The fiscal stance in the euro area: Methodological issues

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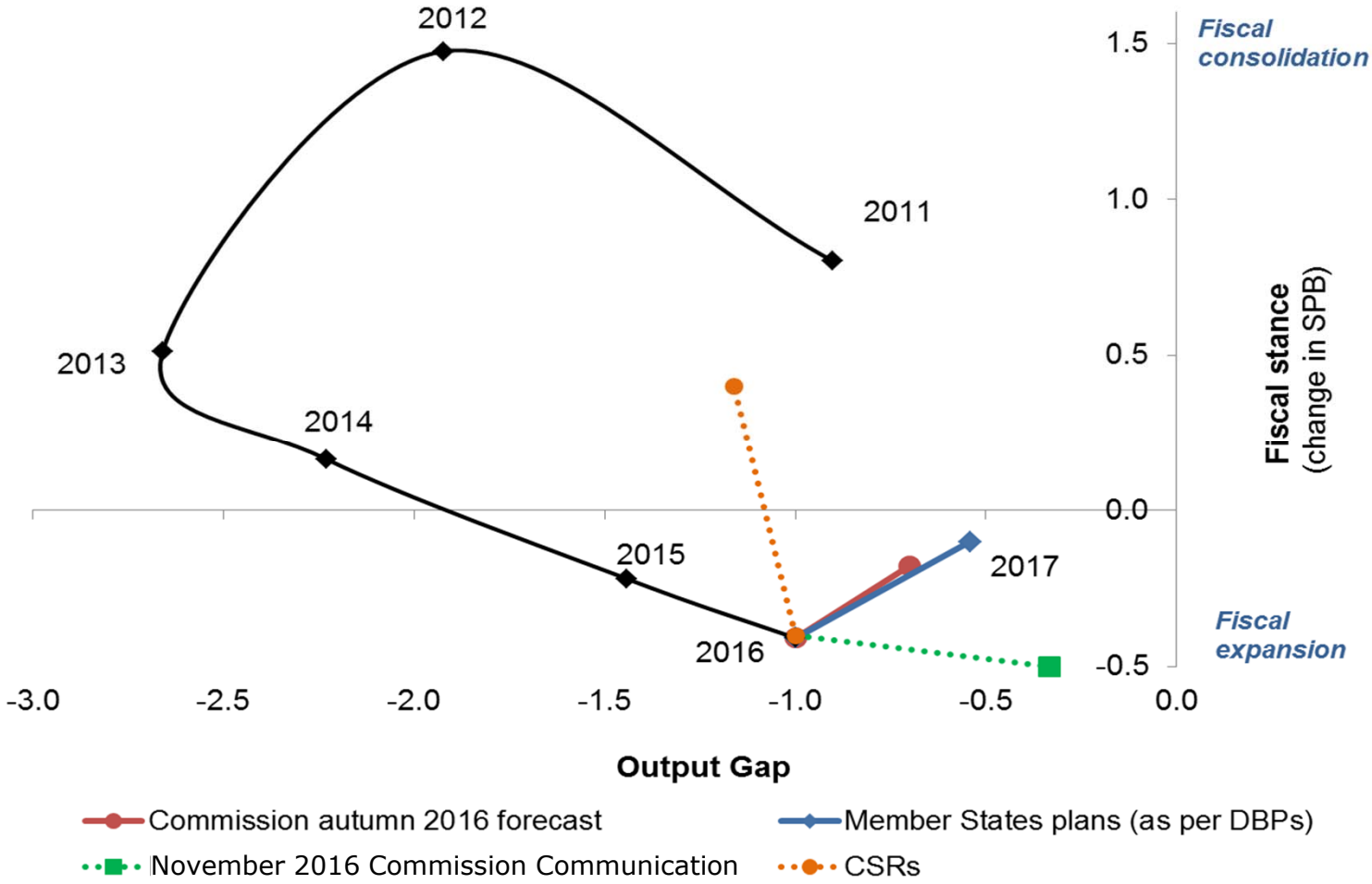
Outline

- What do we talk about when we talk about the (aggregate) fiscal stance?
- Sustainability constraint and stabilisation objective:
  - Which prevails?
  - How to measure and assess needs
- Aggregation:
  - Bottom-up vs. top-down
  - The importance of composition

What fiscal stance for the euro area?

The aim of this paper (from the Commission's 2016 PFR) is to **discuss methodological issues** and **propose possible solutions** to the questions raised by this graph.



Context and recent literature

- **Institutional context**: Two-Pack, European Fiscal Board

- In the **EP** there was a discussion on "The euro area fiscal stance: definition, implementation and democratic legitimacy" in 2016
  - Papers by F. Giavazzi, A. Bénassy-Quéré and the Kiel Institute

- **ECB** Occasional Paper "Euro area fiscal stance" (K. Bankowski, M. Ferdinandusse), January 2017

Stabilisation and sustainability

- **Two needs:**
  - **Stabilisation** of the economy at close to potential *(objective)*
  - **Sustainability** of public finances *(budget constraint)*

- **Which need should discretionary fiscal policy address as a priority?**
  - Not an issue if both needs point in the same direction
  - **In case of conflict**, the choice depends on:
    - **Efficiency:** is fiscal impulse the best policy tool to address the respective needs?
    - **Extent of the needs:** how critical is each need?
    - **Cost-benefit analysis:** are the benefits from addressing one need larger than the cost of not addressing the other?
  - Ultimately this is a **political decision**

When is discretionary stabilisation needed in EMU?

- **Normal times vs. crisis times**

  In normal times, stabilisation is entirely achievable through **monetary policy** (common shocks) and **automatic fiscal stabilisers** (country-specific shocks)

  → **This is not about fiscal fine-tuning**

  → Discretionary stabilisation is needed when these standard policy tools are not sufficient, in particular:

    - if inflation has been very low ***(monetary policy constrained)***
    - in case of a long or severe economic crisis ***(automatic stabilisers not sufficiently large)***

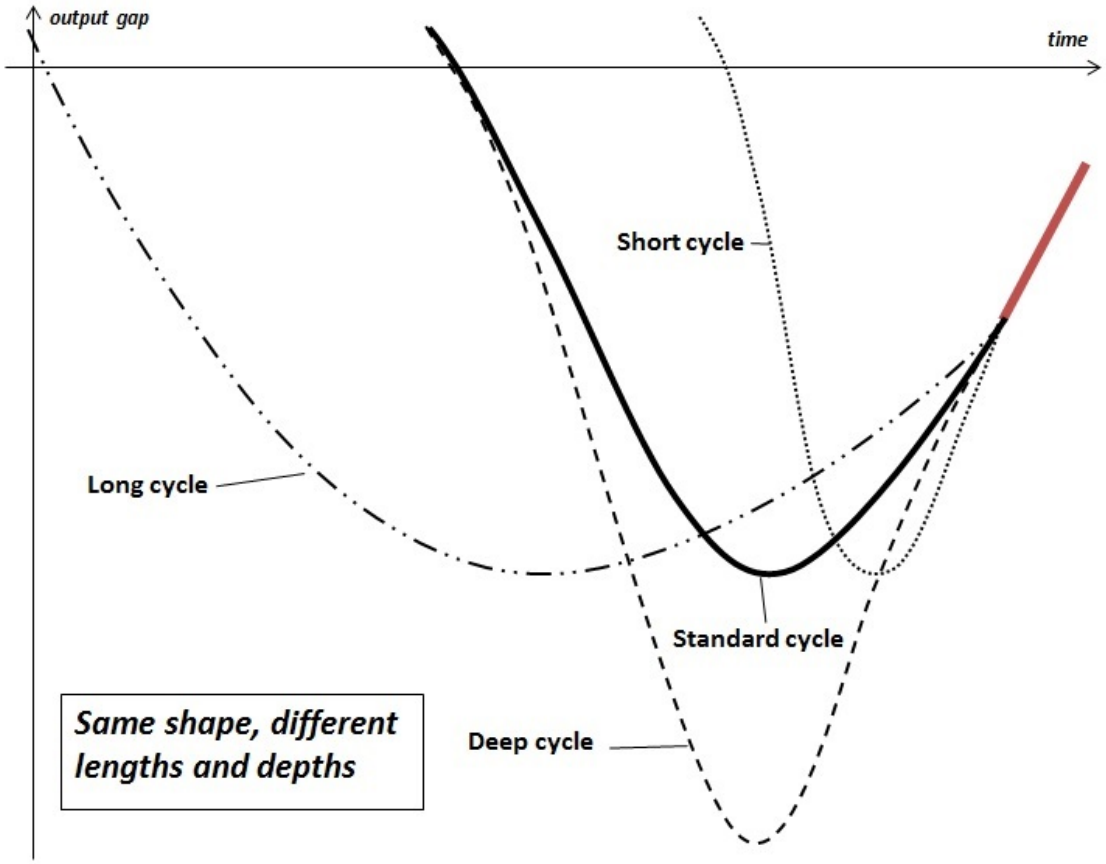
  → Moreover **fiscal multipliers** are expected to be larger in this case

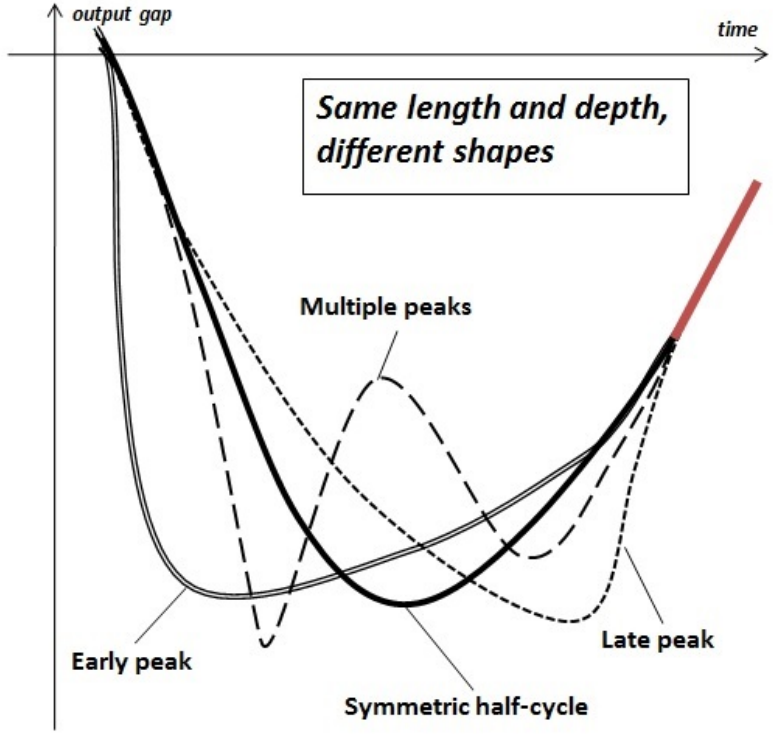
- **Fiscal impulse vs. structural reforms**

  - Discretionary support to demand may be necessary when there is a risk of **hysteresis affecting potential growth** (persistent high long-term unemployment, persistent low investment)
  - Although structural reforms may also be needed to enhance potential growth

Measuring stabilisation needs

Level and change of the output gap: not sufficiently telling





Measuring stabilisation needs

- In the PFR, the methodology uses the output gap
- …both backward-looking and forward-looking
- For the euro area as a whole:
  - Length: in 2016, 8 years of negative output gap (L1); 3 years since the trough (L2)
  - Depth: at the trough, -2.9% of potential GDP (D1)
  - Speed of closure: 20% in 2017 (C3) if neutral fiscal stance

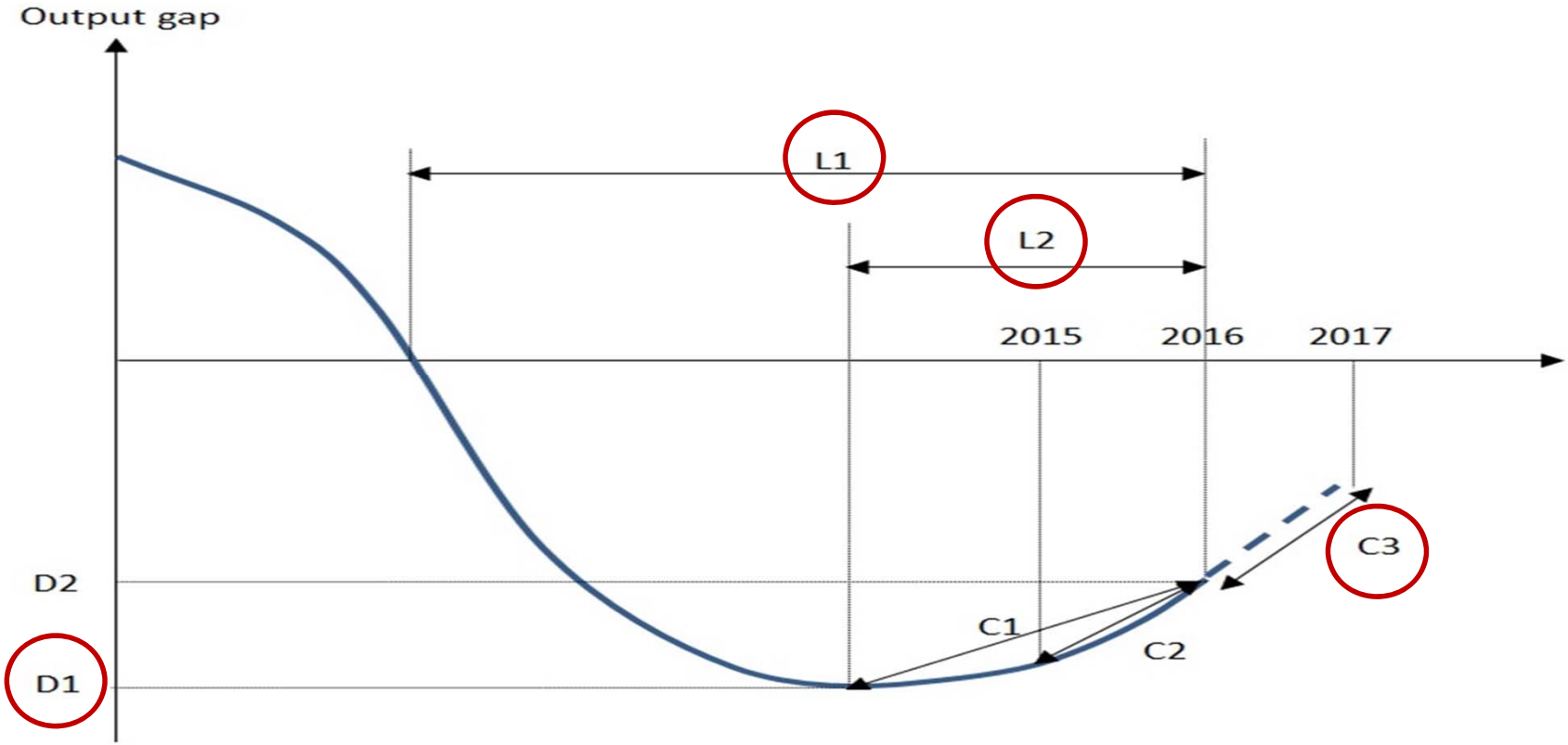
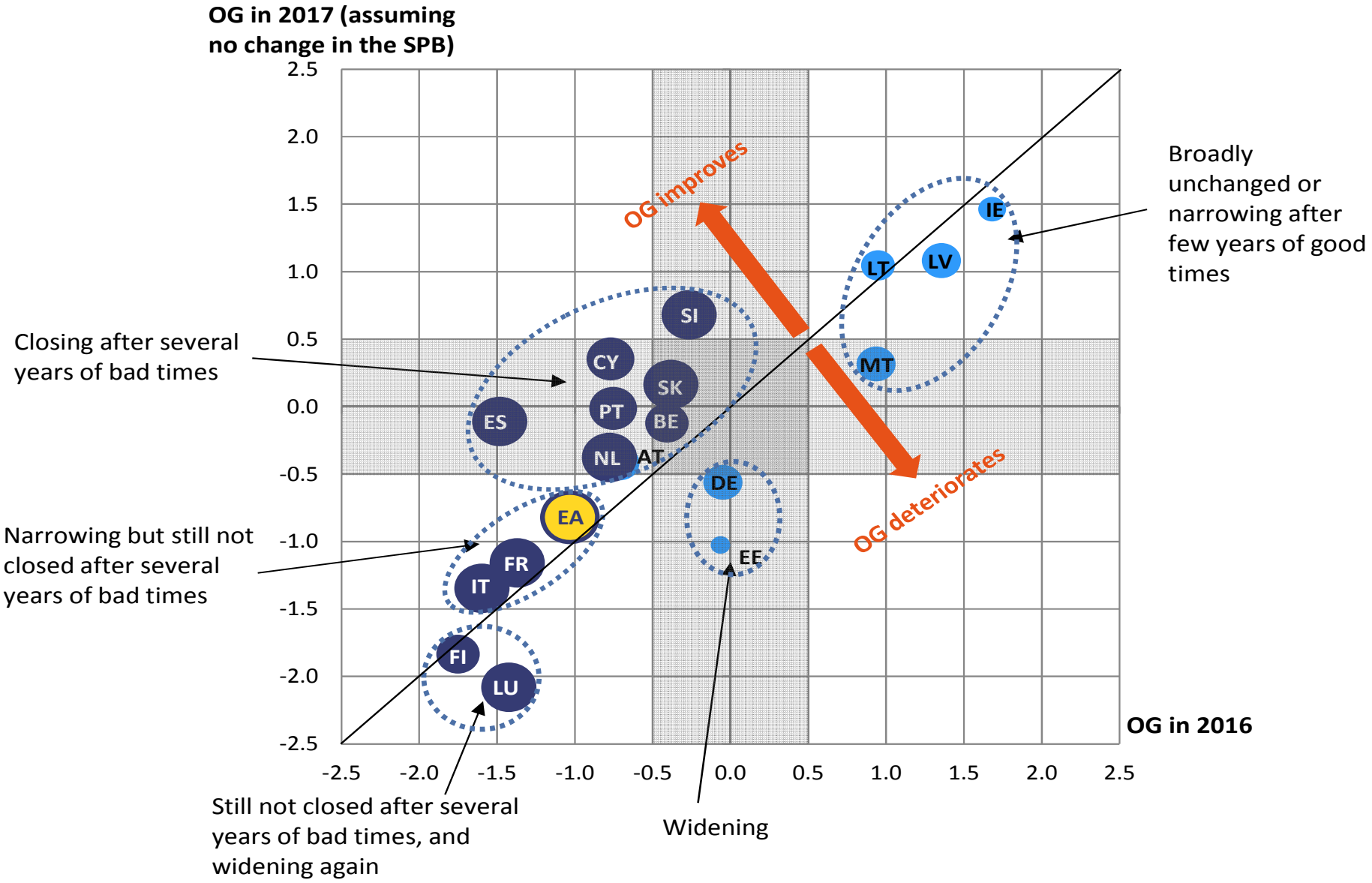


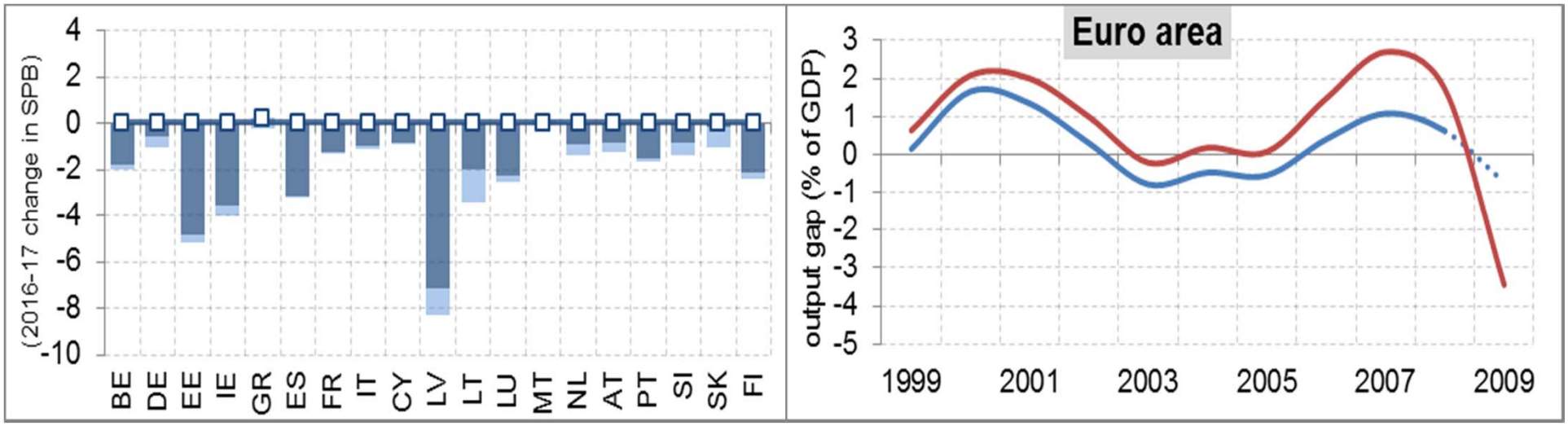
Illustration: evolution of the OG and length

Output gap level in 2016-17 and length of the half-cycle



A challenge: anticipating abrupt crises

The analysis based on real-time OG data for 2008-2009 would have led to recommending a neutral fiscal stance (ECB calculations)



Source: European Commission economic forecast (autumn 2008 and autumn 2016) and ECB calculations based on the PFR methodology

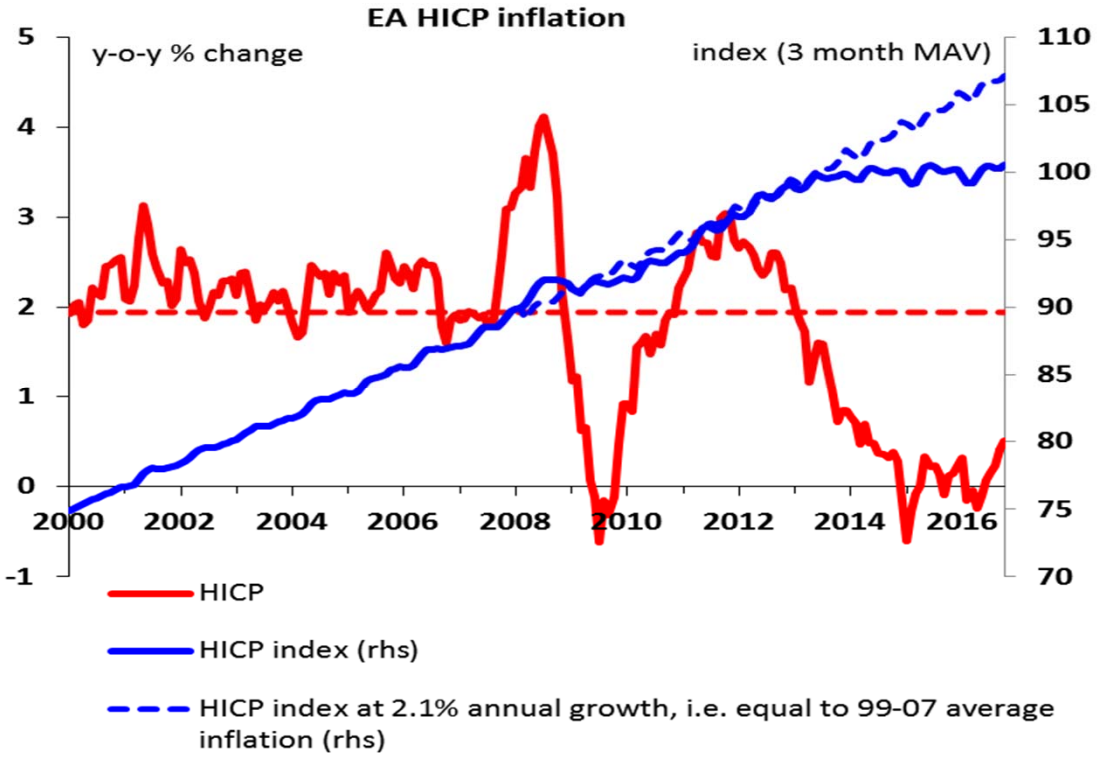
→ This reflects a known inertia in economic forecasts

→ The methodology based on the OG is likely to be more relevant for less abrupt developments such as recoveries, to provide a quantified, consistent analysis of the recent half-cycle

→ When such crises hit, short-term indicators are more useful

Going beyond the output gap

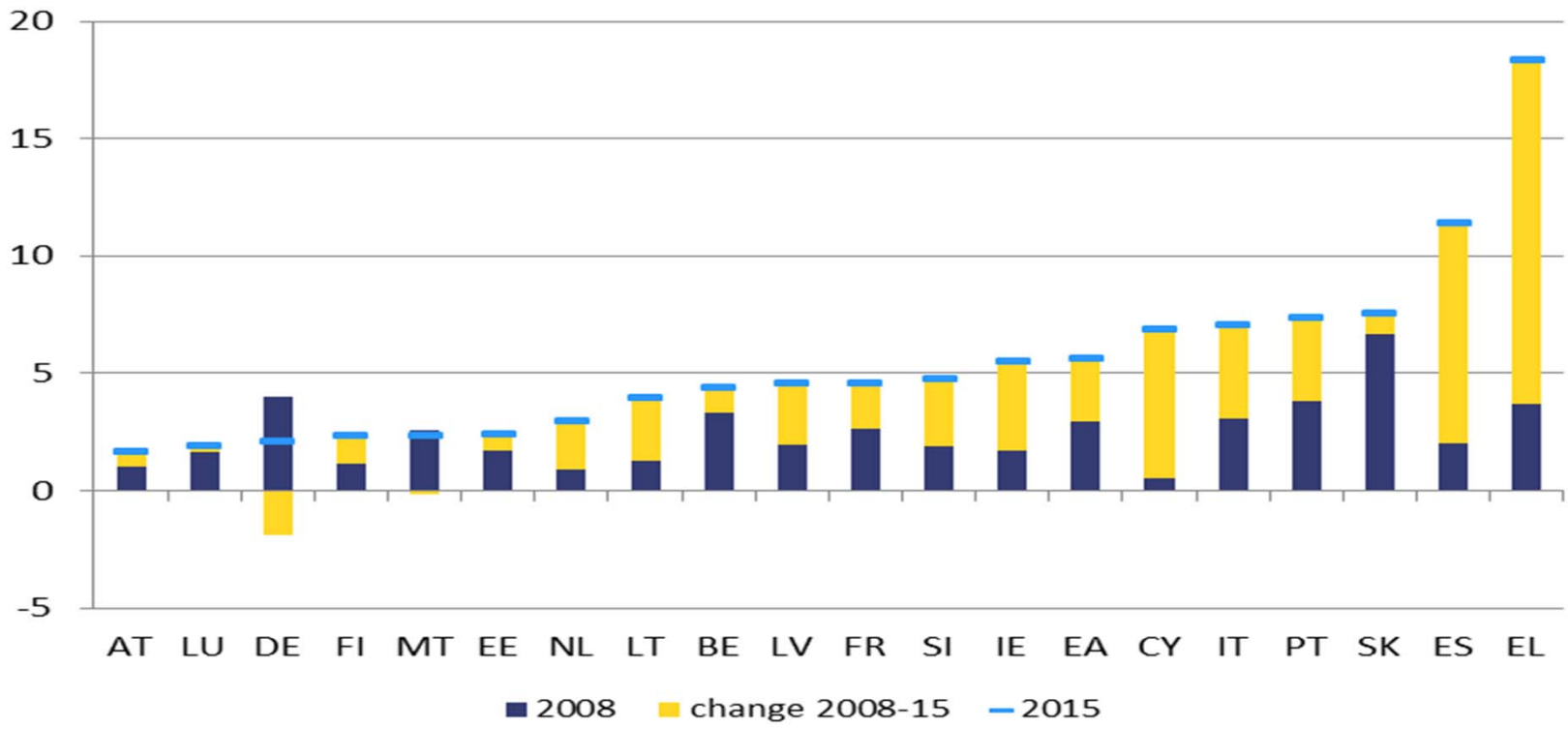
- OG: mechanical and uncertain
  - Useful summary indicator but unobserved. Difficulty of disentangling cycle/trend
  - We don't know the future, regardless of the indicators considered
- Other factors to consider for a richer assessment of the macroeconomic situation (non-exhaustive list)
  - Inflation and monetary policy (below)
  - Hysteresis on the labour market (next slide) and in investment



	Number of consecutive months with Overall HICP inflation < 0.5% y-o-y	HICP excl. energy and unprocessed food < 1% y-o-y
BE	0	0
DE	21	0
EE	0	0
IE	23	8
EL	46	0
ES	35	36
FR	22	24
IT	31	28
CY	24	42
LV	14	0
LT	0	0
LU	24	0
MT	0	0
NL	5	5
AT	0	0
PT	0	44
SI	26	26
SK	33	35
FI	20	0
EA	26	28

Going beyond the output gap

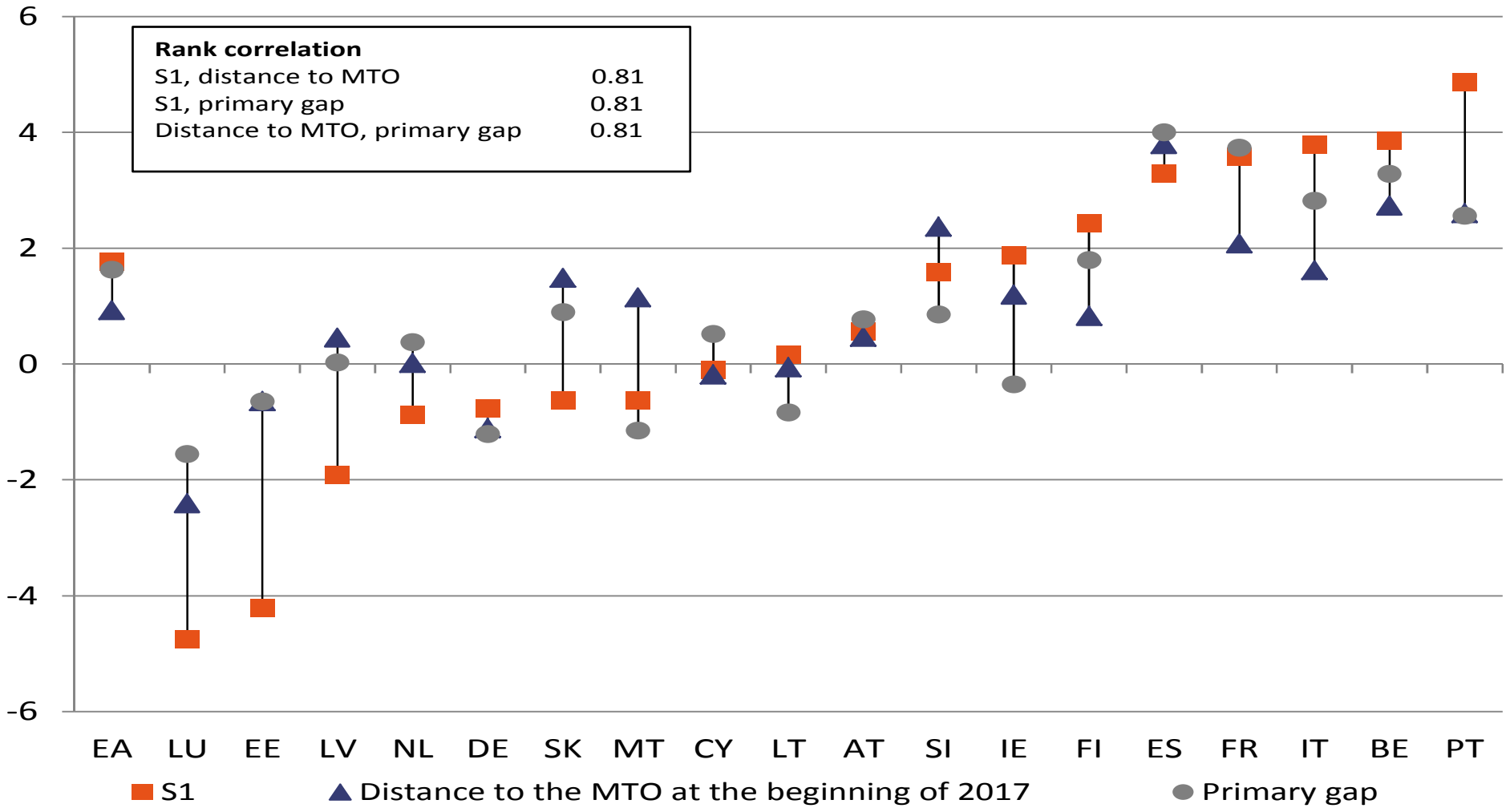
Long-term unemployment (share of labour force), 2008-2015 (%)



When is fiscal consolidation needed?

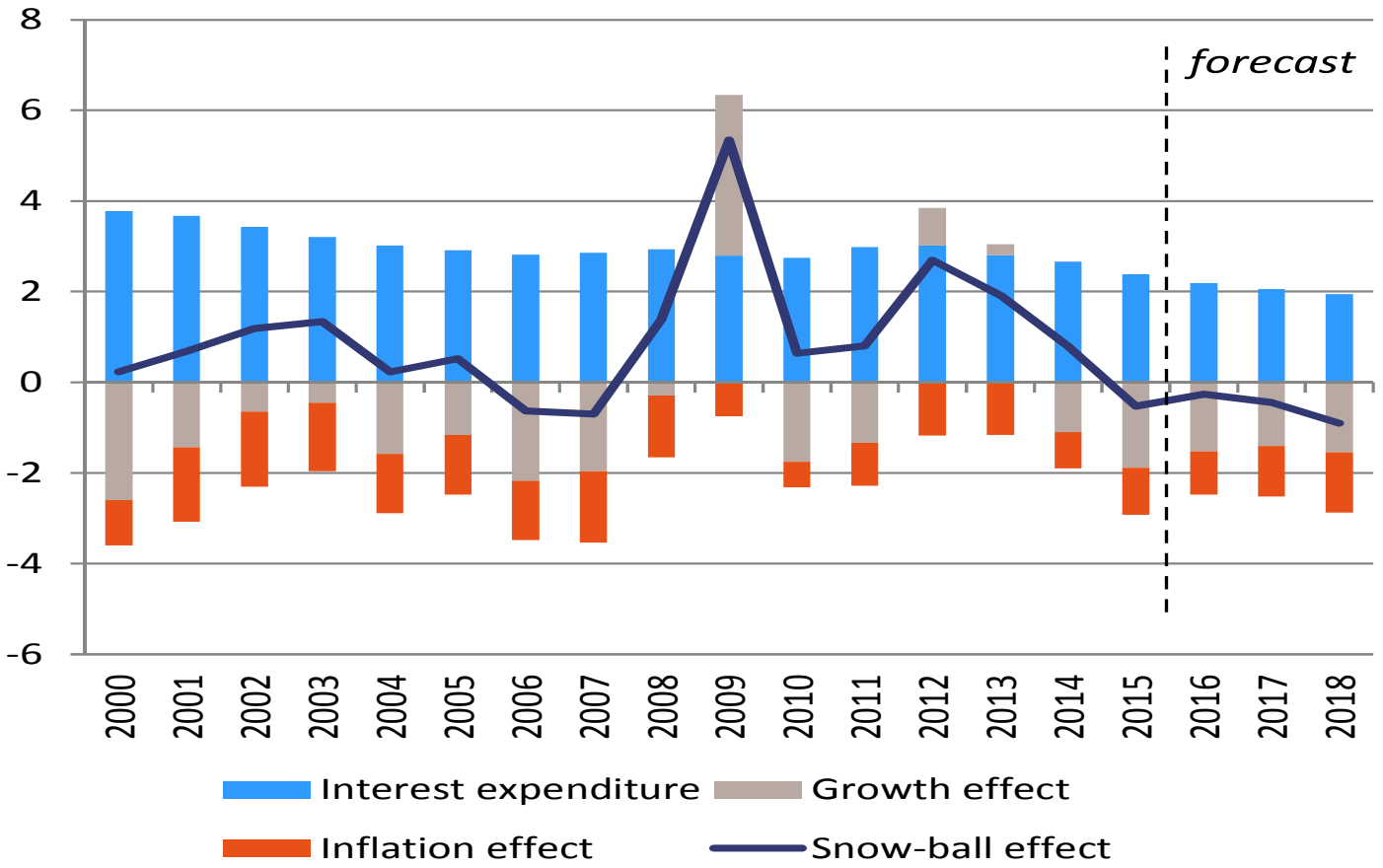
- Sustainability is not an objective per se but an intertemporal budget constraint
- **"Normal" times vs. "crisis" times**
  - "Normal" times: **compliance with the SGP** should ensure sustainability. Member States need to consolidate if they are not at MTO or if debt is too high
  - "Crisis" times: **imminent fiscal stress**, as shown by the S0 indicator and spreads on government bonds, puts pressure for frontloaded fiscal retrenchment
- **Fiscal consolidation vs. structural reforms**
  - Unsustainable debt paths may reflect a need for structural reforms, especially of the **pension and health care systems** (see S2 indicator)

Sustainability: medium-term 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.

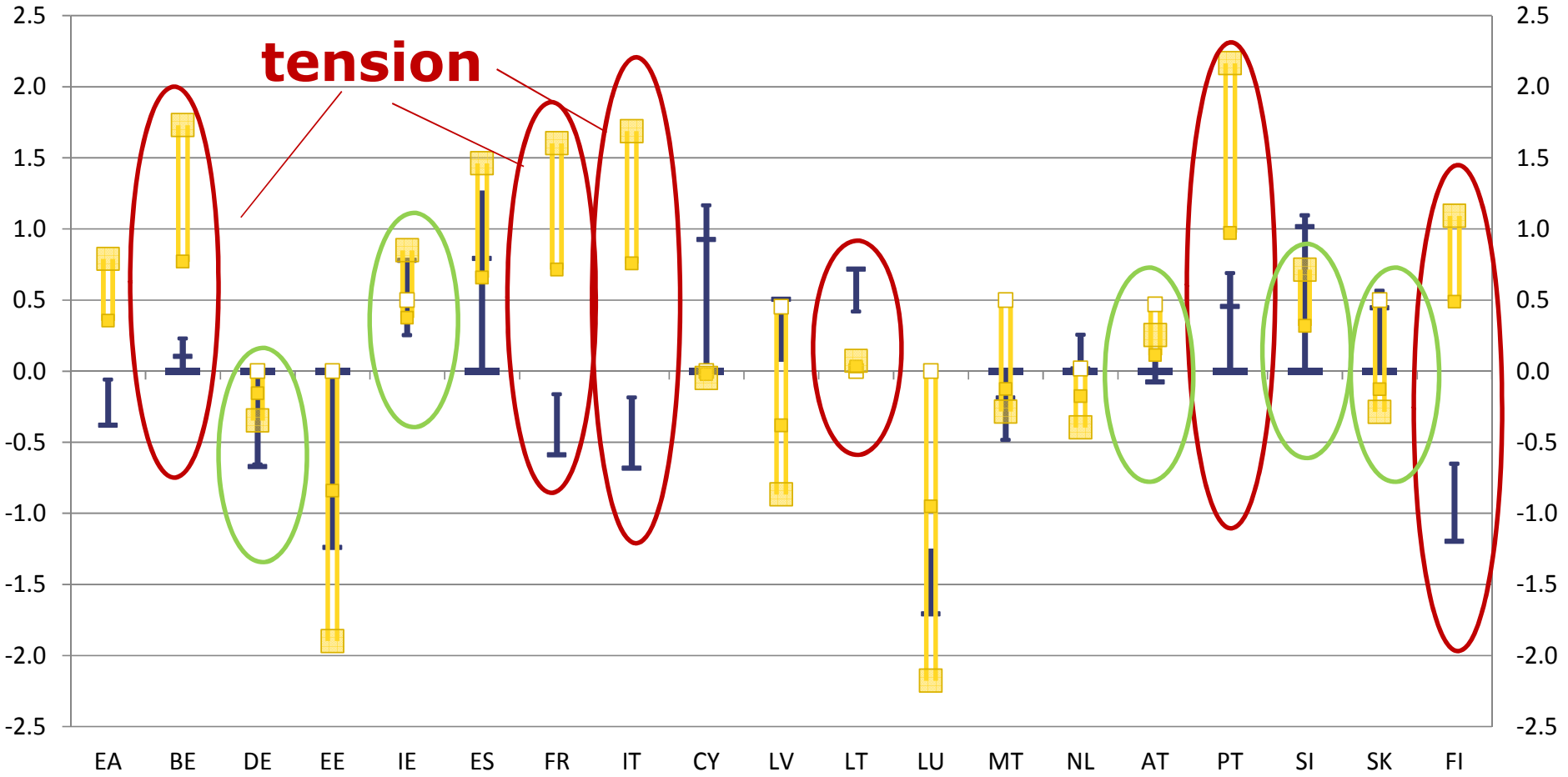
Cost-benefit analysis: the snowball effect in the euro area



- Relatively low cost of delaying adjustment at the current juncture
- But conditional on the continuation of low interest expenditure

Ranges of fiscal targets

(Measured in terms of change in the structural primary balance)



How to interpret this graph

- This is **not a tool to compute a single optimal fiscal stance**
- It is meant to feed policymakers' analysis and **raise questions:**
  - Do the ranges indicate high needs or not? How large is the uncertainty? Are there any tensions?
  - Is the information based on the output gap consistent with other indicators?
  - Should fiscal policy focus on stabilisation or sustainability, and why?
- Necessarily involves **arbitrary technical choices**
  - Unavoidable to define quantitative criteria
  - But transparent, motivated by observation and economic theory, and cross-checked by robustness tests
- Possibility of **different economic views and political preferences**

→ We do not make these choices but force decision-makers to make them

Aggregation issues

1. **Why is aggregation relevant?**
   - Because of spillovers and contagion effects

   → **Stabilisation** becomes a common issue when monetary policy reaches its limits: euro area-wide shock

   → **Sustainability:** risks are neither isolated (despite being the responsibility of sovereign Member States) nor mutualised, but subject to contagion

2. **Technical but important issues**
   - Bottom-up or directly at the aggregate euro area level?
   - Aggregation first by country or by targets?
   - Aggregation of ranges or points?

3. **What weights?**
   - Standard practice: by the size of the economy (GDP) → euro area OG, S1
   - Alternatively: we propose solutions by using different weights
     - Weights reflecting risks
     - Weights reflecting spillover or contagion effects
   - Ideally: an economic model

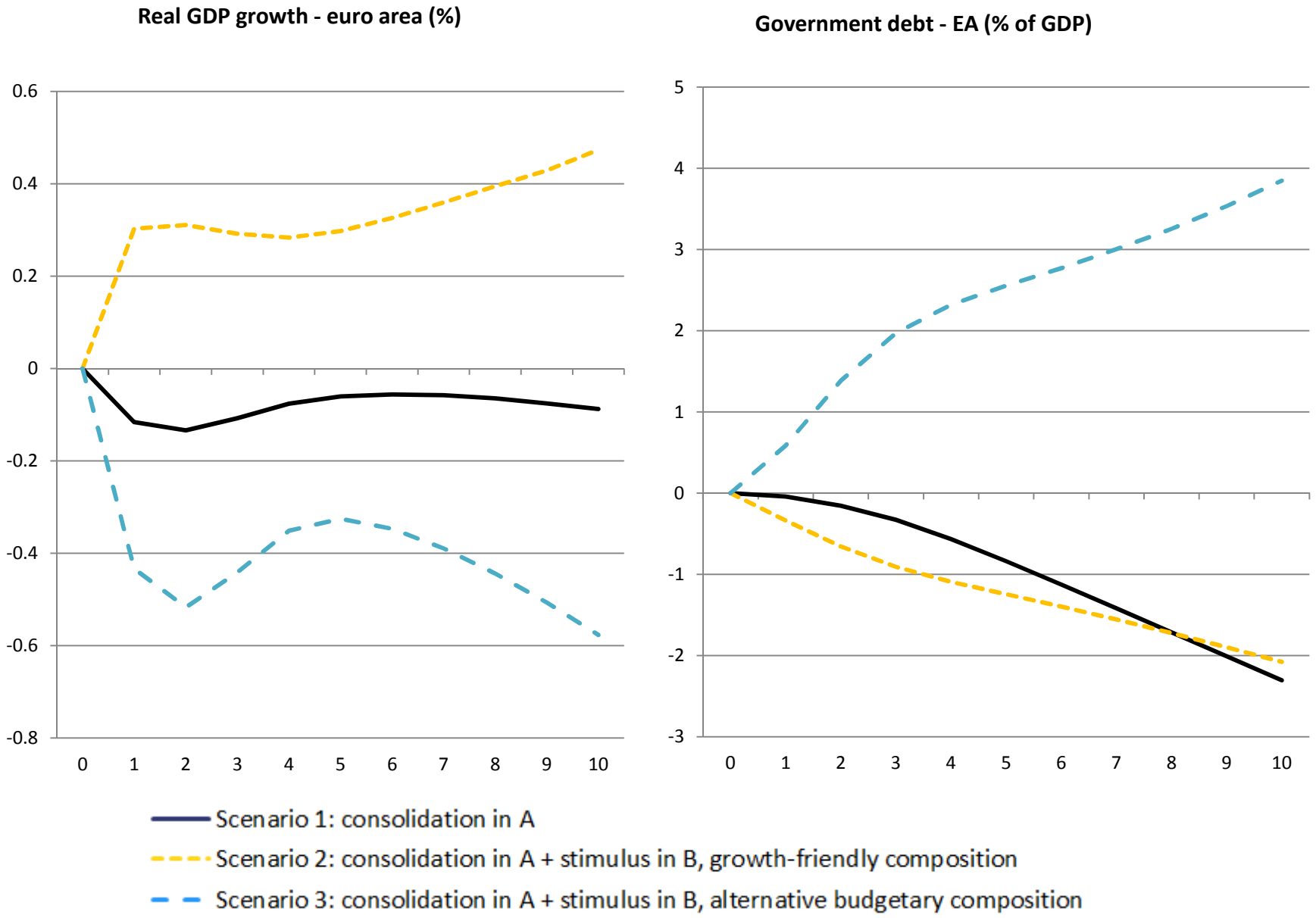
Composition: what difference does it make?

- A certain aggregate fiscal stance can reflect many different national fiscal stances = **geographical composition**
- The outcome depends on several factors:
  - Multipliers (**budgetary composition** + economic context, including national sustainability risks)
  - Spillover effects (depend on structural factors)

➔ **The aggregation of national fiscal stances is more complex than a mechanical sum of balances**

➔ Analysis done in the Commission's QUEST model

Composition matters: an illustration in the QUEST model



Conclusion: main messages

- Aim:
  - The aim is not to come up with a number but meant as food for thought and as clarifying background analysis: raise issues
  - No intention to suggest permanent automatic fine-tuning
- Proposes transparent, consistent, quantified criteria which remain rough but are already an improvement
  - **Stabilisation needs:** Cyclical position subject to uncertainty ➔ use all the information from the recent half-cycle, comparing the length, depth and pace of closure of the OG to standard values
  - **Sustainability needs:** Use medium-term sustainability risk indicators (S1 and debt sustainability analysis, distance to MTO, primary gap)
  - **No predefined weights for stabilisation and sustainability** but focus depending on the current conditions
  - **Spillover and contagion effects internalised** via alternative weightings and, whenever possible, model simulations
- Remains open for discussion

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

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

European Commission (2016), "The 2016 Stability and Convergence Programmes: An Overview and Implications for the Euro Area Fiscal Stance" , *Institutional Papers*, 34, 2 September 2016

https://ec.europa.eu/info/publications/2016-stability-and-convergence-programmes-overview-and-implications-euro-area-fiscal-stance_en

European Commission (2016), "2017 European Semester: Communication on Fiscal Stance" 16 November 2016

https://ec.europa.eu/info/publications/2017-european-semester-communication-fiscal-stance_en

Thank you for your attention

Background slides

Overview of the issues covered in this analysis

ECONOMIC STABILISATION

What can make fiscal stimulus necessary

- Long and severe **economic crisis**
- Persistent high **long-term unemployment**
- Very **low inflation**
- **Other tools not sufficient:** stabilisation not entirely achievable through **monetary policy** and **automatic fiscal stabilisers**
- Risk of persistent **low potential growth**

What can make fiscal stimulus possible and effective

- Available **fiscal space** in some countries
- High fiscal **multipliers**
- Large **spillovers** across Member States
- Focus on investment and **growth-enhancing** measures
- **No risk of overheating** in the Member States where stimulus is implemented

SUSTAINABILITY OF PUBLIC FINANCES

What can make fiscal consolidation necessary

- Compliance with **fiscal rules**
- High **debt** ratios
- High **risks to fiscal sustainability**
- Risk of governments losing **access to financial markets**
- Risk of **contagion** across Member States

What can make fiscal consolidation more effective

- Accompanying **structural reforms**
- Focus on **growth-friendly** consolidation

Fiscal multipliers
QUEST, 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.
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%

Aggregating country-specific information

Stabilisation

- **Risk-related:** length of cycle
- **Spillover-related:** GDP x intra-EA trade

	Share in euro area GDP (2016)	Share of imports from the EU in total imports	Share in GDP x trade	Difference with/without trade
BE	3.9%	63.6%	3.9%	0.0%
DE	29.2%	65.6%	30.1%	0.9%
EE	0.2%	81.8%	0.3%	0.1%
IE	2.6%	65.2%	2.6%	0.0%
EL	1.6%	49.3%	1.3%	-0.4%
ES	10.5%	60.0%	9.8%	-0.7%
FR	20.7%	68.2%	22.3%	1.6%
IT	15.4%	57.9%	14.1%	-1.3%
CY	0.2%	73.0%	0.2%	0.0%
LV	0.2%	79.8%	0.3%	0.1%
LT	0.4%	67.8%	0.4%	0.0%
LU	0.5%	74.5%	0.6%	0.1%
MT	0.1%	64.4%	0.1%	0.0%
NL	6.5%	45.1%	4.6%	-1.9%
AT	3.3%	76.7%	3.9%	0.7%
PT	1.7%	75.4%	2.0%	0.3%
SI	0.4%	69.4%	0.4%	0.0%
SK	0.8%	77.8%	0.9%	0.2%
FI	1.9%	71.8%	2.2%	0.3%

Sustainability

- **Risk-related:** debt ratio, share in euro area debt
- **Contagion-related:**
  - **Most favourable scenario ("early EMU")**: interest rates aligned on least risky → S1 = 0.5
  - **Least favourable (sovereign debt crisis)**: full weight on the Member States with the highest spreads vis-à-vis Germany

	Debt-to-GDP ratio	Share of debt in total euro area level	Government bond yield spreads against Germany	Focus on highest spreads
BE	106	4.5%	0.4	
DE	69	21.7%	-	
EE	10	0.0%	n.a.	
IE	89	2.1%	0.7	
EL	183	3.2%	8.6	5.0
ES	100	11.4%	1.4	0.5
FR	97	21.9%	0.4	
IT	133	22.4%	1.3	0.5
CY	109	0.2%	3.8	1.0
LV	40	0.1%	0.5	
LT	41	0.2%	1.0	0.5
LU	23	0.1%	0.2	
MT	61	0.1%	0.9	
NL	65	4.6%	0.2	
AT	85	3.0%	0.3	
PT	126	2.4%	2.9	1.0
SI	80	0.3%	1.2	0.5
SK	53	0.4%	0.4	
FI	65	1.4%	0.3	

A heat map of stabilisation needs

	LENGTH (IN 2016)				DEPTH				PACE OF CLOSURE				CONCLUSION	
	L1		L2		D1		D2		C1		C2			
	Number of consecutive years with same sign		Number of years since latest peak/trough*		Level at latest peak/trough*		Level in 2016		Annual percentage of closure between latest peak/trough and 2016*		Percentage of closure 2015-2016		Intensity of needs	
	Standard	SUR	Standard	SUR	Standard	SUR	Standard	SUR	Standard	SUR	Standard	SUR		
EA-19	**8**	8	3	3	-2.9	-3.2	-1.0	-0.7	22	26	37	34	high	Negative output gap
LU	8	8	4	4	-5.2	-6.2	-1.4	-2.4	18	15	25	15	high	
NL	8	8	3	3	-3.1	-3.6	-0.8	-1.6	25	19	36	23	high	
PT	6	9	3	4	-4.2	-7.2	-0.8	-2.5	27	16	49	31	high	
CY	6	8	3	3	-7.3	-10.3	-0.8	-4.5	30	19	79	38	high	
ES	8	8	3	3	-8.4	-10.1	-1.5	-3.3	27	22	63	45	high	
IT	8	8	3	2	-4.1	-4.8	-1.6	-2.7	20	22	38	25	high	
FR	8	8	2	2	-1.8	-2.1	-1.4	-1.9	12	6	7	7	high	
FI	5	8	2	2	-2.6	-2.7	-1.8	-2.0	16	14	27	25	high	
AT	4	5	1	1	-0.9	-1.4	-0.7	-1.3	23	9	23	9	medium	
SI	8	8	3	3	-5.5	-6.2	-0.3	-0.9	32	28	83	57	medium	
BE	5	5	3	3	-1.5	-1.1	-0.4	-0.2	24	29	-22	-101	medium	
SK	8	2	3		-2.7		-0.4	2.6	29		63	-88	low	Broadly closed OG
DE	4	6					0.0	1.8			80	-29	low	
EE	1	5		2		2.9	-0.1	1.3		27	105	41	low	
LT	3	3	2		1.0		0.9	1.6	5		-21	-86	medium	Positive output gap
IE	2	2					1.7	2.4			-24	-72	medium	
MT	4	4	1	1	1.6	2.3	0.9	1.9	40	19	40	19	medium	
LV	4	4	1		1.5		1.4	2.1	10		10	-12	medium	

What if the needs of the euro area conflict with those of individual countries?

- Case of conflicts between the national need for stabilisation and need at the euro area level