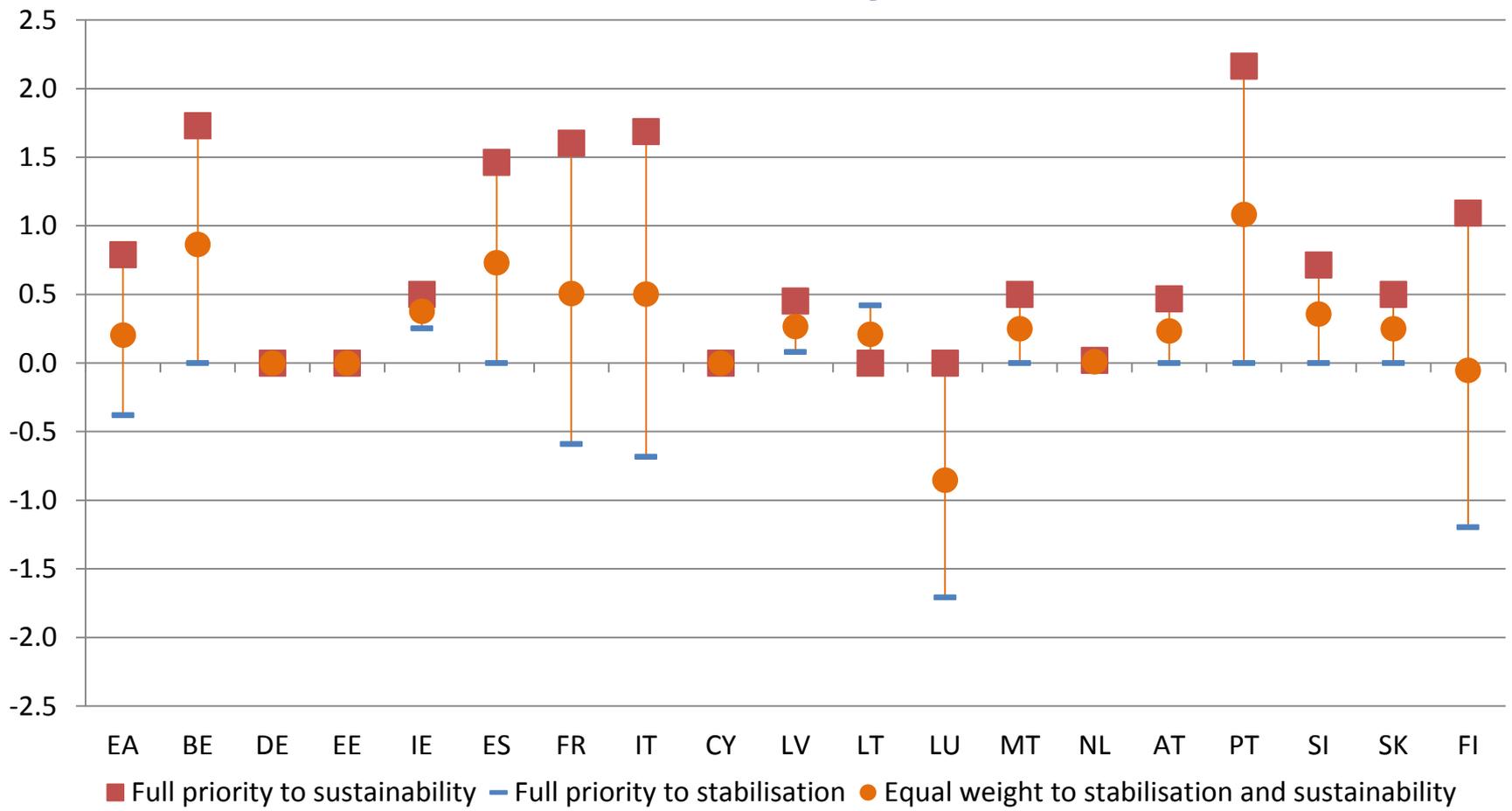
# High sustainability needs: traditional sustainability risk indicators (% of GDP)



Source: Commission services.

Note: The chart shows the euro area on the left, followed by Member States ranked by increasing level of S1. S1 is expressed in terms of structural primary balance, the distance to the MTO in terms of structural balance, and the primary gap in terms of primary balance. A negative distance to the MTO means that the Member State is above its MTO. For Slovenia, the graph shows the distance to the minimum benchmark.

# Ranges of fiscal targets derived weighing stabilisation and sustainability needs



# Weighing stabilization and sustainability targets

## 3 main criteria (**but ultimately political**)

- **Cliff effects**

1. Persistent demand shortfall rooted in the asymmetry in the correction of imbalances.
2. Risk of hysteresis from the crisis (high long-term Unemployment, low investments)
3. No immediate fiscal risk (S0 and spreads)

- **Efficiency of the policy instrument**

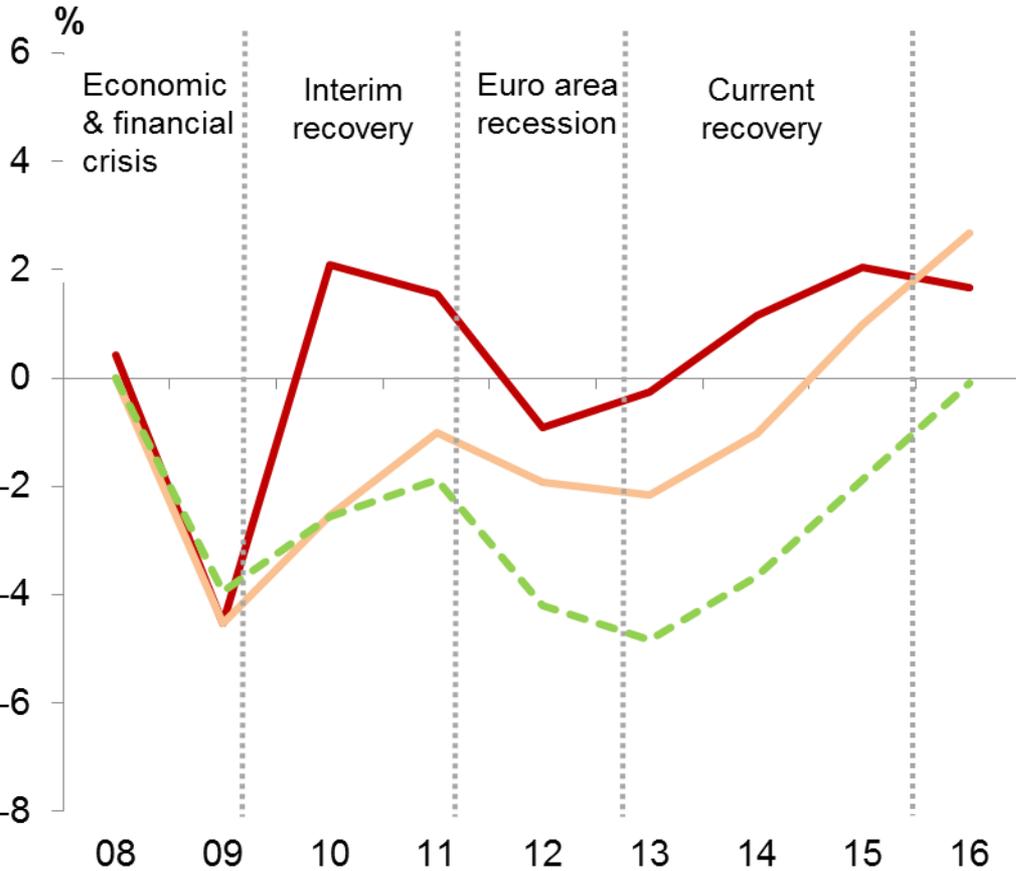
1. Monetary Policy strained
2. High fiscal multipliers

- **Cost-benefit analysis**

1. Checks the adverse effects of addressing one objective at the expenses of the other: low cost of delaying adjustment at the current juncture

# Cliffs: the real side

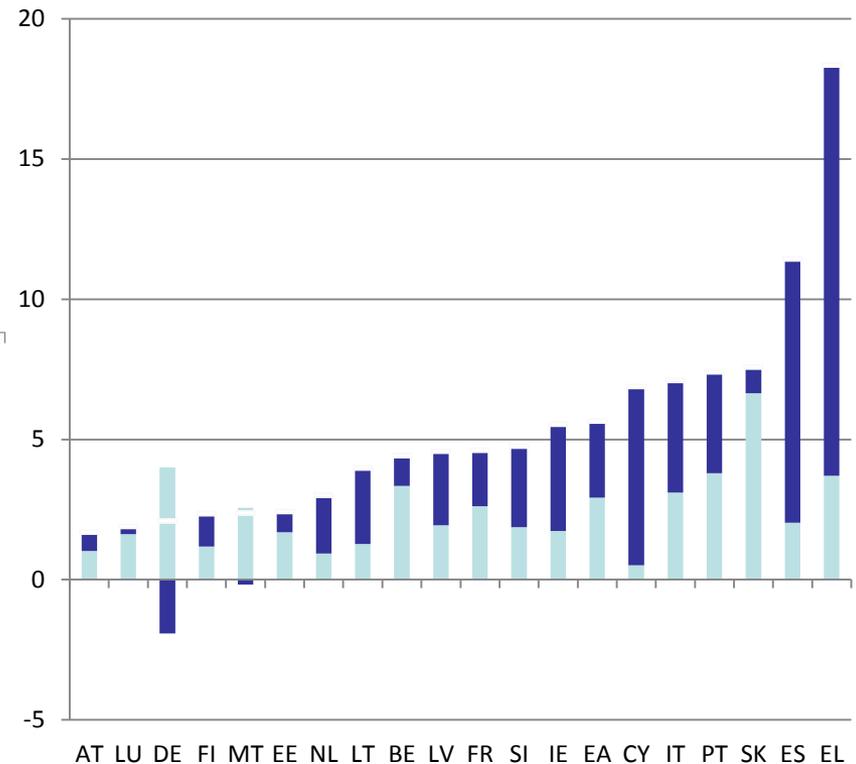
## Euro area GDP: annual growth rate and cumulative change, 2008-16



- Annual GDP growth rate
- Cumulative change in GDP since 2008
- - - Cumulative change in domestic demand since 2008

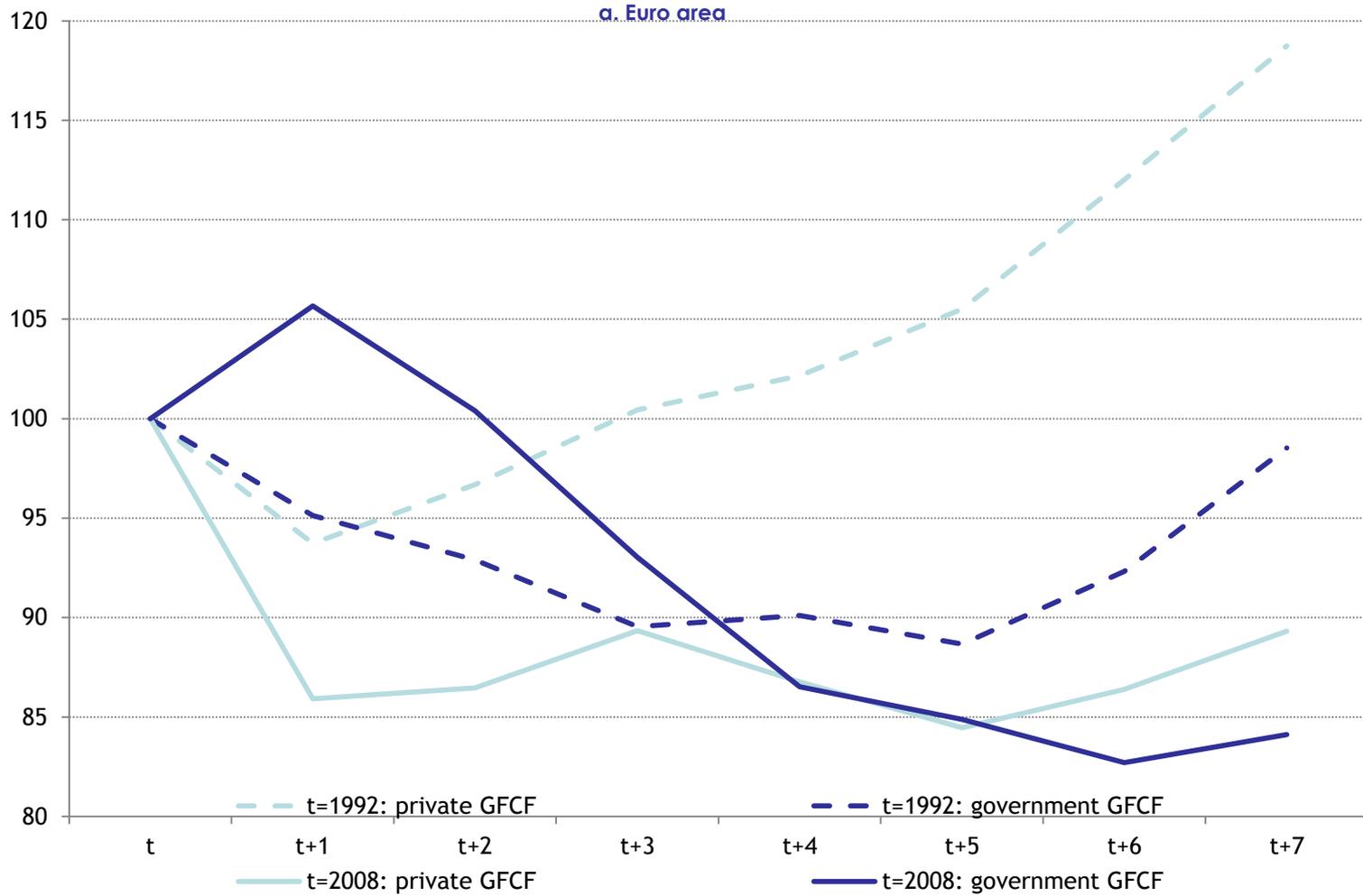
## Long-term unemployment, euro area

a. Share of the labour force in long-term unemployment, 2008-2015 (%)

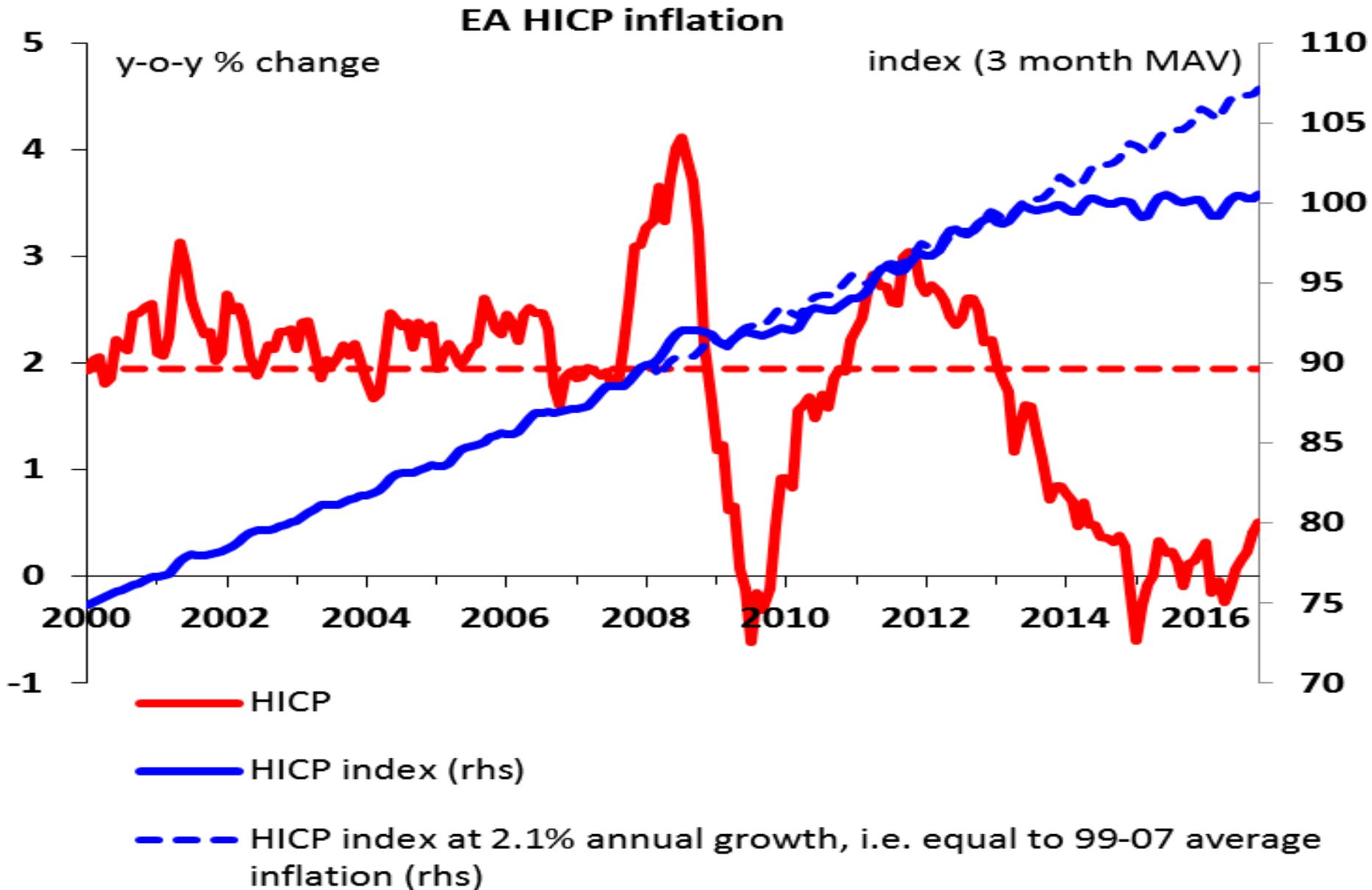


- 2008
- change 2008-15
- 2015

# Cliffs: the real side, investments



# Cliffs: the inflation side



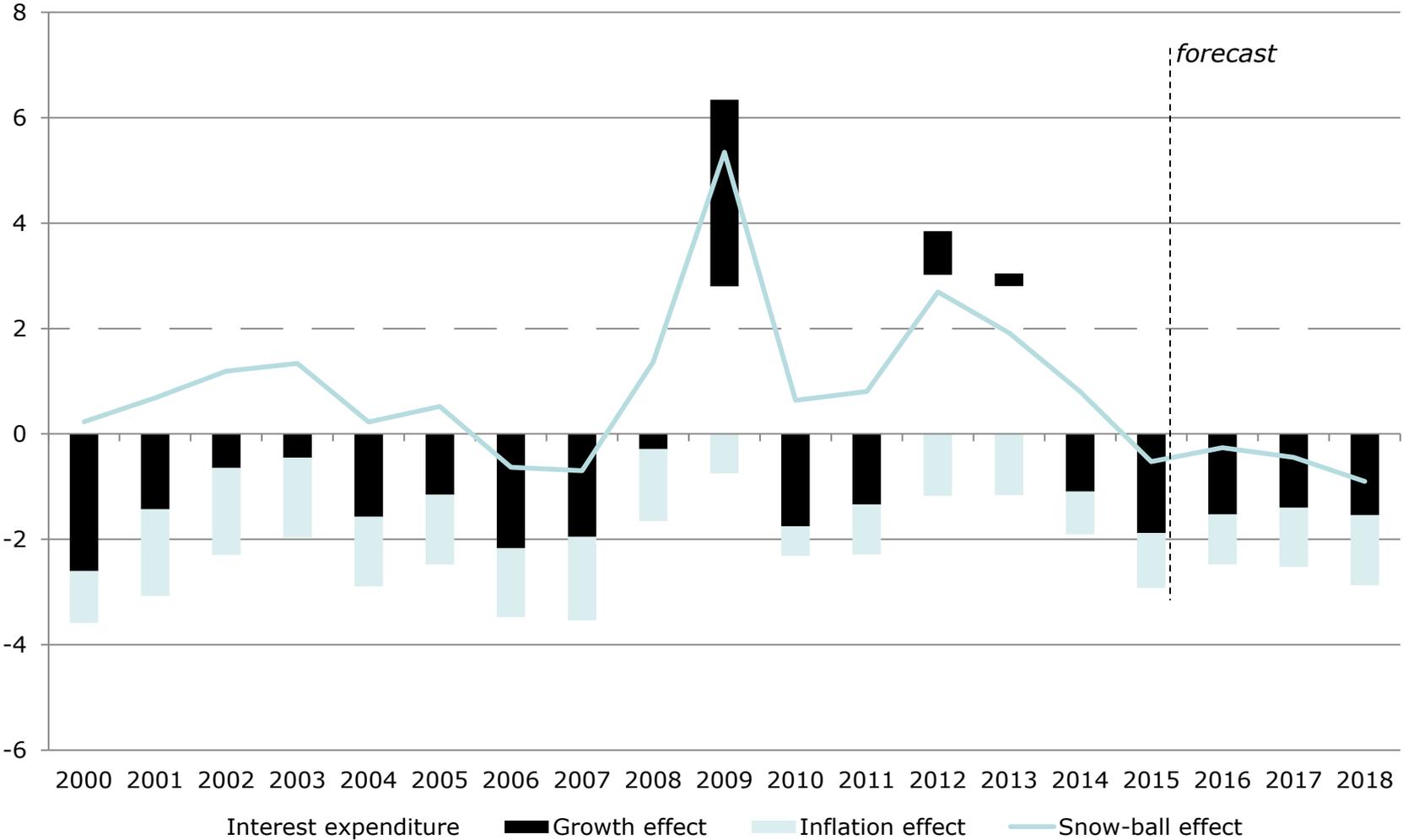
# Efficiency: Fiscal multipliers in QUEST for temporary shocks (one-year fiscal stimulus)

	Low share of constrained households (30%)	High share of constrained households (60%)	High share of constrained households and zero lower bound
Government investment	0.9	0.9	1.1
Government purchases	0.8	0.8	1.0
General transfers	0.2	0.4	0.5
Transfers targetted to credit-constrained households	-	0.7	0.9
Transfers targetted to liquidity-constrained households	0.7	0.7	0.9
Labour tax	0.2	0.4	0.6
Consumption tax	0.4	0.5	0.7
Property tax	0.0	0.1	0.2
Corporate income tax	0.0	0.0	0.0

Source: Commission services. Public Finances report

Note: The table shows the first-year impact on EU GDP (as percentage difference from the baseline) for a temporary one-year fiscal stimulus of 1%

# Cost-benefit analysis: snowball effect



# Aggregation issues when indicating the euro area fiscal stance

- Technical but necessary:
  1. Aggregation of ranges or points?
  2. Aggregation by country or by targets?
- ***Different results, but weighting choices are decisive***

	Full weight on stabilisation	Equal weight for stabilisation and sustainability	Full weight on sustainability
Analysis based on country data			
ABC	-0.3	-0.2	0.9
ACB	-0.5	-0.1 to 0.7	1.7
BAC	-0.5	0.2	1.0
BCA	-0.5	0.2	1.0
CAB	-0.5	0.2 to 0.6	1.7
CBA	-0.5	0.2	1.0
Analysis directly based on euro area data			
AB	-0.4	0.2	0.8
BA	-0.4	0.1 or 0.2	0.8

## **Fiscal Stance and the SGP**

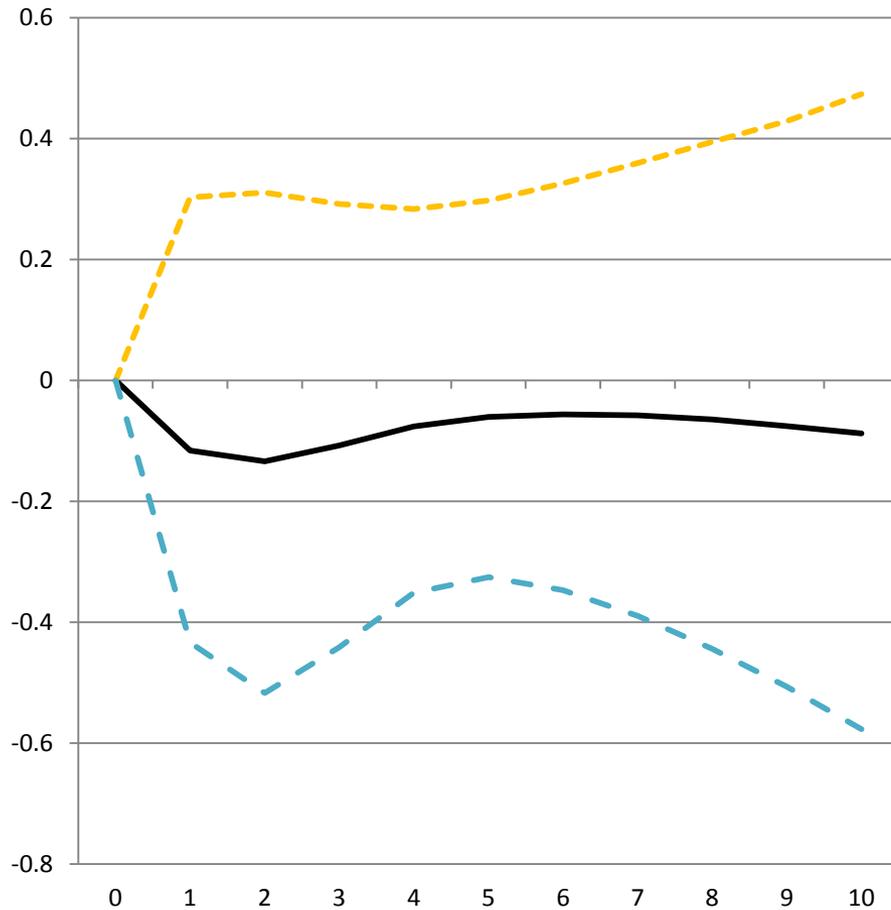
- The Commission can express its opinion as economic policy is a matter of common concern (Art. 121 TFEU). This may be relevant given the asymmetry of the SGP.
- The relevance of co-ordination is also stressed in the Two-Pack (DBP assessment, horizontal view discussed in EWGA)
- The Commission intends to apply the SGP (with a full use of the flexibility of the SGP and of its prerogatives). Indeed...

# An expansionary fiscal stance: Commission Communication of 16 Nov 2016

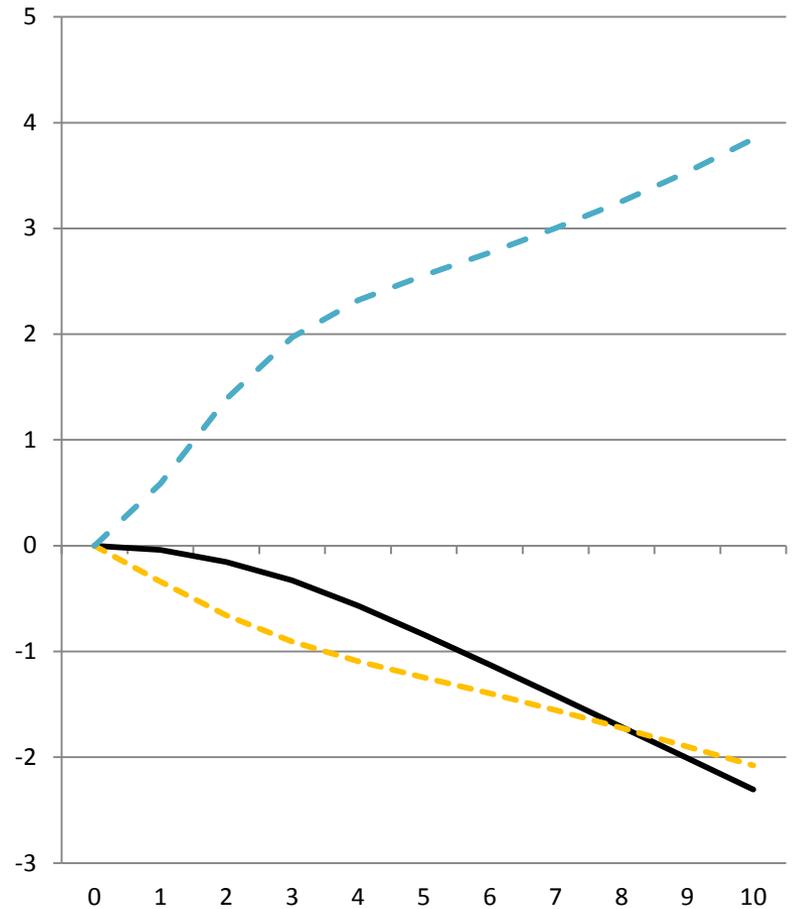
- Moving from the policy centralisation perspective to the reality of decentralised fiscal policies, the Commission stresses **differentiation across country** in line with the Stability and Growth Pact (SGP).
  - "for Member States under the corrective arm, ensure a timely correction of their excessive deficits, including by providing fiscal buffers"
  - "Member States that need further fiscal adjustments under the preventive arm of the Pact, make sure to be broadly compliant with the requirements of the Stability and Growth Pact"
  - "for member States which are over-achieving their fiscal objectives, use their fiscal space to support domestic demand and quality investments"
- The only group of countries receiving an unambiguous expansionary message are the surplus countries. But SGP cannot be used to enforce expansion. The call for a fiscal expansion is meant to invite surplus countries to do more to boost demand (and inflation), not to set aside the rules of the SGP constraining deficit countries.
- Relevance of composition of public finance, in particular **public investment**

# Composition issues

Real GDP growth - euro area (%)



Government debt - EA (% of GDP)

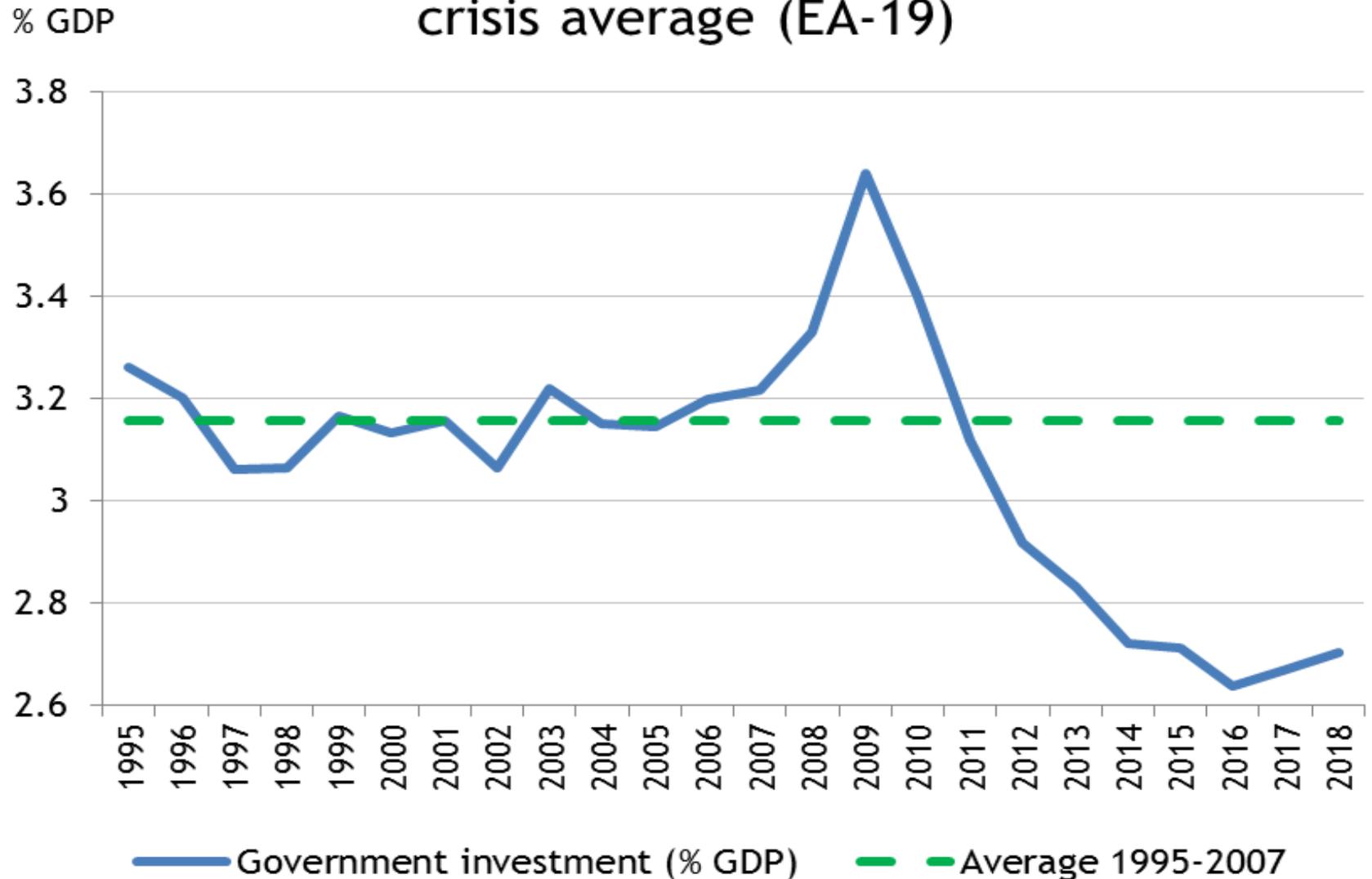


- Scenario 1: consolidation in A
- Scenario 2: consolidation in A + stimulus in B, growth-friendly composition
- Scenario 3: consolidation in A + stimulus in B, alternative budgetary composition

# Gap in government investments

## The shorter-term perspective

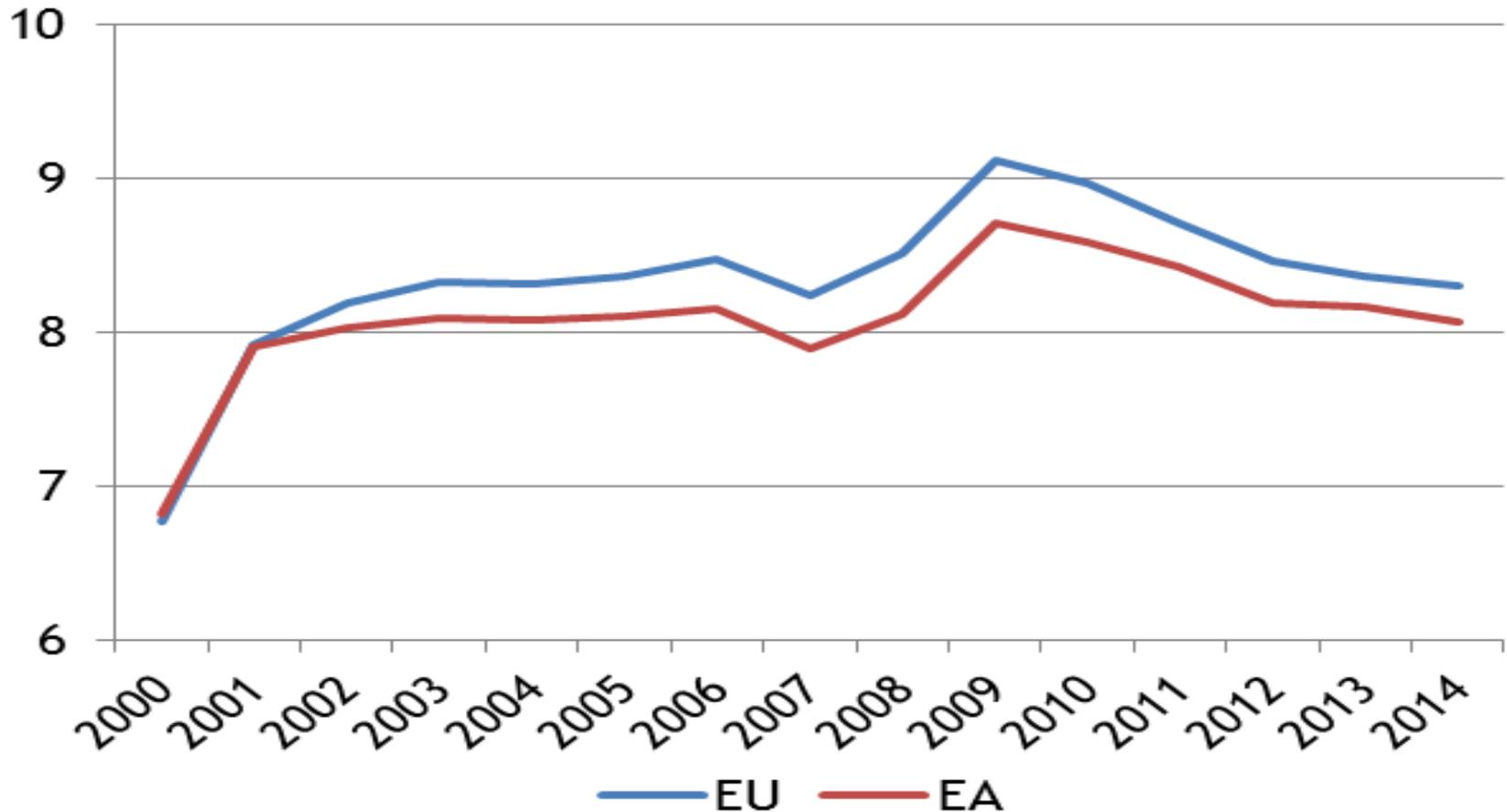
Government GFCF compared to its pre-crisis average (EA-19)



# Current level of government investment is far from optimal

Public spending has NOT been reallocated towards other productive spending categories (e.g. human capital)

## Productive spending (% GDP)



# References

European Commission (2016), "Report on Public Finances in EMU 2016", *European Economy, Institutional Papers*, 045, available at:

[https://ec.europa.eu/info/publications/report-public-finances-emu-2016-0\\_en](https://ec.europa.eu/info/publications/report-public-finances-emu-2016-0_en)

Part III: Government investment in the EU: evolution and challenges

Part IV: The fiscal stance in the euro area: Methodological issues

**Thank you**