Bundesministerium
der Finanzen

A GERMAN VIEW ON THE EA FISCAL STANCE

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The views expressed are those of the authors and do not necessarily reflect those of the German Ministry of Finance

STARTING POINT NOVEMBER 2016 COM COMMUNICATION ON FISCAL STANCE FOR EA

recommends a "moderately expansionary fiscal stance" of "up to 0.5 % of GDP at the level of the euro area“, recommendation is made from a hypothetical fiscal policy centralisation perspective: "as if there were a Finance Minister for the euro area as a whole. In reality, the euro area consists of individual countries with different stabilisation needs and above all different degrees of fiscal space:

- "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”

I. IS THERE A GOOD CASE FOR INTRODUCING A FISCAL STABILISATION OBJECTIVE ON THE EA LEVEL ?

Use of Discretionary Fiscal Policy to influence the cycle?

“in normal times” **not useful** (or not needed…), monetary policy and national automatic stabilizers can impact business cycle (see ECB 2016)

“in exceptionally bad times” (severe crisis, low inflation, high unemployment, other tools not sufficient) **potentially useful,** member states can stabilize on national level within rules of the SGP

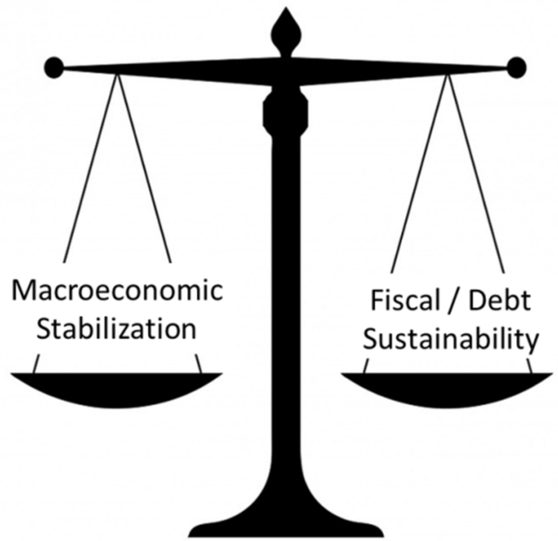
- **but “problems” of discretionary fiscal policy for influencing cycle remain (uncertainty regarding cyclical position, implementation lags, reversibility etc.)**
- **e.g. 2009 discretionary policies (cash for clunkers-program and short-time work) in Germany provided stimulus, but time lags were often long, procyclical effects were the result, it was mostly automatic stabilizers that buffered the economic downturn in Germany**
- **Structural problems cannot be solved by fiscal stimulus**

Cross-Border Stabilization on the EA level ?

Current Approach to EU Fiscal Policy Coordination

- Fiscal policy coordination via EU fiscal rules, focus on debt sustainability on country level
- Built-in flexibility in SGP for use of automatic stabilizers
- Countries can stabilize within limits of SGP
- No “contract”/consensus about steering euro area fiscal stance

COM communication on Aggregate Fiscal Stance implicitly changes the approach by introducing stabilization objective as equally important policy goal on EA level and suggesting cross-border stabilization

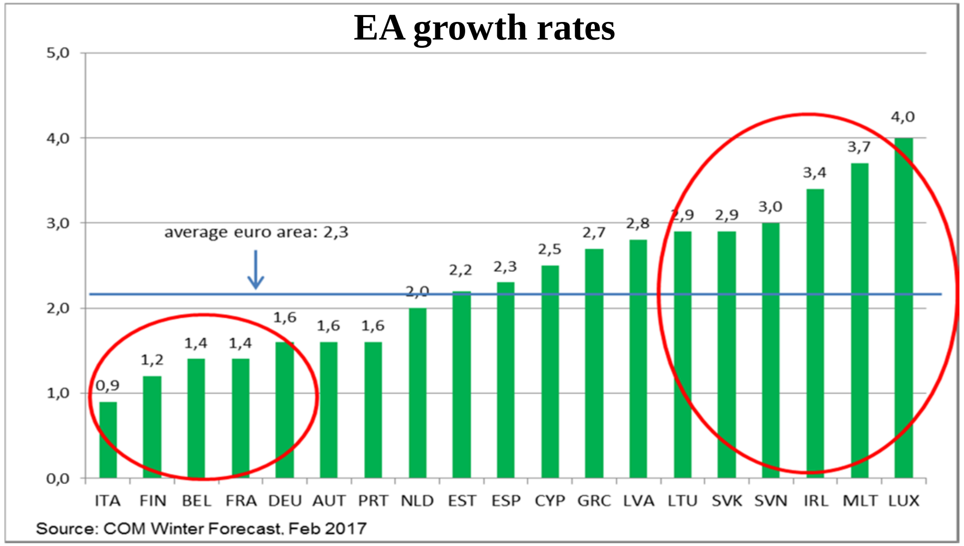


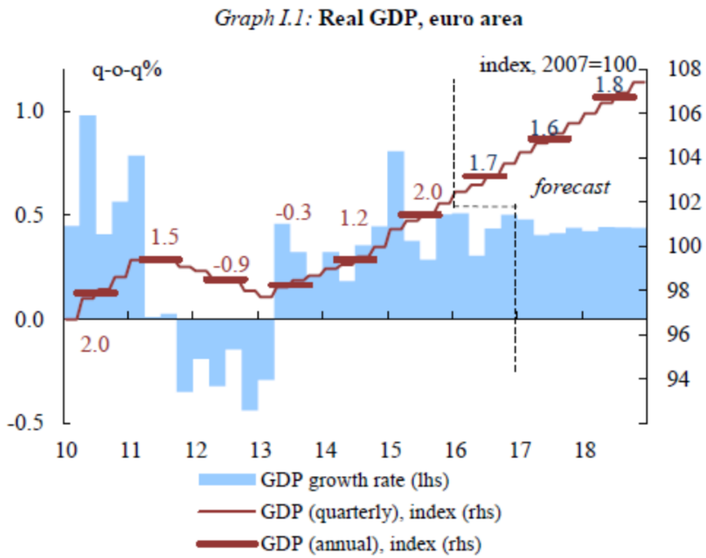
Source: IfW Kiel

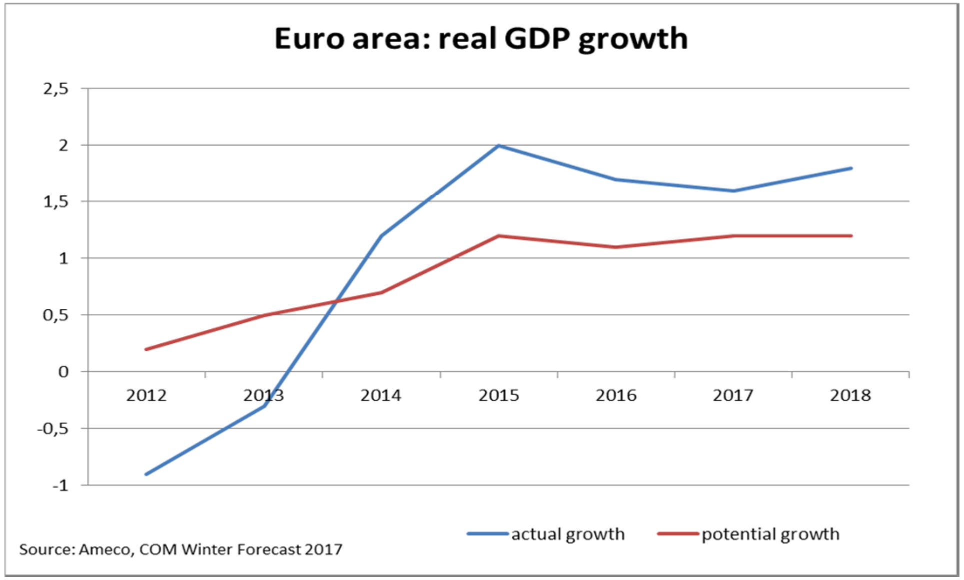
No consensus for new approach

II. DOES ECONOMIC SITUATION IN EA JUSTIFY FISCAL EXPANSION ?

Recovery continues……

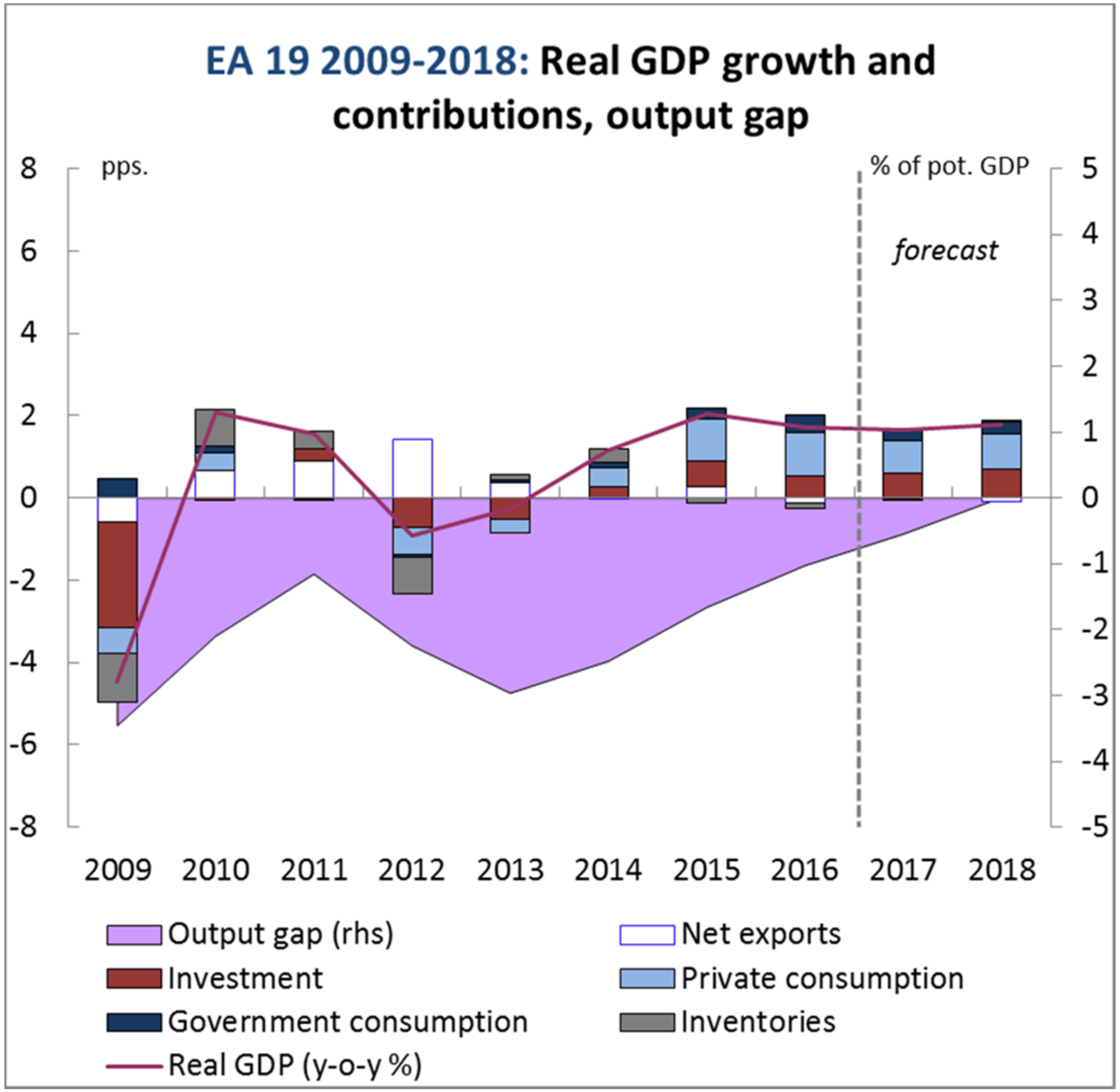






EA growth rates: above potential, **COM:** projects for 2017 euro area growth of 1,6%, potential growth of 1,2%), **IMF:** projects +1,6% for 2017……

Recovery continues……



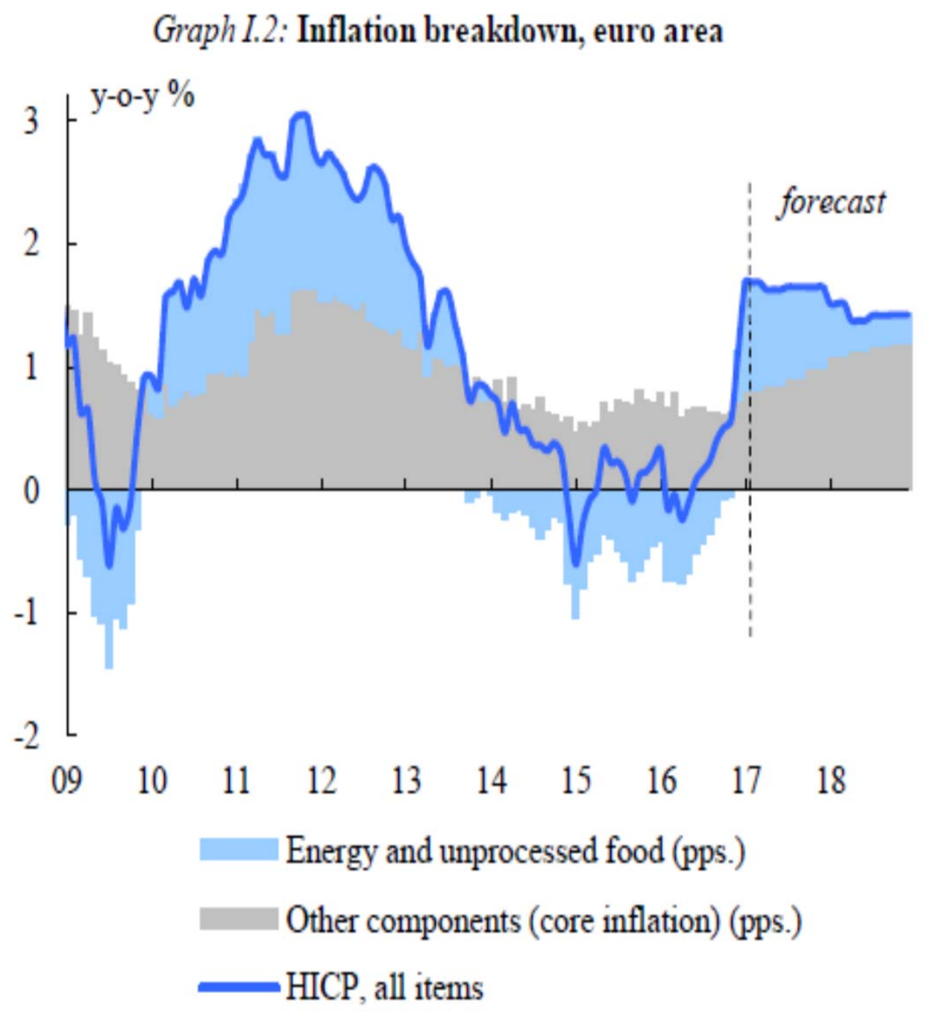
Source: MoF Staff based on COM winter forecast

…..output gap of -1 for 2016 projected to fully close by 2018

“normal times” according to SGP matrix definition

ECB Assessment in March: “recovery in the euro area is steadily firming and will continue to firm and broaden”

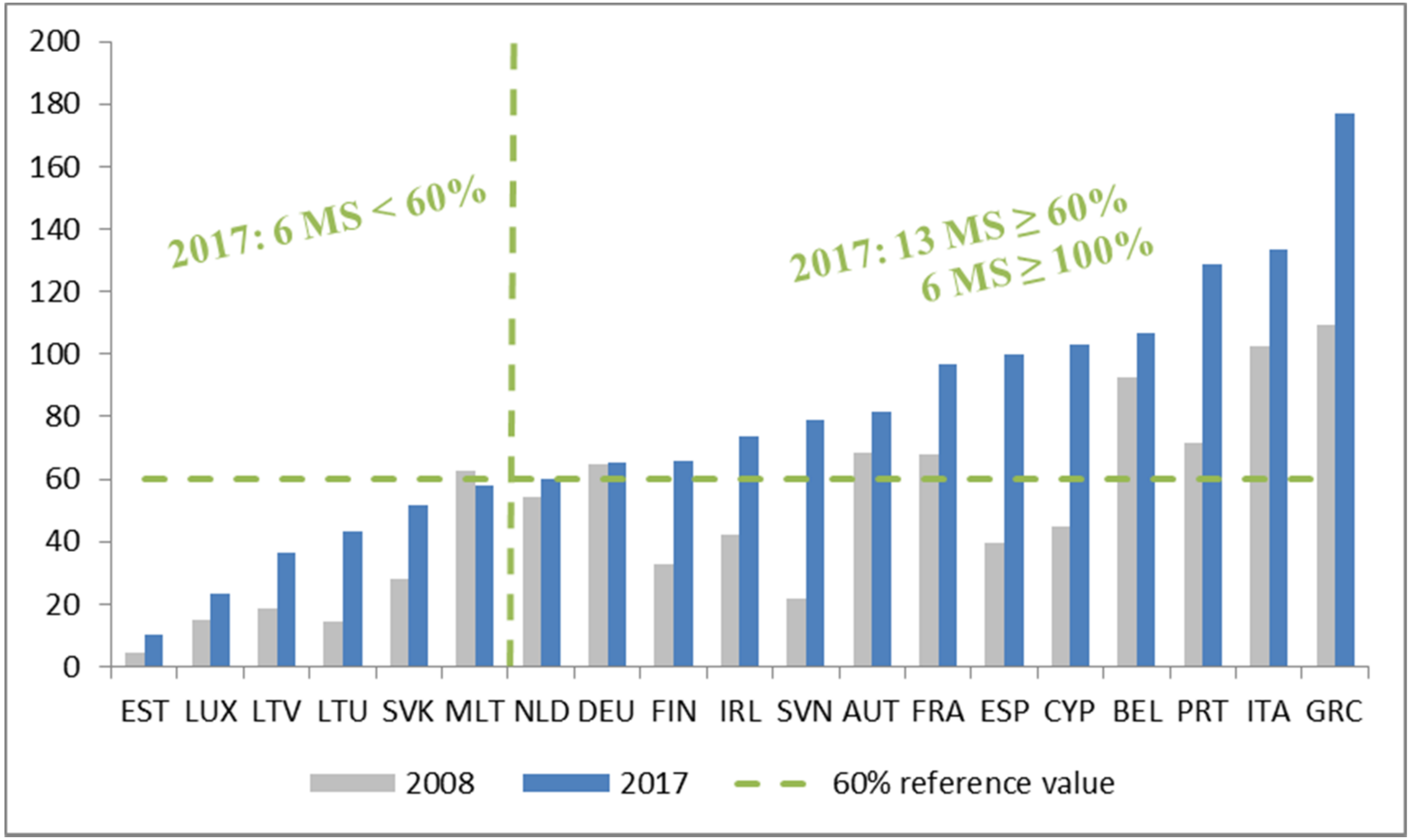
Recovery continues……



……inflation forecast to pick up.

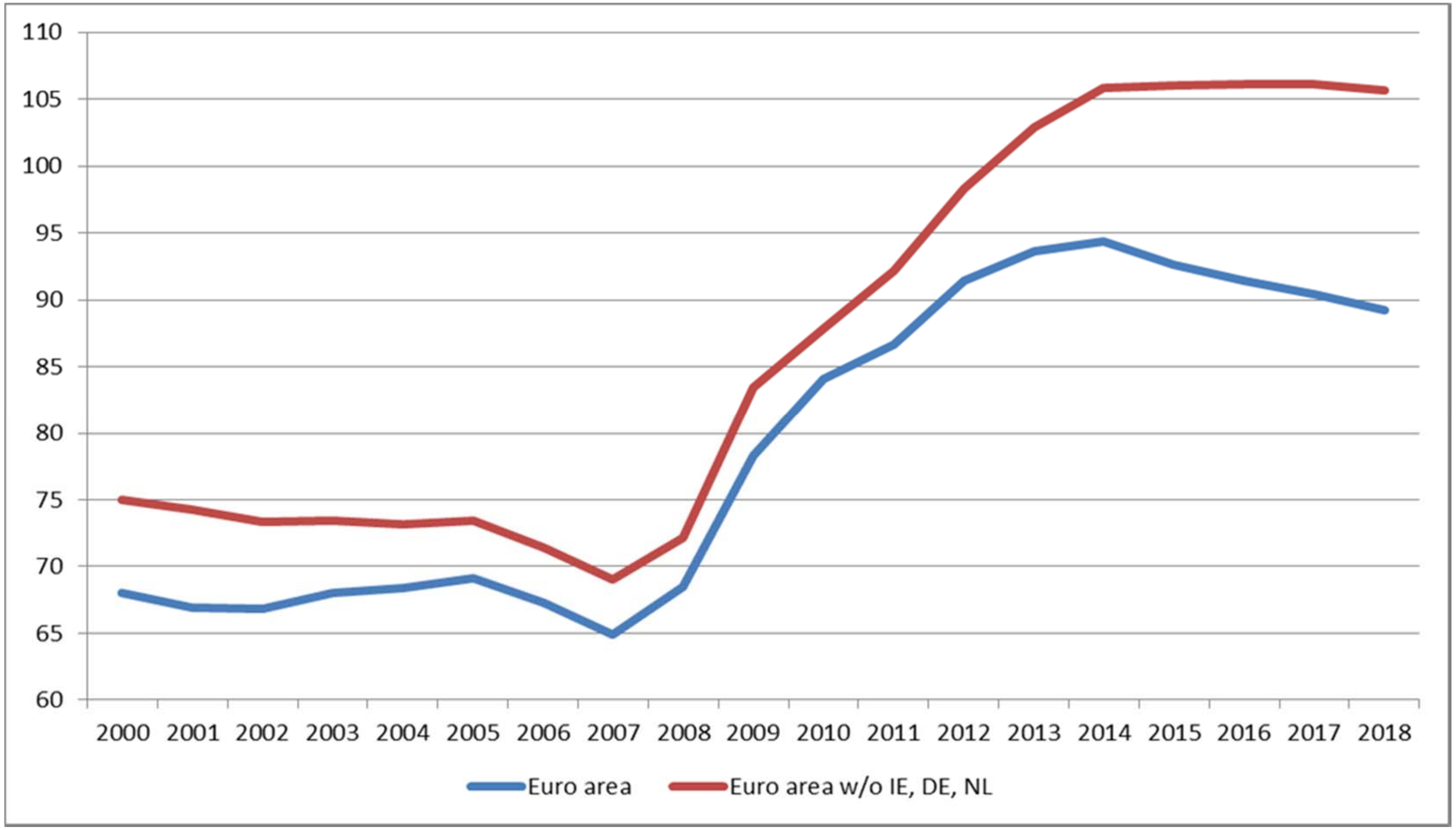
Source: COM winter forecast 2017

….while legacy of high debt is still there



Source: MoF Staff based on COM winter forecast

….while legacy of high debt is still there



Source: COM Winter Forecast 2017, MoF staff calculations. IE, DE, NL: MS with the fastest decrease in debt to GDP 2014-2018.

Right time for fiscal expansion ?

III. WOULD DISCRETIONARY FISCAL INTERVENTION WITH THE GOAL OF CROSS-BORDER-STABILIZATION BE EFFECTIVE?

Effectiveness of Cross-Border-Stabilization

What can make fiscal stimulus possible and effective

- Available fiscal space
- High fiscal multipliers
- Large spillovers across Member States
- Benefits from fiscal stimulus larger than the cost of delaying fiscal adjustment
- Focus on investment and growth-enhancing measures
- No risk of overheating in the Member States where stimulus is implemented

Source: COM Public Finance Report 2016

Channels for Cross-Border-Spillovers

1. **International trade:** A fiscal impulse in one country spills over to another country dependent on the trade intensity between the two countries (positive spillover)
2. **Monetary policy:** The increase in economic activity may trigger a more restrictive joint monetary policy (negative spillover).
3. **Exchange rate:** The Euro may appreciate which dampens economic activity (negative spillover).

Extreme case: A fiscally induced boom in Germany causes joint monetary policy to become more restrictive, while trade effects, e.g. with some MS are low. In sum, there may be a contractionary effect on the recovery in some MS.

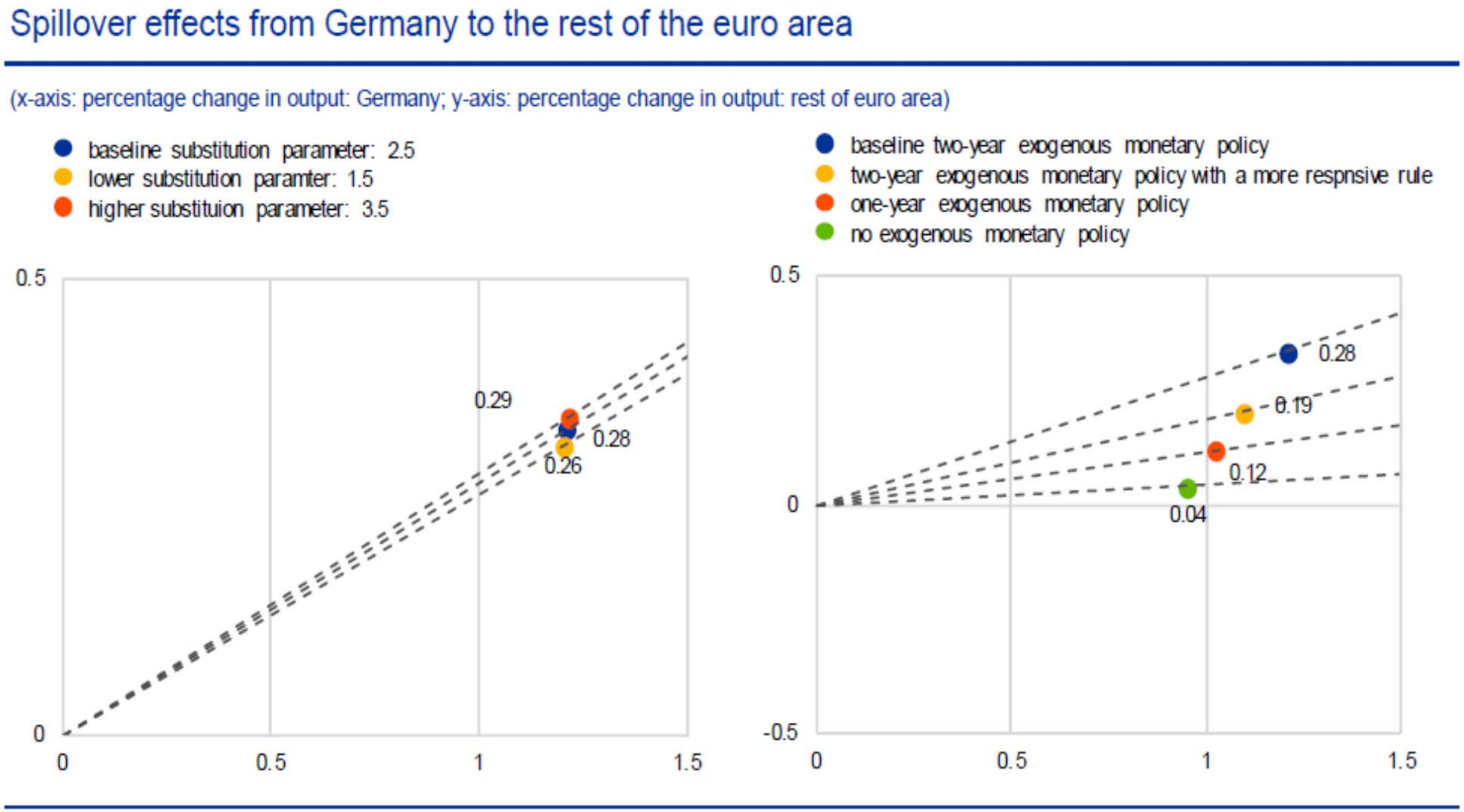
Overall, size of (net) spillovers ?

Overview of recent studies on Size of Spillover-Effects

Study	Fiscal Impulse in Germany	Monetary Policy Reaction	Effect on EA GDP
In´t Veld (2013)	1% GDP, 2 years	No	+0.2%
Elekdag, Muir (2014)	1% GDP, 2 years	No Yes	+0.3% +0.2%
German Council Economic Advisors (2015)	0.3-0.9% GDP, 9 quarters	No Yes	+0.1% around 0.0%
EU-COM (2016)	1% GDP, nA	Yes	+0.3%
ECB (2016)	1% GDP, 5 years	No Yes	+0.5% <+0.1%
Deutsche Bundesbank (2016)	1% GDP, 2 years	No Yes	+0,26% +0,18%
EU-COM (2016)	1% GDP, nA	No	+0,3-0,5%
Bańkowski, Ferdinandusse (2017)	1% GDP, 2 years	No Yes	+0,28% +0,04%

Source: Bundesbank Literature Overview, own Research.

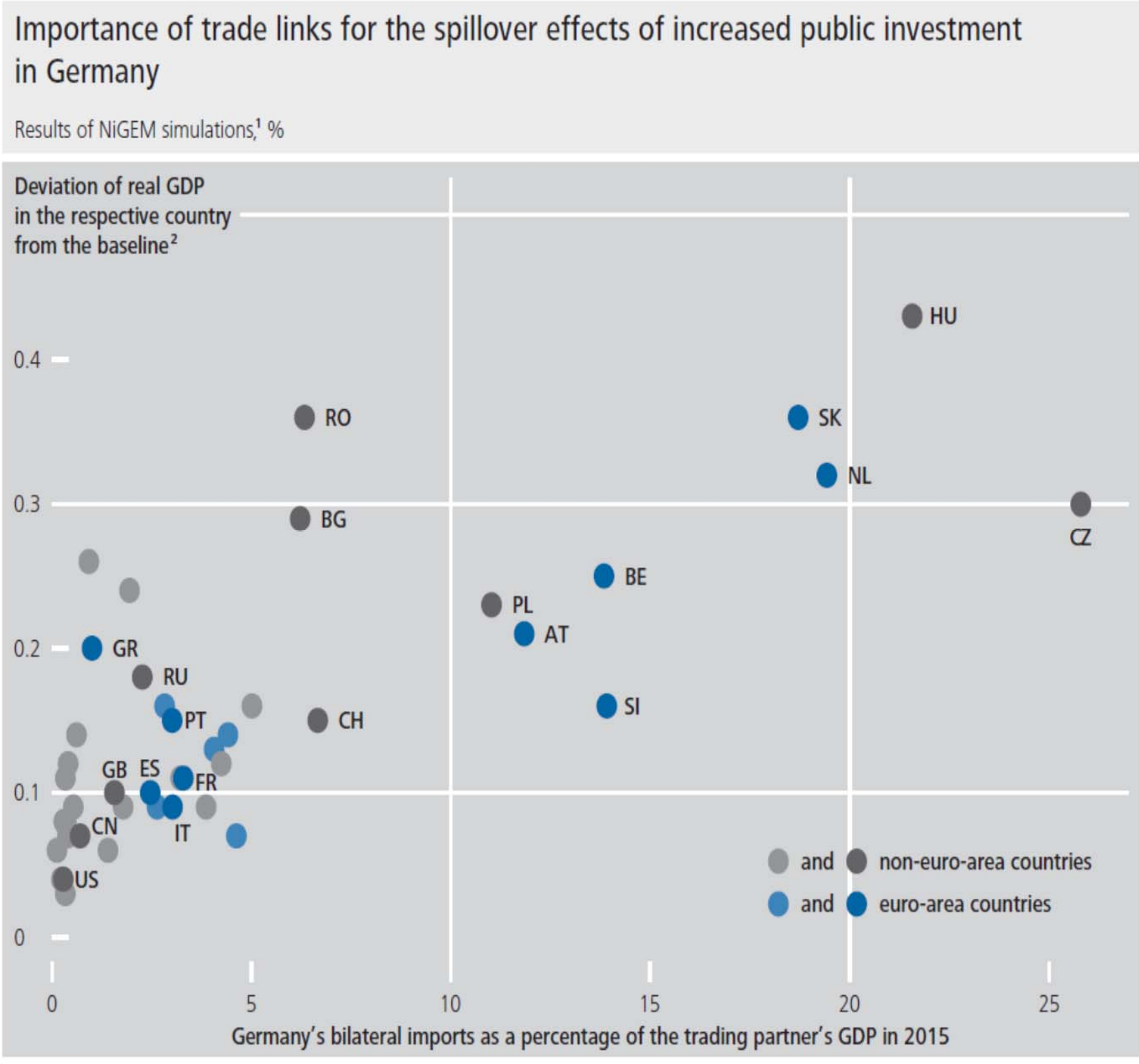
Size of Spillover-Effects – An Example



Main Takeaway: Size of spillovers crucially depends on model assumptions, in particular about role of monetary policy

Source: ECB Occasional Paper 182 2017.

Geographical Distribution of Spillovers



Source: Deutsche Bundesbank 2016

Stabilization in the right countries ?

Substantial spillovers only in NL, HU, SK, CZ

Moderate spillovers in PL, BE, AT, SI.

Spillovers to potential “target countries” FRA, ES, PT, IT, GR seem to be limited

Discretionary fiscal intervention in Germany hard to justify on that basis

Conclusion First Part

No formal contract or consensus about approach of managing/steering aggregate euro area fiscal stance

Current economic situation EA does not justify expansionary fiscal policy

Effectiveness for countries in need of stabilization of stimulus in other countries not evident (Reaction of monetary policy and exchange rates can counteract impulses in foreign demand, spillovers may materialize in “wrong” countries)

More growth friendly composition of public spending can be alternative

IV. IS FURTHER FISCAL EXPANSION GOOD ADVICE FOR GERMANY?

- A GERMAN PERSPECTIVE -

Setting: COM recommends Germany an expansionary fiscal stance and to foster infrastructure investment.

Challenges following these recommendations:

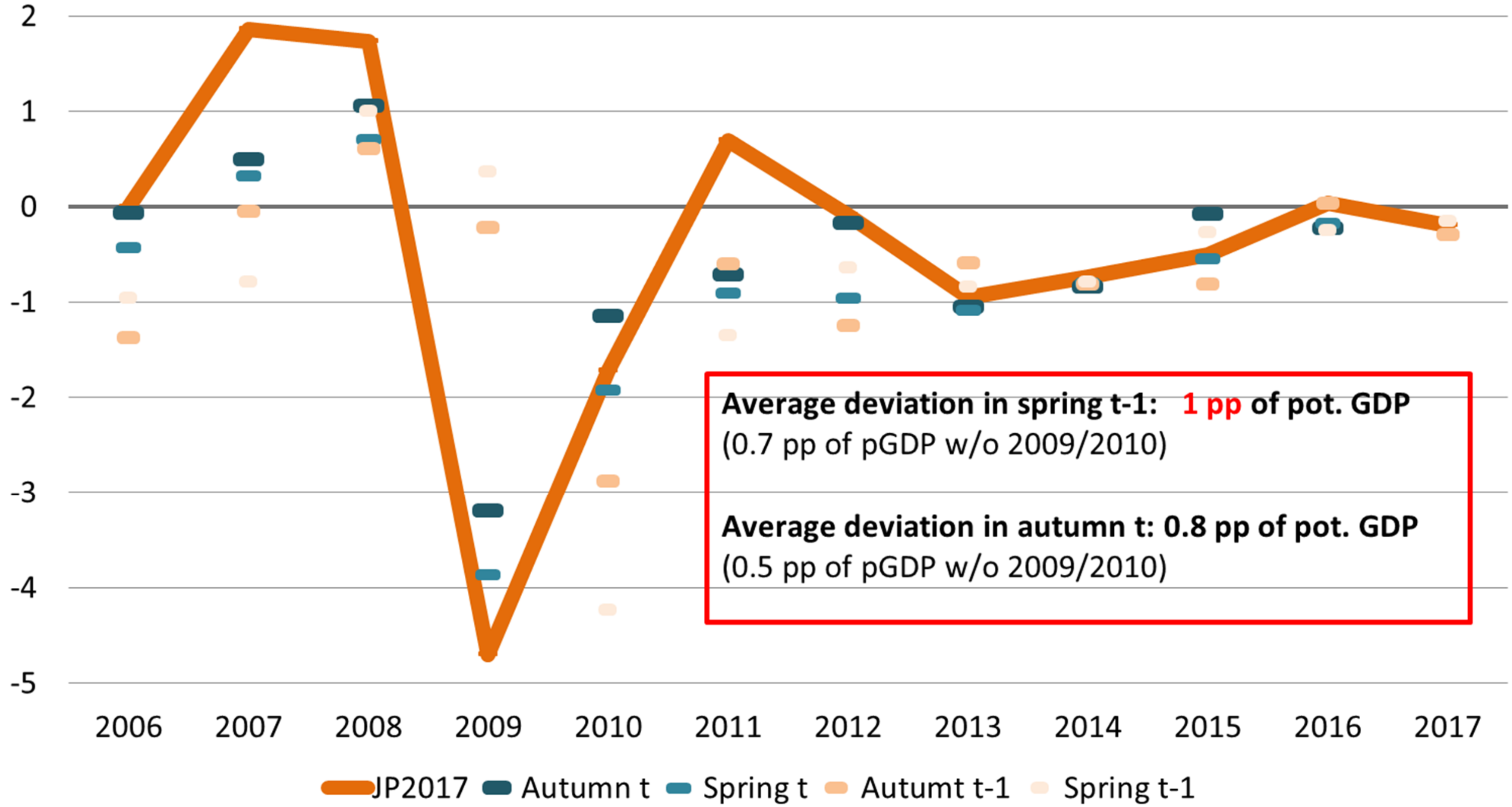
1. Output gap revisions are strong: macroeconomic fine-tuning with fiscal policy can be misleading

2. Expansionary fiscal policy is not appropriate due to the output gap being already closed

3. Budget balance is sugar-coated by interest expenditure saved post-crisis

4. Infrastructure gap?

Output gaps (in % of GDP) vary strongly - fiscal stance no reasonable instrument for macro fine-tuning

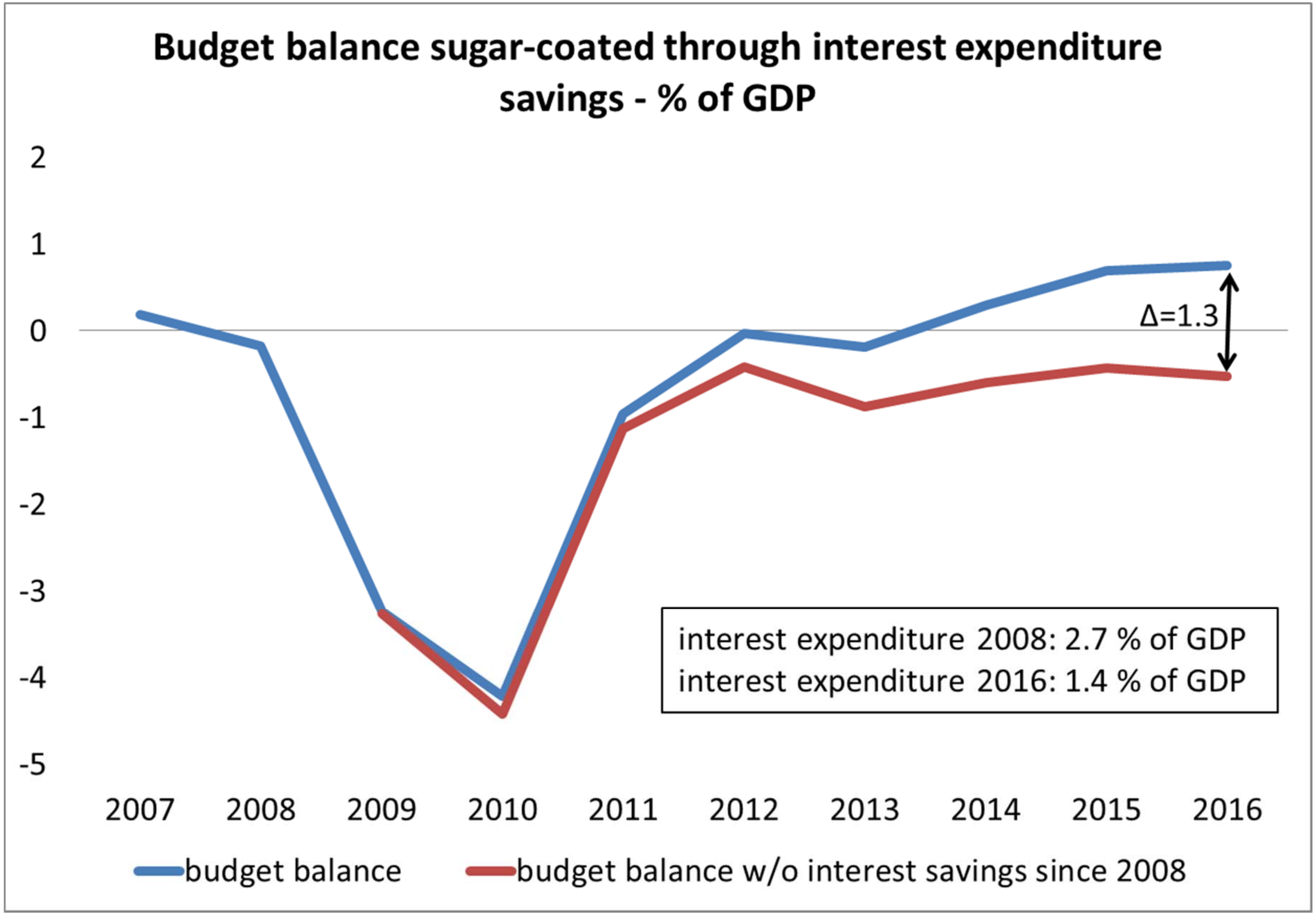


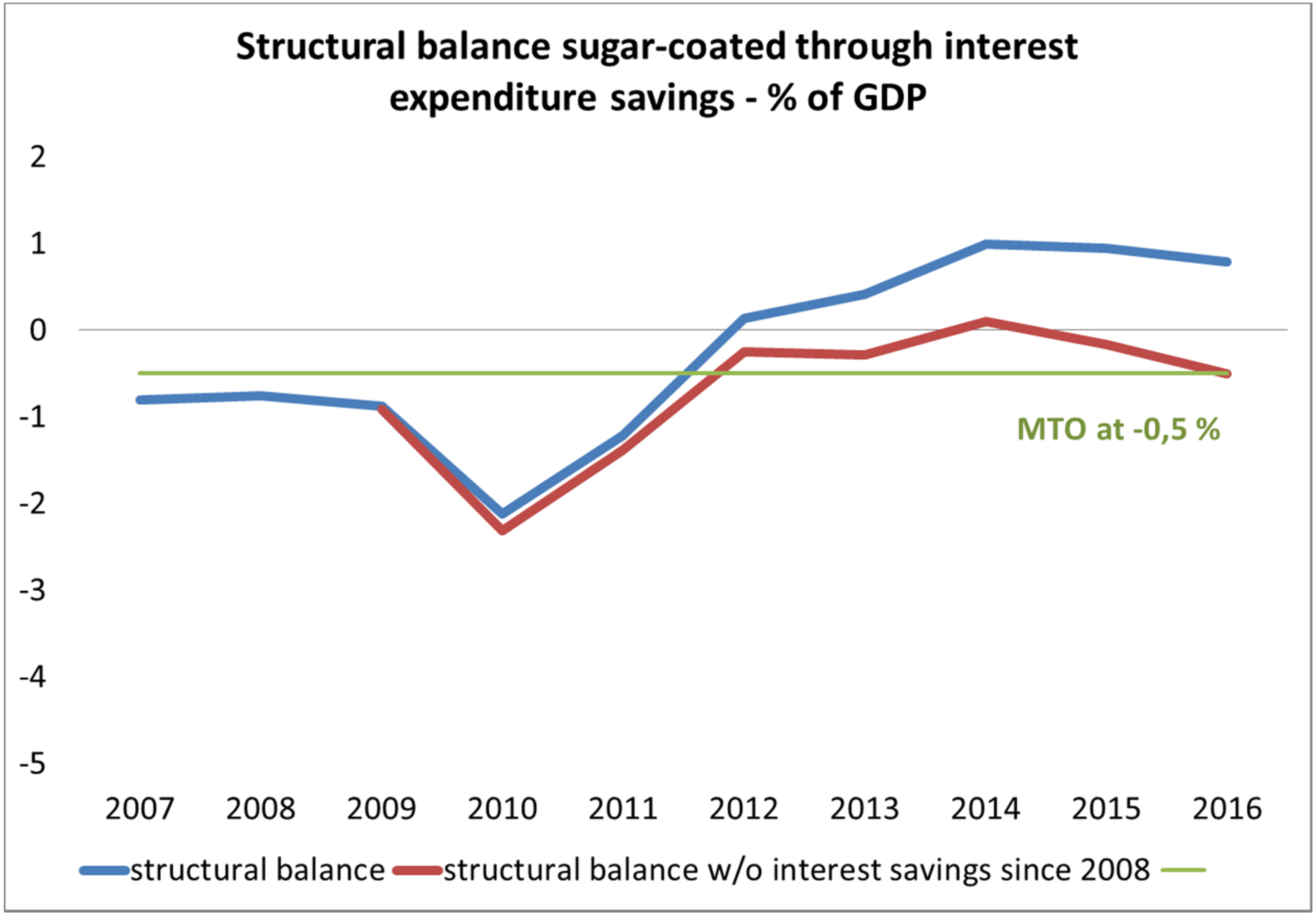
Average deviation in spring t-1: 1 pp of pot. GDP
(0.7 pp of pGDP w/o 2009/2010)

Average deviation in autumn t: 0.8 pp of pot. GDP
(0.5 pp of pGDP w/o 2009/2010)

No output gaps in Germany

		2017	2018
COM winter forecast	Feb 17	-0.1	+0.1
Germany Jahreswirtschaftsbericht	Jan 17	-0.2	-0.1
Germany Council of Economic Experts	Mar 17	+0.7	+1.2
Germany Joint Economic Forecast	Oct 16	+0.5	+0.5


Budget balance sugar-coated through interest expenditure savings - % of GDP
2
1
0
-1
-2
-3
-4
-5
2007
2008
2009
2010
2011
2012
2013
2014
2015
2016
Δ=1.3
interest expenditure 2008: 2.7 % of GDP
interest expenditure 2016: 1.4 % of GDP
budget balance
budget balance w/o interest savings since 2008


Structural balance sugar-coated through interest expenditure savings - % of GDP
2
1
0
-1
-2
-3
-4
-5
MTO at -0,5 %
2007
2008
2009
2010
2011
2012
2013
2014
2015
2016
structural balance
structural balance w/o interest savings since 2008

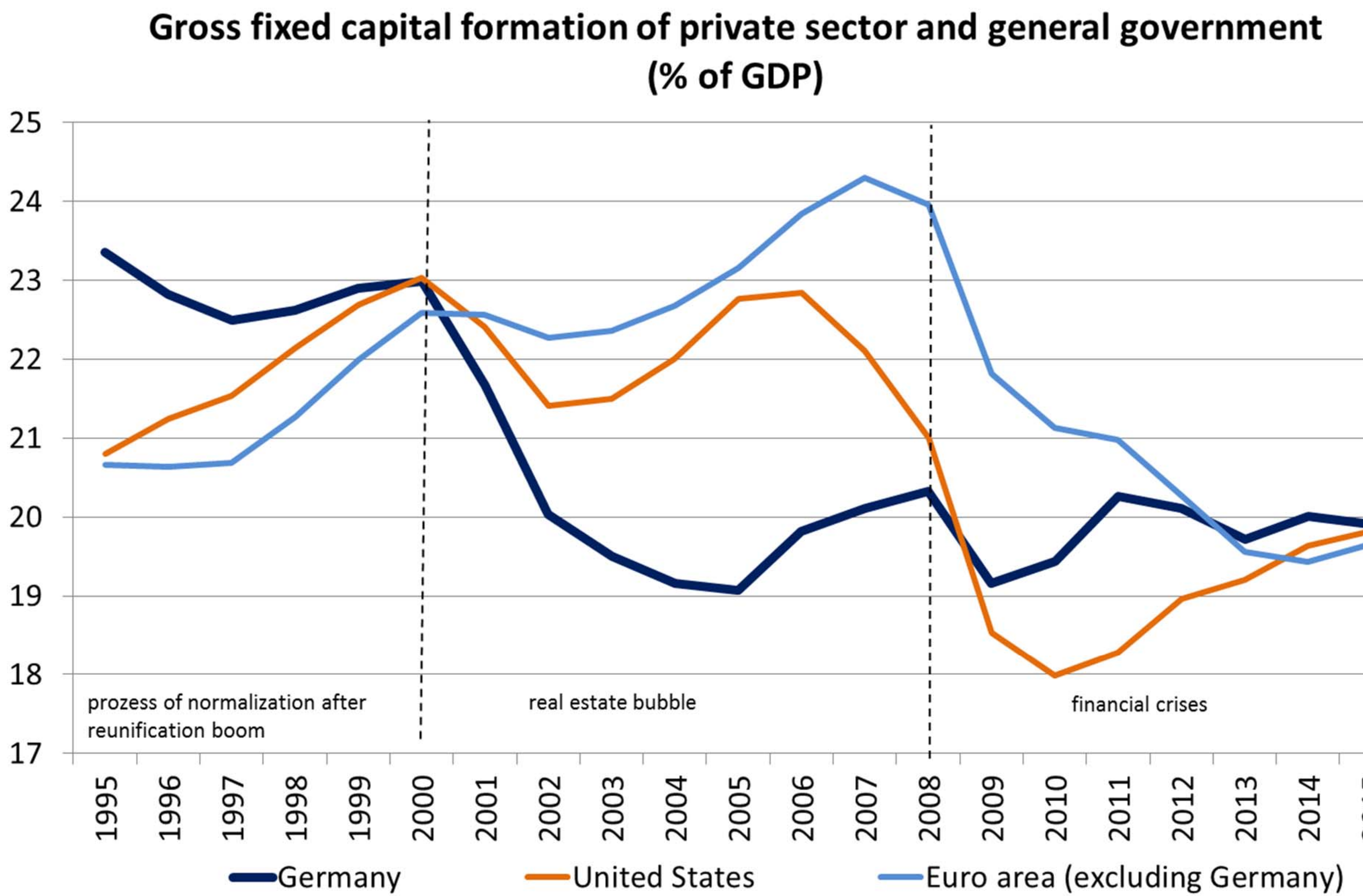
Infrastructure gap?

Methodological issues:

- ESA definition of infrastructure missing
- Infrastructure is not only provided by general government but also by private sector, i.e. rail, road, hospitals
- Erratic recording of military equipment

Implementation issues:

- time-lags
- capacity constraints due to closed output gap
- Spillover analysis with an increase in public investment of 1% of GDP = ivory-tower analysis


Gross fixed capital formation of private sector and general government
(% of GDP)
25
24
23
22
21
20
19
18
17
prozess of normalization after
reunification boom
real estate bubble
financial crises
1995
1996
1997
1998
1999
2000
2001
2002
2003
2004
2005
2006
2007
2008
2009
2010
2011
2012
2013
2014
2015
2016
Germany
United States
Euro area (excluding Germany)

Time-lag and some maths on public investment

COM PFR 2016: Average duration for a typical transport infrastructure project in Germany: 2 years

- ➢ Infrastructure projects thus not feasible for short-term fiscal stance expansion

Germany's car pool ≈ 330.000 vehicules, assuming 30.000 € per car ≈ 10 bn € or 0.3 % of GDP

- ➢ Substantial fiscal stance through a complete exchange of Germany's car pool reasonable?

Germany‘s fiscal aims:

1. Interest expenditure saved today should not be misused for primary expenditure – like in the mid 2000s in other EU MS – while improving quality of expenditure
2. Stick to rule-based fiscal-policy & letting automatic stabilisers work – with great results in the past
3. Bring investment on sustainable track – step by step increase paired with structural reform (federal infrastructure agency)
4. Increase resilience by bringing debt down now – Germany‘s 2016 debt below 70 % of GDP first time in 8 years

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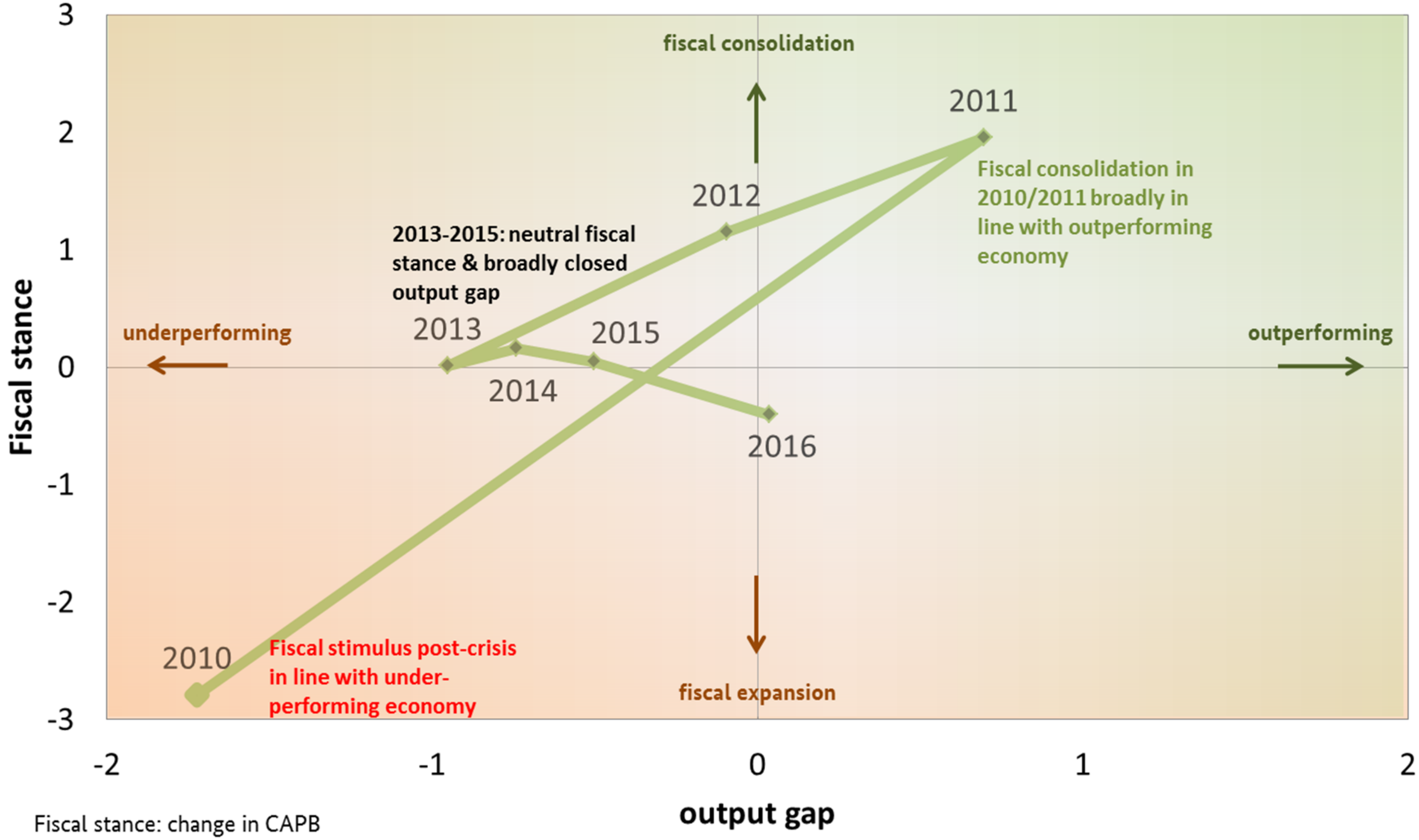
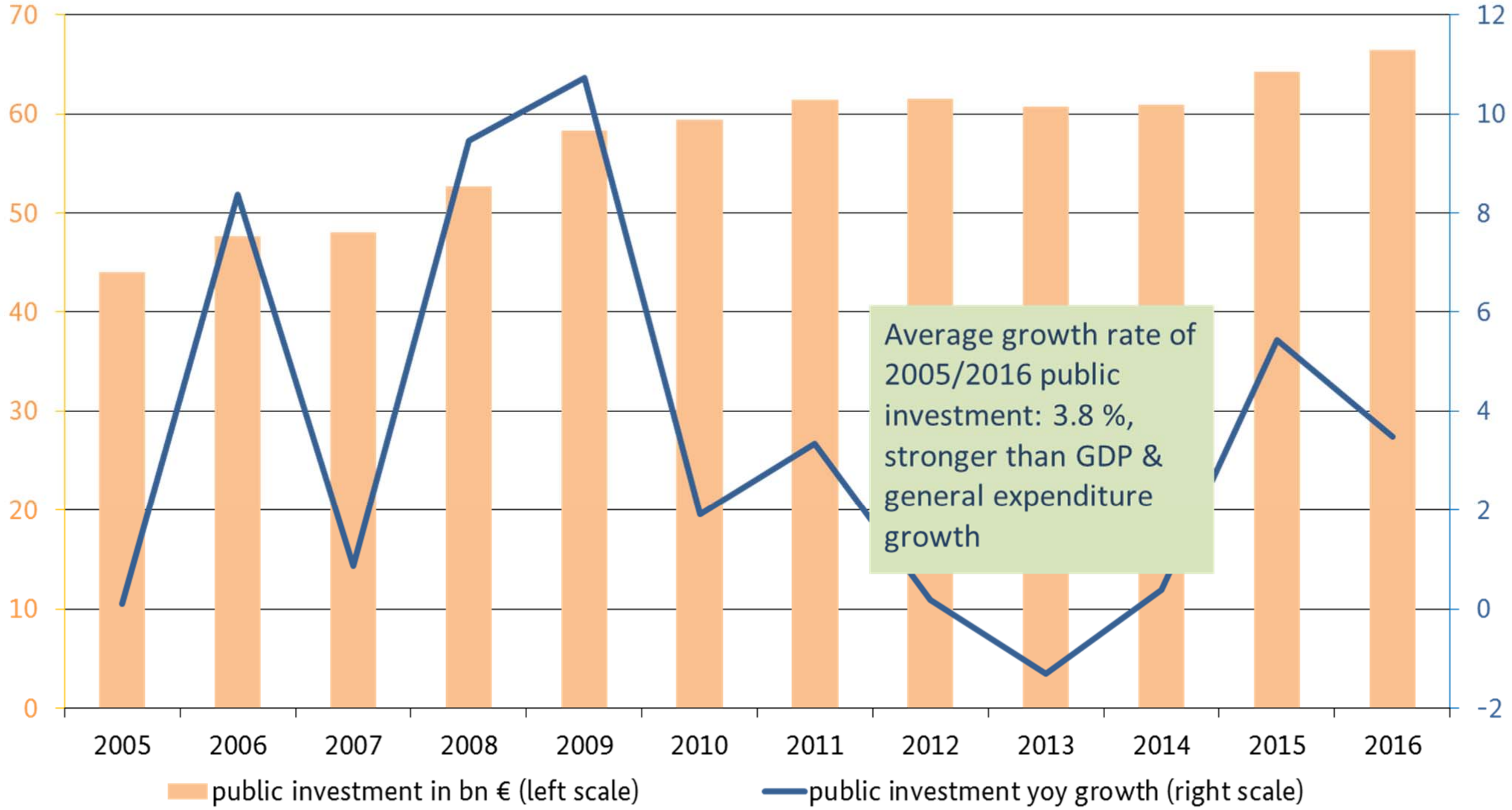
Referat I A 4

Fiscal stance and Output Gap
- in % of GDP -



Fiscal stance: change in CAPB
Output Gap according to January 2017 macro forecast

Sustainable general government investment increase



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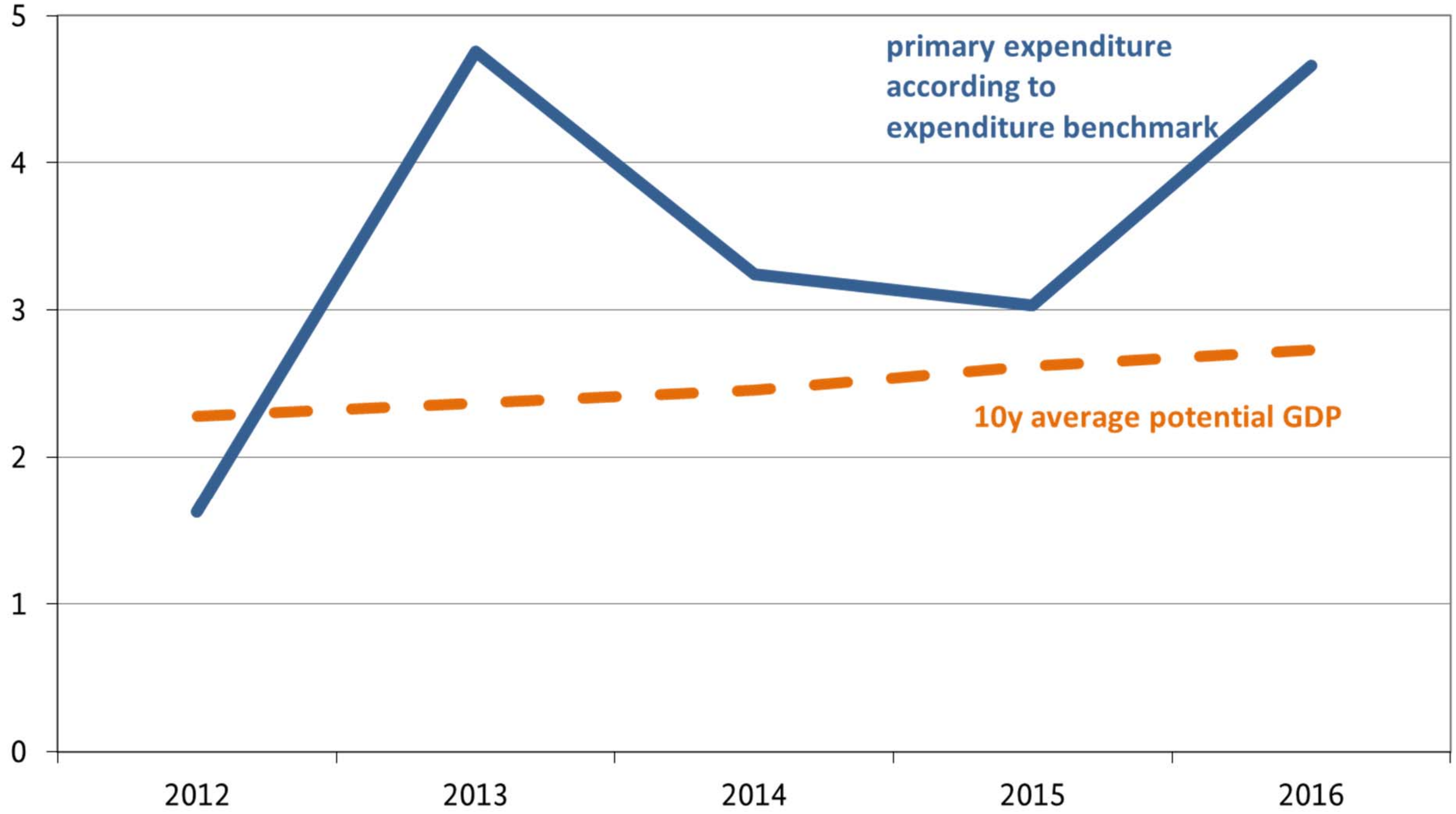
Referat I A 4

Expenditure benchmark: expenditure growth exceeding potential GDP growth

- yoy growth in % -



Conclusion

In the end Germany's fiscal policy is not so bad:

- ✓ **anticyclical fiscal policy when required**
- ✓ **primary balance on track for sustainable public finances**
- ✓ **steady increase in public investment**

but:

Primary expenditure growth exceeding expenditure benchmark