



The interrelations between fiscal policy and macroeconomic imbalances

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Objective of the presentation

Spark a debate on interrelations between fiscal policy and macroeconomic imbalances

- Can **fiscal policy** prevent macroeconomic imbalances ? What avenues to do so?
- Under what conditions does the presence of macroeconomic imbalances hamper **public debt sustainability**?
- What implications of these inter-relations for **economic surveillance** ?

Complex interrelations that are difficult to disentangle. Useful to distinguish between 1) the pre-crisis period 2) what happened during the crisis 3) the situation today

The interrelations between fiscal policy and macroeconomic imbalances

I - Macroeconomic imbalances and fiscal policy before the crisis

II – What was revealed by the crisis?

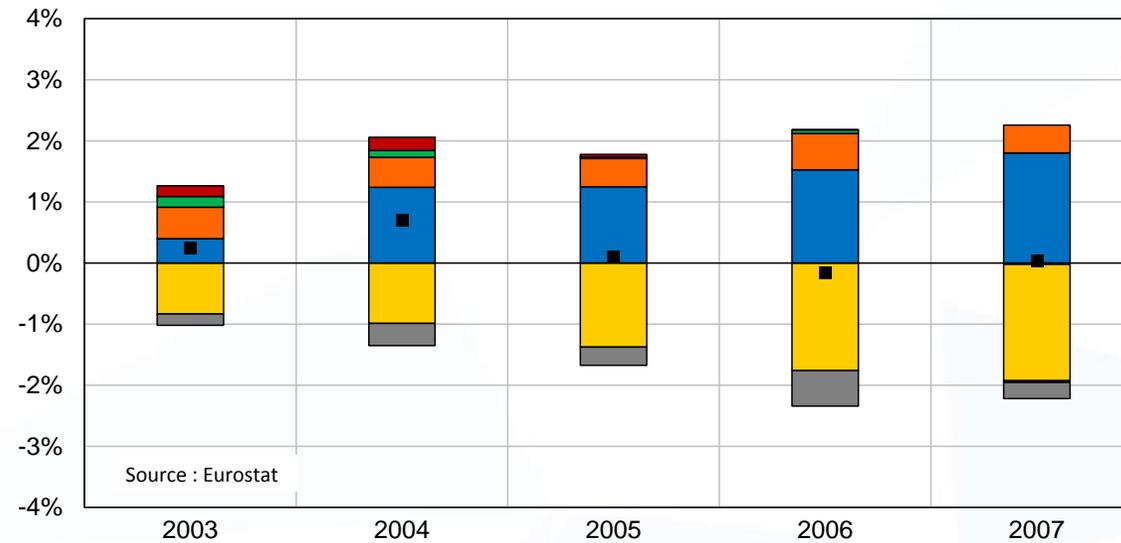
III – What is the situation today?

IV – Imbalances at the euro area level : does it raise some issues ?

I - Macroeconomic imbalances and fiscal policy before the crisis

- On aggregate, the Euro area current account position was rather balanced
- But large current account divergences at Member States level
- At that time, illusion that current account imbalances did not matter

Euro area current account composition (as % of EA GDP)

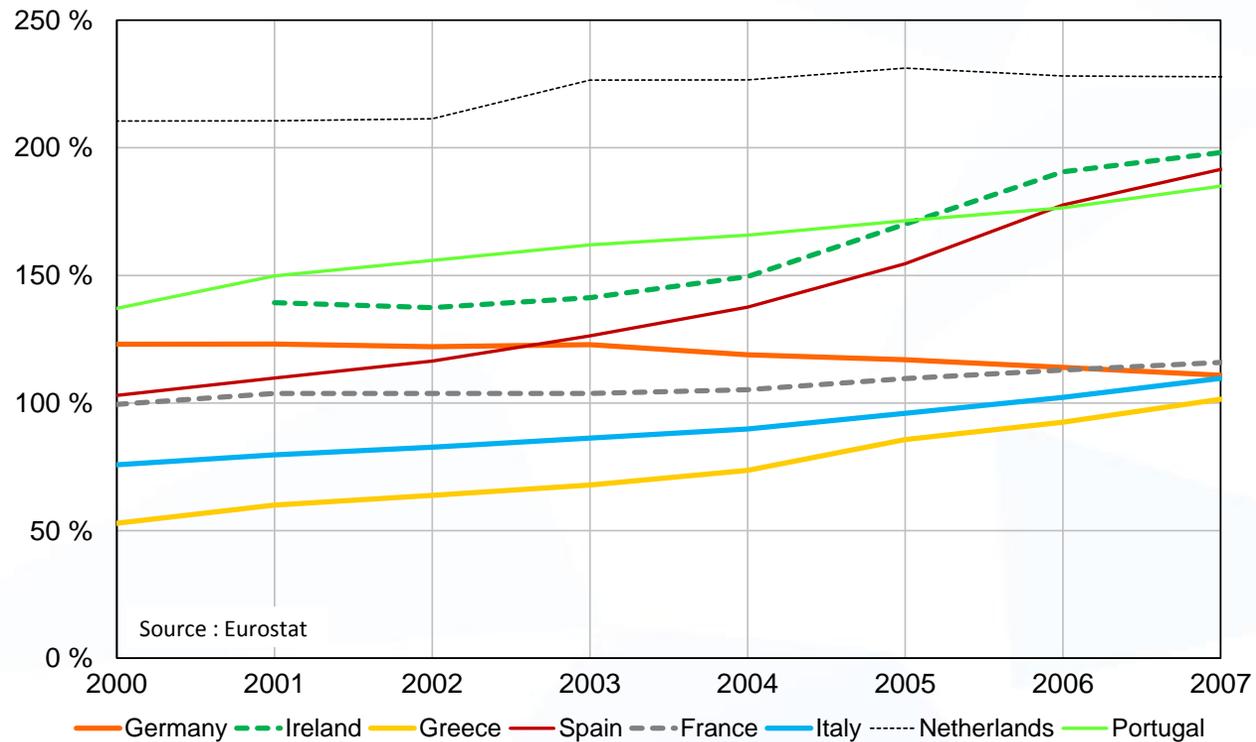


■ Germany ■ Netherlands ■ France
■ Greece-Italy-Spain-Portugal ■ Others EA countries (inc. Ireland) ■ Statistical adjustment
■ Euro area

I - Macroeconomic imbalances and fiscal policy before the crisis

- Current account deficits were for some countries the reflections of rapidly increasing private indebtedness.

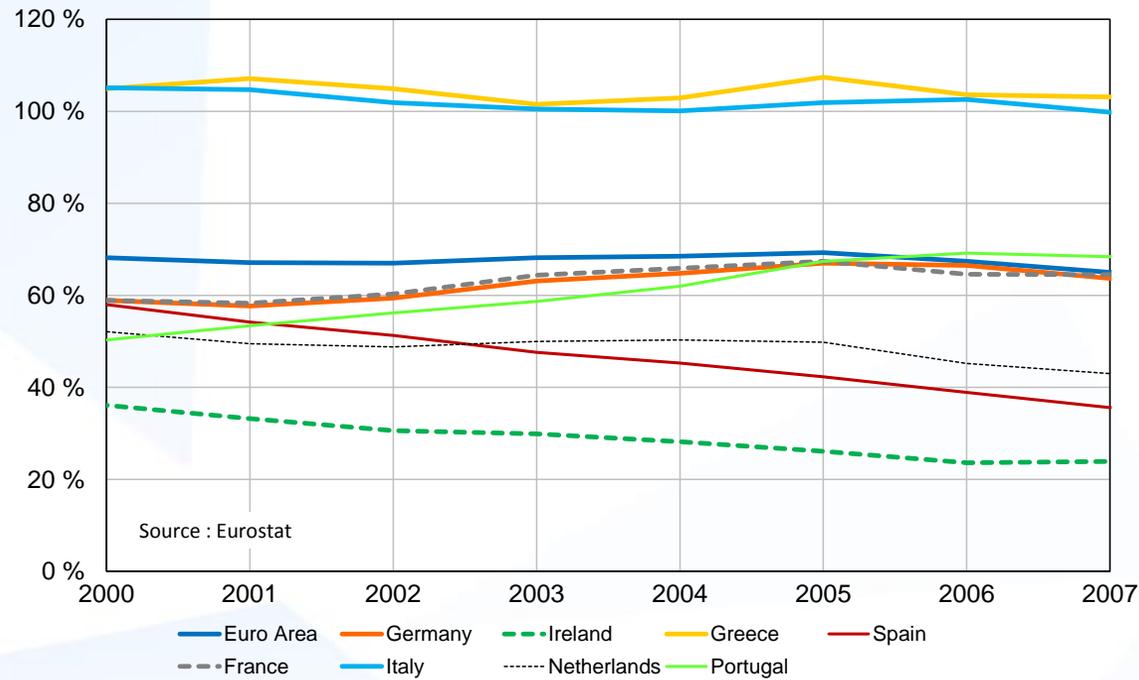
Non financial private sector debt (% of GDP)



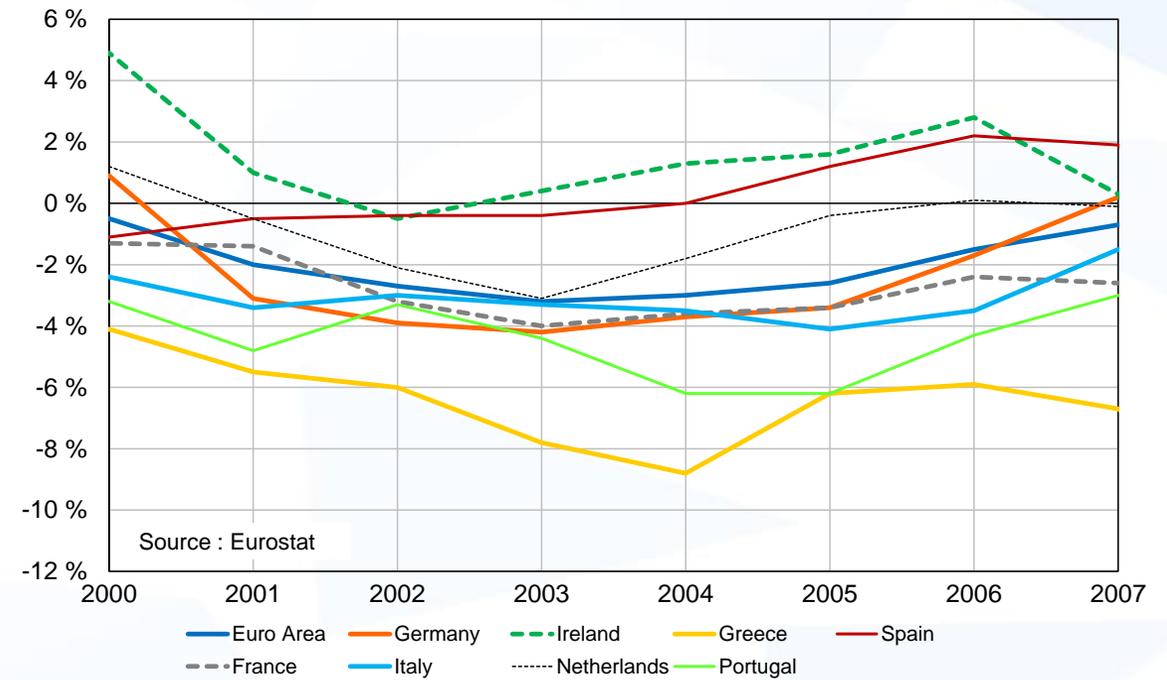
I - Macroeconomic imbalances and fiscal policy before the crisis

- With very heterogeneous fiscal situations, which were overly not worrisome

Public debt (as % of GDP)



Government deficit/surplus (as % of GDP)



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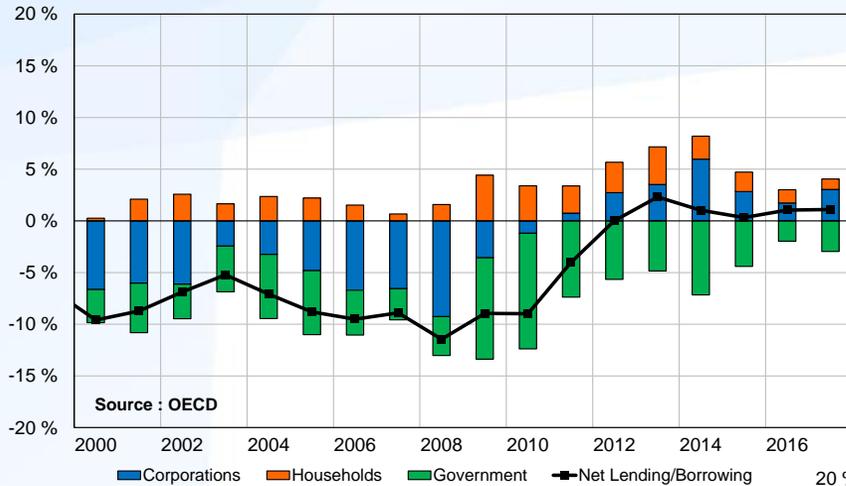
II - What was revealed by the crisis?

- The shock of 2007 revealed the weaknesses of the growth drivers in some countries :
 - Sharp decline in economic activity / steep increase in unemployment
 - Collapse in private domestic demand, partly offset by the increase in government deficits

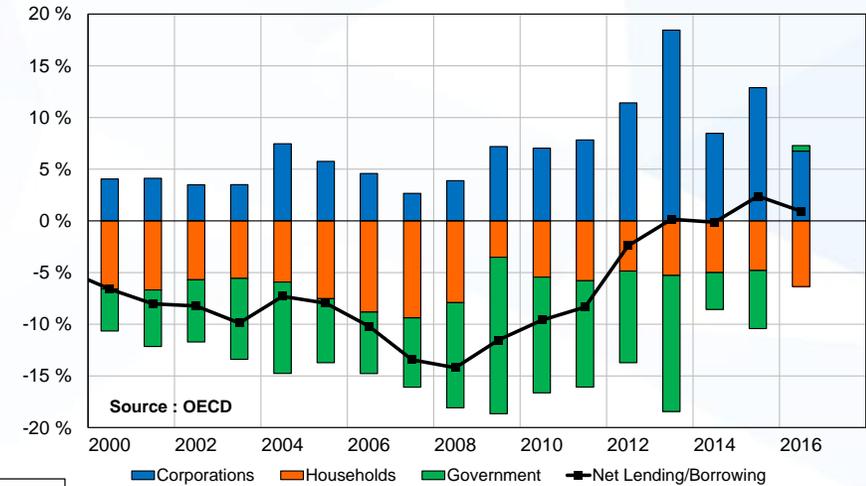
II - What was revealed by the crisis?

- Very strong fiscal policy response to offset the collapse in private domestic demand

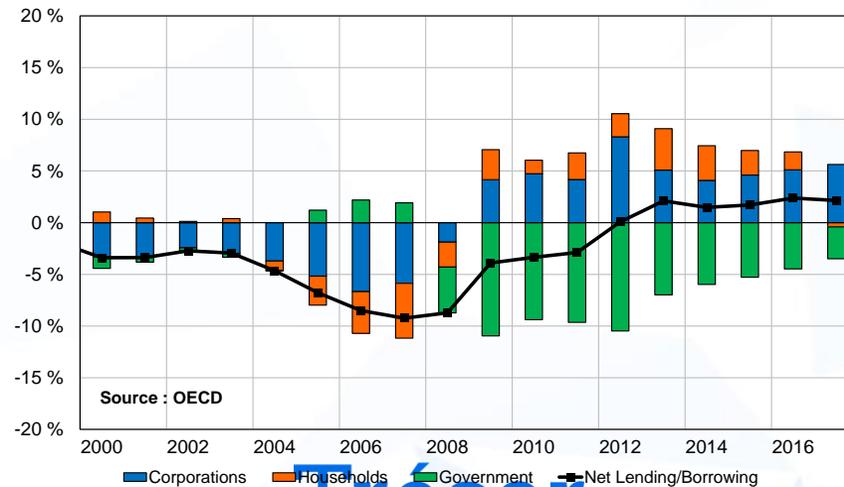
Portugal : Saving-investment gap per institutional sector
(% of GDP)



Greece : Saving-investment gap per institutional sector
(% of GDP)

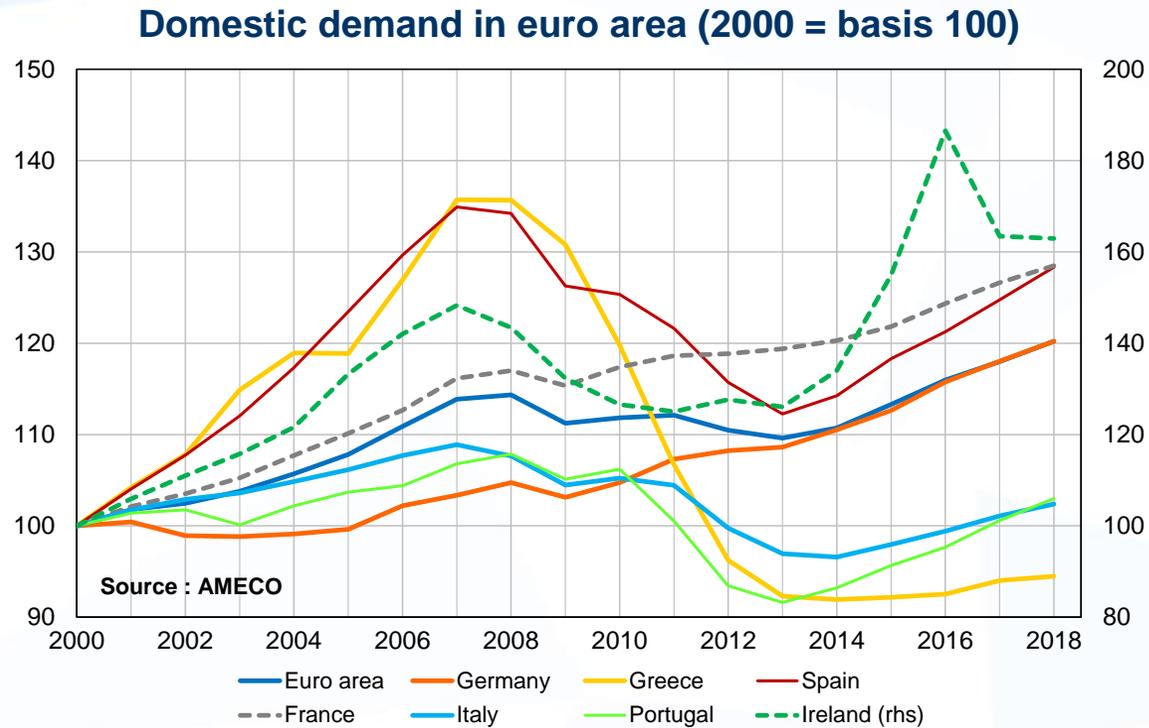


Spain : Saving-investment gap per institutional sector
(% of GDP)



II - What was revealed by the crisis?

- Adjustment took place at the expense of a strong fall in domestic demand/imports implying durable social costs and a strong public involvement at the national level



II - What was revealed by the crisis?

- Main lessons :
 - Clear inter-relation between Macroeconomic Imbalances and Fiscal Policy
 - Current account imbalances were to some extent related to fiscal imbalances (GR mainly) but not the case for other countries (IE, ES and PT)
 - However, those macroeconomic imbalances clearly impacted public finances ex-post through the bank-sovereign doom loop for ES and IE
 - In spite of an overall balanced current account, highly heterogeneous current account balances across member states can be very problematic.
 - Private indebtedness can impact public indebtedness through the bank-sovereign doom-loop.

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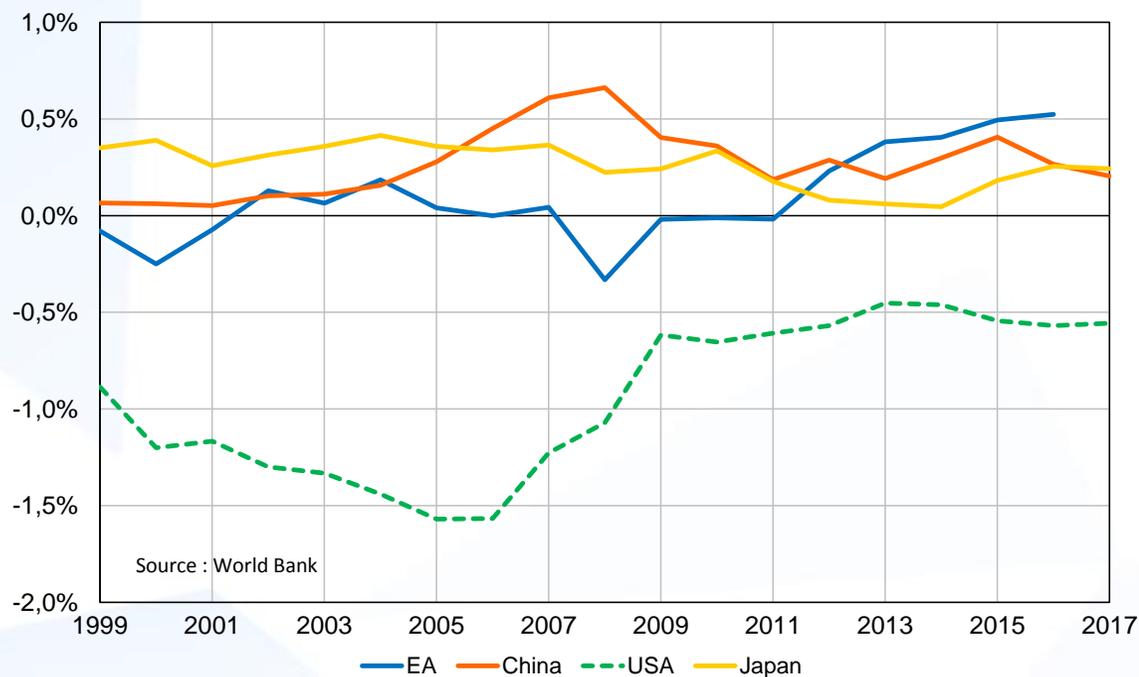
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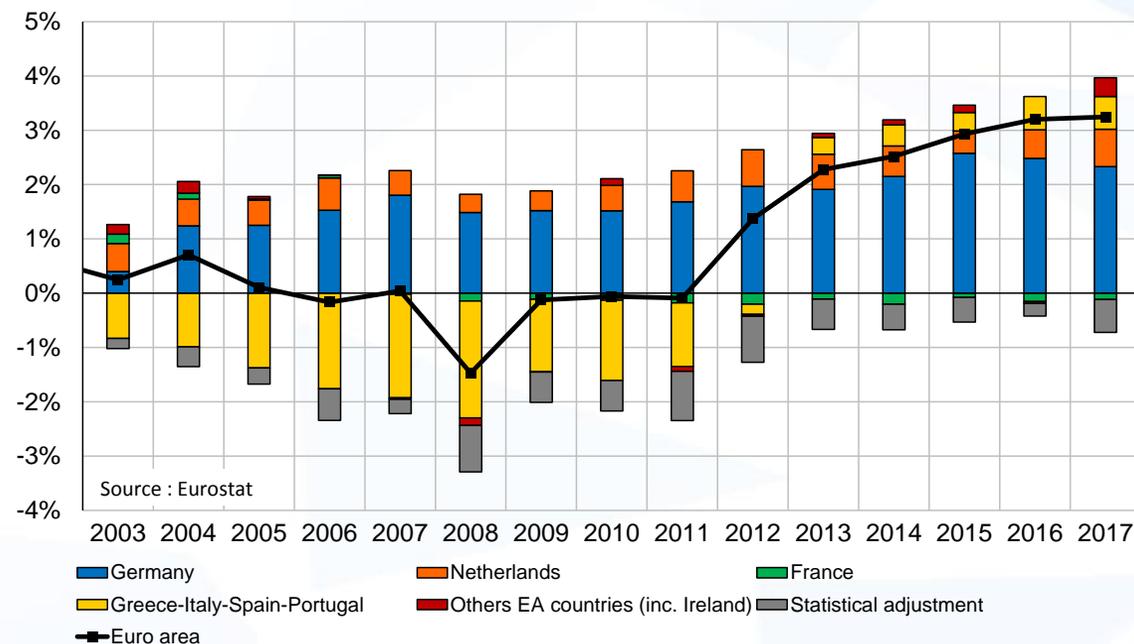
III – What is the situation today ?

- At the aggregate level, current account imbalances have increased.
- The current account surplus in euro area is the world highest in nominal terms
- The euro area surplus (roughly 3,5 % of GDP) is mainly a reflection of persistently high surpluses in Germany and the Netherlands

Current account (as % of world GDP)

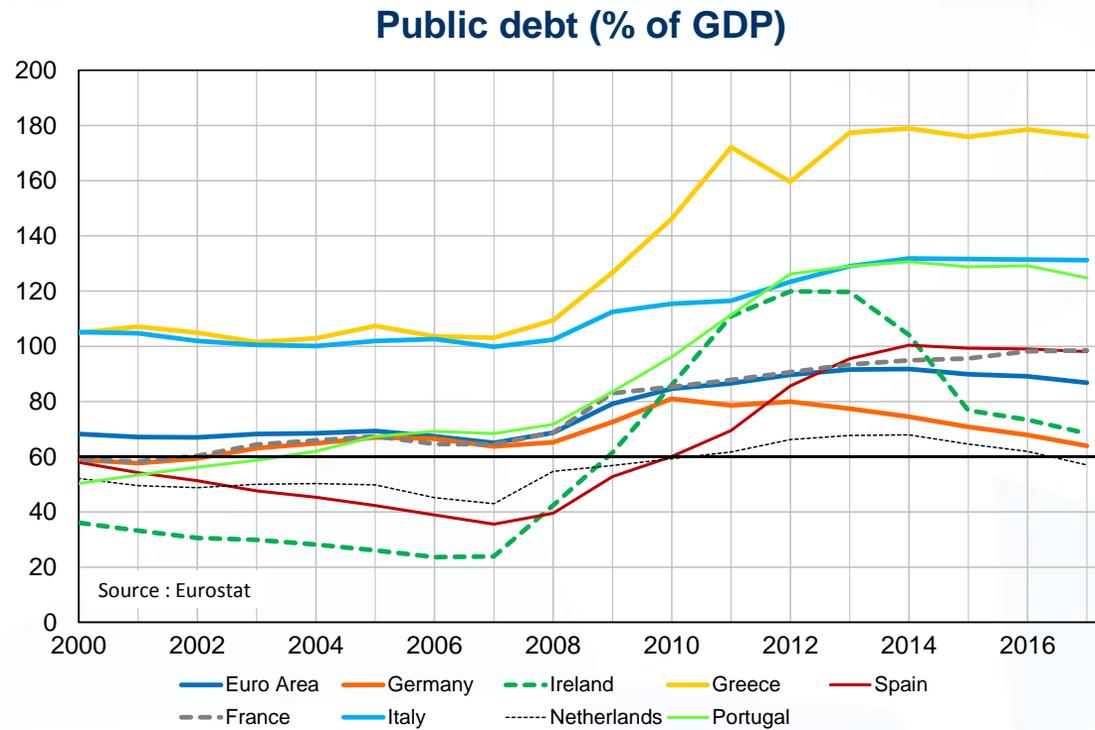


Euro area current account composition (as % of EA GDP)



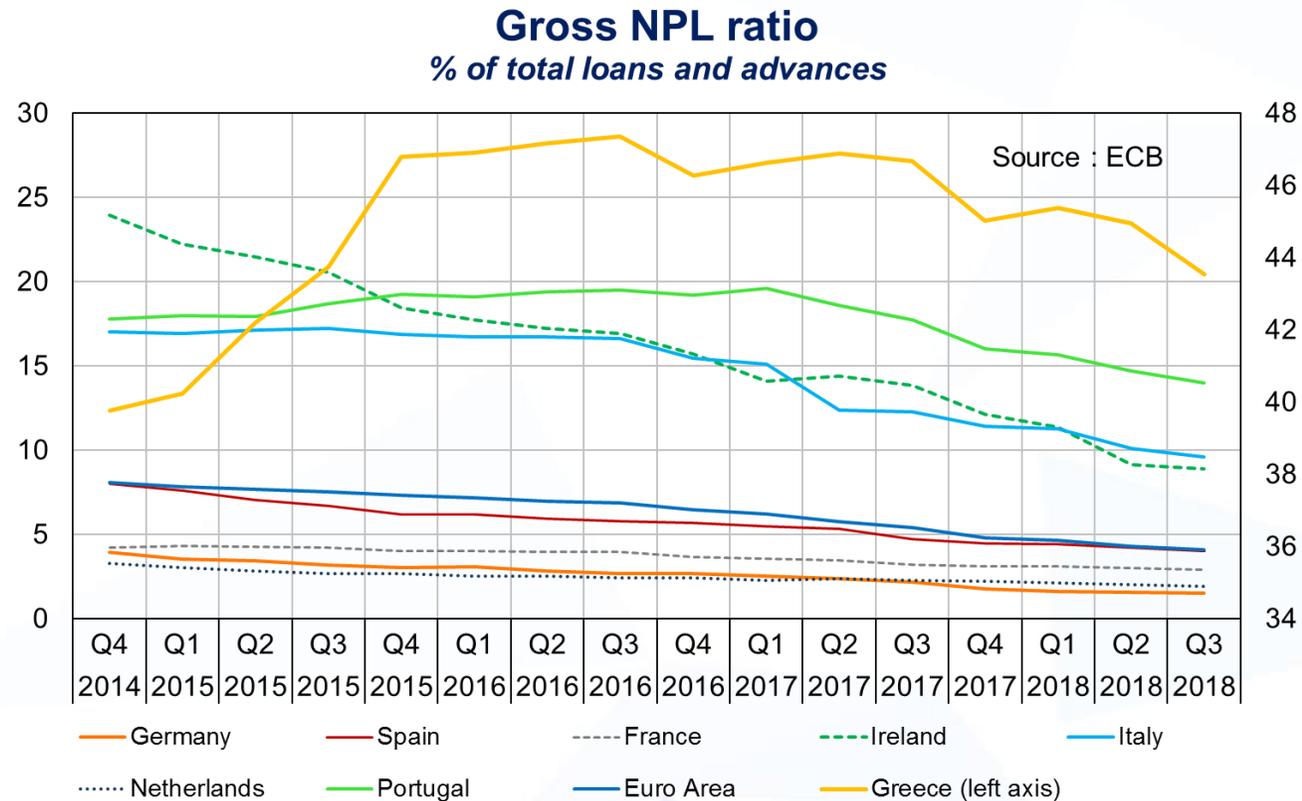
III – What is the situation today ?

- The crisis legacy still heavily weighs on the economy and on public finances
- Public debt started decreasing only recently but with very high heterogeneity between Member States



III – What is the situation today ?

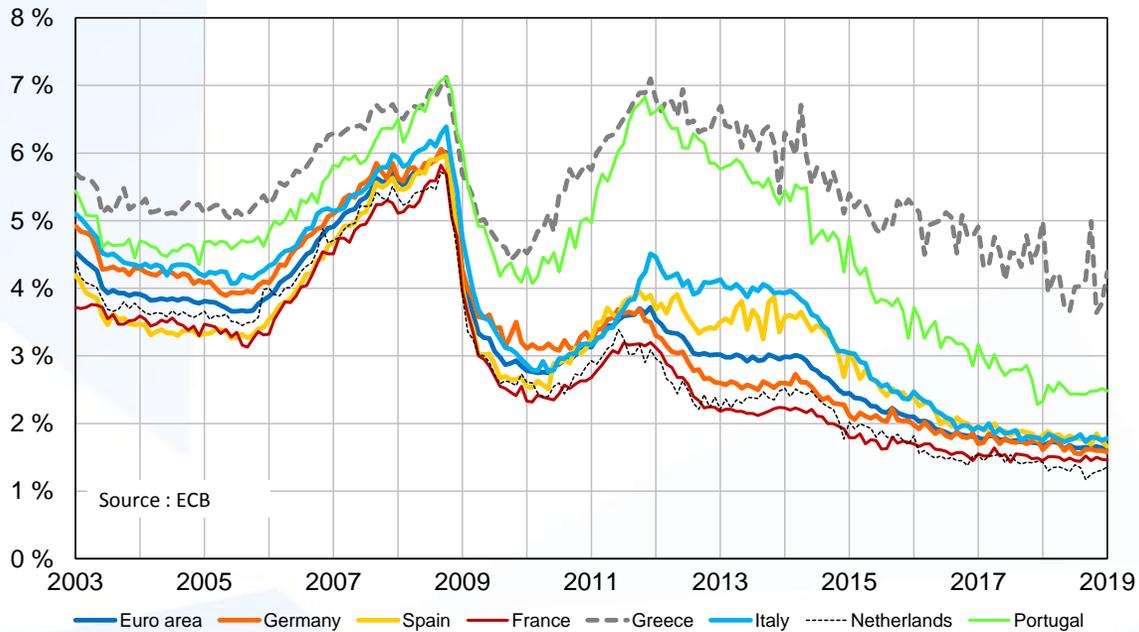
- NPLs are on a downward trend but remain elevated in many countries.
- the banking sector is much better capitalized compare to the pre-crisis period and the resolution framework should help preventing public intervention although it remains to be tested in crisis period



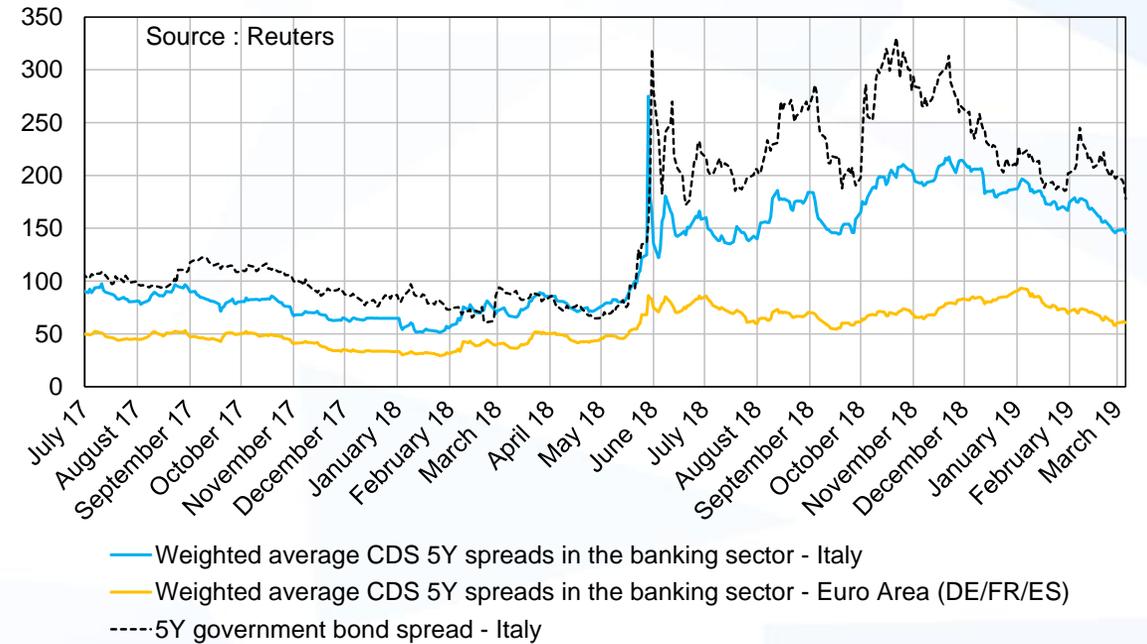
III – What is the situation today ?

- The doom loop may still be present

Non Financial-Corporations : interest rate for borrowing purposes (%)

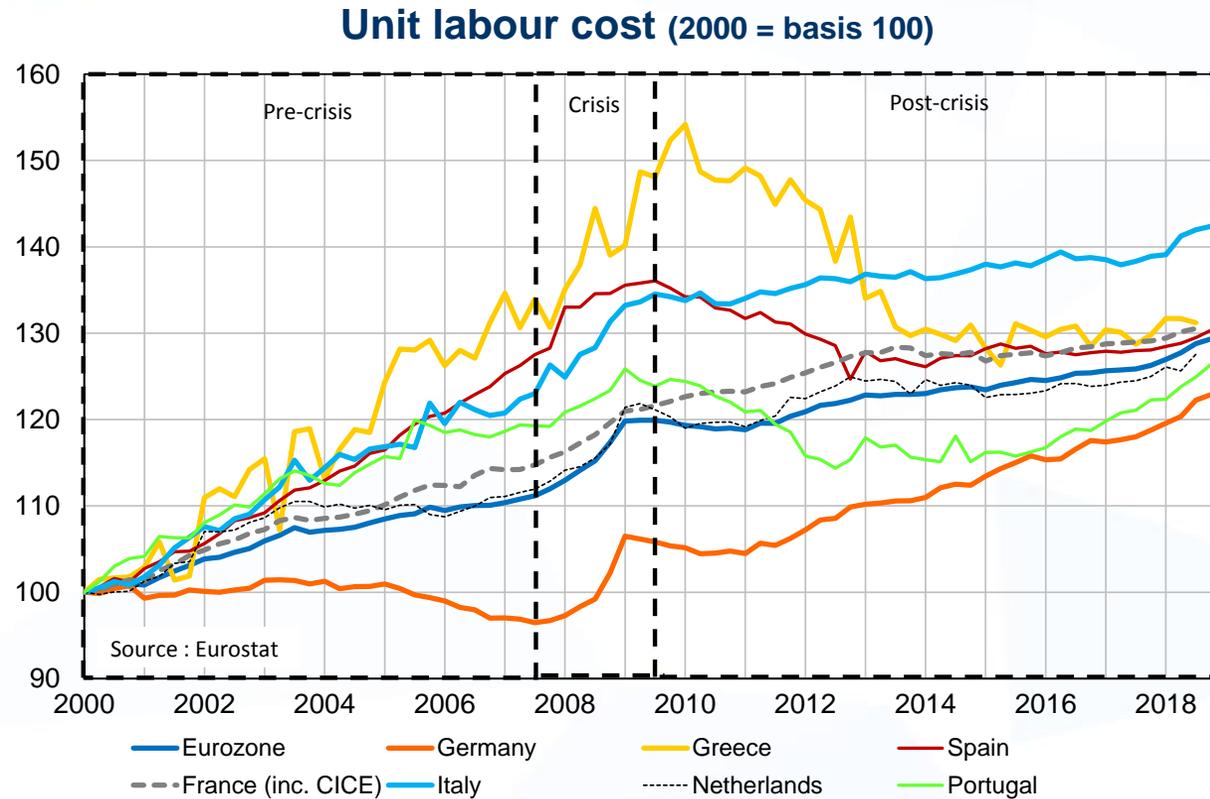


Banks CDS spreads and government bond spread (basis points)



III – What is the situation today ?

- The adjustment of cost-competitiveness is so far only partial.



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IV – Imbalances at the euro area level : does it raise some issues ?

- The Euro area as a whole is today more imbalanced than in 2007, with a surplus above levels consistent with economic fundamentals.
- A huge current account surplus primarily reflects the weakness of domestic demand in the EA. Such surplus may, to some extent, explain the low level of inflation experienced since 2012 in spite of unemployment rate close to its 2007 level, high utilization capacity rate and high participation rate.
 - Low inflation in turns constraints monetary policy with interest rates which should remain low for an extended period of time.
 - Low interest rates impact savings rate of return in spite of high saving rates for the EA
 - Low inflation makes adjustments in countries with negative NIIP more difficult
- It also makes the euro area more vulnerable to external shocks (tariffs, trade tensions, external slowdown, etc...) which could in turn impact the fiscal situation of member states.

IV – Imbalances at the euro area level : does it raise some issues ?

- Policy implications :
 - Need a more dynamic domestic demand for the euro area as a whole : private or public investment (education, R&D, infrastructure, innovation...), support wages dynamics...
 - Need more coordination between fiscal policies in different member states : countries with fiscal space should use it while countries without fiscal space should further reduce their public deficit.
 - Low investment may hamper potential growth in the long run.
- Current account deficits have been considerably reduced, although there is still a long way to go to correct the still negative external investment position for some countries → need for further improvement of their current account. **Can / should the Euro area record an even higher current account surplus ?**

IV – Imbalances at the euro area level : does it raise some issues ?

- Implications for economic surveillance ?
- Is the Macroeconomic imbalances procedure fit to tackle those issues ?
- Should the MIP be different for EA member states ?
- Should the monitoring of the aggregate fiscal stance and macroeconomic position of the euro area as a whole be given a more important place in the surveillance ?
- Need further research on the interactions between macroeconomic imbalances and fiscal policy