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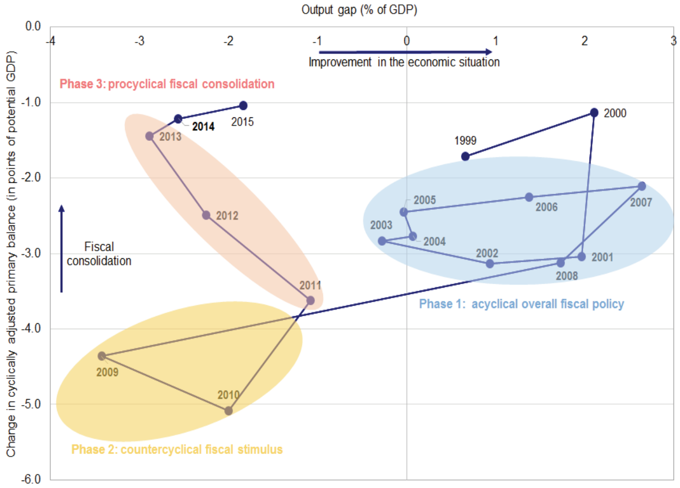
Towards a better management of the fiscal stance in the euro area?

- Since the introduction of the single currency in 1999, the fiscal policy of the euro area has consisted of the juxtaposition of national fiscal policies, largely irrespective of the overall economic conditions in the euro area. During preparations for the launch of the Economic and Monetary Union (EMU), a case was made for a coordinated approach to develop an appropriate fiscal policy at EMU level. Despite these arguments, however, fiscal governance has focused on exercising mutual monitoring to prevent excessive public deficits. The goal was to adopt a minimum set of common rules so that fiscal policies–which remain a national responsibility–would not hinder the fulfilment of the monetary policy mandate, namely ensuring the price stability, which is essential to the proper functioning of the monetary union.
- In addition to the objective of financing public goods, fiscal policy can also serve as an economic stabiliser. Spillover effects of national fiscal policies make a case for a comprehensive and consolidated assesment of the fiscal stance at euro area level.
- The fiscal stance at EMU level has proved relatively insensitive to the economic cycle for most of the single currency's first 15 years. By and large, the playing of national fiscal policies and of the rules of the Stability and Growth Pact (SGP) proved to be acyclical until 2007 and did not create room of manoeuvre at the top of the cycle. As a result, fiscal buffers were relatively weak in the run up to the crisis. After a brief period of countercyclical stimulus in 2009, fiscal policy became largely restrictive and procyclical from 2011 to 2013, in order to restore confidence in public finances.
- In 2011-2013, despite the existence of manoeuvring room with respect to the recommendations of the Stability and Growth Pact (SGP), consolidation severely constrained euro area growth. A more "top-down" approach to SGP implementation could have made more allowance for the effects of Member States' fiscal policies on the area's economy, which were particularly strong during the crisis. This would have fostered the emergence of an aggregate fiscal policy better suited to the cycle.
- We seek to promote an aggregate perspective of the fiscal policy, in compliance with the current treaties and legislation underpinning the SGP. We thus propose a change in the calendar of the European Semester that would assign a central role to the Council's recommendation for the euro area. The recommendation–now realeased at the start of the European Semester-would quantify the desirable aggregate fiscal stance. Depending on their status in the SGP, all euro area Member States-including those enjoying some room of manoeuvre within the Pact–would be invited in their country-specific recommendation to perform a fiscal adjustment compatible with the attainment of the desired aggregate fiscal stance. This would foster a more symmetrical approach to the Pact.

Fiscal stance in the euro area, 2000-2015



Source: European Commission, Autumn 2015 forecasts; DG Trésor calculations.

MINISTÈRE DES FINANCES ET DES COMPTES PUBLICS
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1. While fiscal policy coordination is instrumental to the functioning of a monetary union, EU fiscal governance has, until now, limited the scope of such coordination to the monitoring of national deficits

1.1 Fiscal policy coordination was acknowledged at a very early stage of EMU creation as necessary for the proper fonctioning of a monetary union

The need to coordinate fiscal policies in a monetary union is due to the strong interdependence between Member States, arising from (1) their common monetary policy and exchange rate, and (2) their close trade integration.

In a monetary area, each Member State's fiscal policy can have spillover effects on its partners through several channels. For example a fiscal expansion in a Member State[1] will have repercussions on its partners via:

- **interest rates:** the European Central Bank (ECB) will have to raise rates in response to the increase in euro area inflation generated by the expansion: the Member State will temporarily enjoy more favourable real rates, while the others will be subject to higher real rates, with adverse effects on their economies;
- **exchange rate:** these higher interest rates may lead to a short-term inflow of foreign capital into the area, promoting an appreciation of the common currency;
- **competitiveness:** the fiscal expansion may put upward pressure on prices and wages, undermining the competitiveness of its economy, which may lose market share to its competitors without being able to adjust through the exchange rate;
- **foreign trade:** the rise in domestic demand in the Member State concerned may have a positive impact on its partners' exports and therefore on their economies.

In a monetary union, some heterogeneity in economic policies may be needed to cope with asymmetrical shocks. Nevertheless, monetary policy–which is delegated to a single, homogeneous institution–cannot handle such heterogeneity.

Within the euro area, fiscal policy coordination between Member States should target the following objectives:

- **ensure the union's stability:** in a monetary union, the risk of sovereign insolvency or default in one Member State concerns all the others, since it can constrain the central bank's monetary policy;
- **prevent a Member State's fiscal policy from harming the economic situation of its partners** through the spillover effects described above;
- **define an optimal aggregate fiscal stance,** particularly for the purpose of short-term stabilisation: absent a common budget, the euro area's fiscal stance is merely the aggregation of national policies; consequently, should some States not be in a position to achieve the optimal fiscal policy needed to meet this objective, it may be desirable to adjust the fiscal stance of the other States, so as to converge towards an optimal fiscal stance at the euro area level[2].

As for the third point, **the cyclical stabilisation function of fiscal policy is important for long-term growth.** Strong economic fluctuations can adversely impact long-term growth[3] in many ways including (1) a decline in investment due to economic uncertainty or a protracted contraction in demand, and (2) hysteresis effects on human capital at the bottom of the cycle.

The 1989 Delors Report, which gave the initial impetus for the establishment of the Economic and Monetary Union, already recommended the implementation of a broad coordination to define the overall stance, so as to reach an appropriate fiscal policy for the Union[4].

1.2 Nevertheless, EU governance has–until now–given priority to compliance with fiscal rules, assessed country by country

The EMU's institutional architecture, defined by the Maastricht Treaty in 1993, supports both the coordination of national economic policies (Articles 119 and 121 of the Treaty on the Functioning of the European Union (TFEU)[5]) **and fiscal discipline for Member States** (TFEU Article 126).

On the one hand, fiscal discipline was deemed essential to the functioning of the single currency amid the high public deficits of the early 1990s (the EU public deficit stood at 6.1% of GDP in 1993) and at a time when the preservation of autonomy in the preparation of national budgets was politically necessary[6] .

On the other hand however, the attempts to coordinate national fiscal policies in the early 2000s did not succeed. The March 2002 European Council in Barcelona admited the need to strengthen existing fiscal policy coordination mechanisms. The Commission proposed defining common standards for the conduct of economic policies in the euro area that would have supplemented the SGP mechanisms. However, these proposals were never followed up. The deterioration in the public finances and the first breaches of the Pact eventually led the Council and the Commission to focus on the difficulties of SGP implementation[7].

Ultimately, the macroeconomic policy governance prevailing since the creation of the euro can be summed up as follows: **cyclical economic stabilisation at euro area level is**

(1) A restrictive policy will have symmetrical effects.

(2) See Lamfalussy, A., "Macro-coordination of fiscal policies in an economic and monetary union in Europe", 1989. Unlike the first two points, this third point has not yet been implemented in operational terms in the European laws and regulations.

(3) See especially Ramey, G. and Ramey, V.A., (1995) "Cross-Country Evidence on the Link Between Volatility and Growth", *The American Economic Review*, vol. 85, no. 5, pp. 1138-1151 and IMF (2015), "Can fiscal policy stabilize output?" *Fiscal monitor*, Chapter 2, April.

(4) Delors Committee, Report on Economic and Monetary Union in the European Community (12 April 1989), particularly §30.

(5) Article 119 (1): "[…] the activities of the Member States and the Union shall include, as provided in the Treaties, the adoption of an economic policy which is based on the close coordination of Member States' economic policies […]"; Article 121 (1): "Member States shall regard their economic policies as a matter of common concern and shall coordinate them within the Council, in accordance with the provisions of Article 120."

(6) The then prevailing academic consensus voiced doubts about the effectiveness of fiscal policy as an economic stabiliser and about Member States' ability to coordinate. These doubts largely contributed to focusing attention on fiscal discipline.

(7) See European Commission (2003), "EMU after five years", *European Economy.*

handled by the ECB, while asymmetrical shocks are accommodated by national automatic stabilisers–with no coordination between Member States beyond deficit monitoring under the Stability and Growth Pact.

2. Since the creation of the euro, the European fiscal framework has repeatedly failed to deliver an adequate fiscal policy for the euro area as a whole

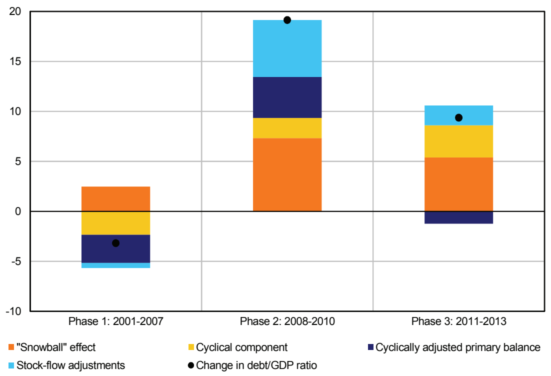
2.1 Since 1999, the fiscal policy in the euro area has rarely been countercyclical, and in particular did not allow the creation of sufficient manoeuvring room to cope with the crisis

In 1999-2007, the euro area's aggregate fiscal policy has been broadly neutral during economic upswings. The fiscal stance was broadly acyclical during this period, except in 2001, a year of strongly procyclical fiscal expansion (see cover chart). After a sharp deterioration in 2001, the cyclically adjusted balance (an indicator commonly used to estimate the fiscal stance: see Box 1) remained virtually stable. This maintained a relatively weak fiscal position, with the cyclically adjusted balance averaging a negative 2.5 points of GDP. Given the relatively positive economic conditions, a tighter fiscal policy would have been justified, in particular for building up fiscal manoeuvring room. Instead, while economic growth remained buoyant, the debt only decreased by an average 0.5 point GDP per year between 2001 and 2007 (Chart 1).

In 2009 and 2010, by contrast, fiscal policy was countercyclical at euro area level, with a fiscal expansion of around two points of GDP during the economic downturn. This dampened the negative impact of the crisis, mitigating the potential long-term loss of productive capacity. On the other hand, it heavily undermined what was already a rather adverse public finance position of the Member States[8].

In 2011-2013, fiscal policy in the euro area was distinctly procyclical, improving the cyclically adjusted primary balance by a total 3.8 points of GDP. This was achieved despite an output level well below its potential: on average, the output gap was more than 2 points below potential GDP[9]. 2014 marked a clear shift, with a 0.2-point improvement in the cyclically adjusted balance, a fiscal stance that was maintained in 2015.

Chart 1: Breakdown of debt variations in the euro area, 2001-2014 (in points of potential GDP)



Source: European Commission, Autumn 2015 forecasts; DG Trésor calculations.

Box 1: How to measure the fiscal stance?

The change in the general government budget balance reflects both policy decisions (discretionary measures regarding expenditures, taxes and/or transfers) **and variations in economic conditions** (spontaneous changes in public revenues and expenditures, i.e., automatic stabilisers).

There are several indicators for qualifying the fiscal stance. The changes in the primary government budget balance (i.e., excluding interest payments on the debt) can be broken down into three categories: (1) *variations in the cyclical deficit*, measured by the estimated effect of the economic cycle, on the basis of an average output gap elasticities of expenditures and revenues; (2) *one off and temporary measures*; (3) *variations in the primary structural balance*. This third measure, which is commonly treated as an estimate of the discretionary component of fiscal policy, is imperfect in real time, for it incorporates a non-discretionary component that is tied to economic fluctuations for two reasons: (1) the difficulty of estimating the output gap, and (2) the change in the budget balance's sensitivity to the output gap (elasticity effects), whereas the cyclical balance depends on an average effect. A cyclical factor beyond the government's control thus persists in the real-time estimate of the change in the primary structural balance. To capture these effects in its assessment of Member States' fiscal policy, the Commission has therefore introduced an "adjusted structural balance". As an alternative approach to better measure the proportion of the change in the structural balance that is due to discretionary factors, the French Directorate General of the Treasury (Direction Générale du Trésor) has built a "structural effort" indicator[a]. It is the sum of an expenditure saving effort, measured as the gap between (1) the change in spending other than unemployment insurance and (2) nominal potential growth, and a revenue effort (sum of discretionary tax measures). In EU governance, this approach is used to assess the expenditure rule of the SGP's preventive arm; in the corrective arm, it is reflected in the "bottom-up" indicator, used to determine the additional fiscal efforts required to comply with the Council's recommendation.

a. See Duchêne, S. and Lévy, D. (2003), "Solde structurel et effort structurel: un essai d'évaluation de la composante discrétionnaire de la politique budgétaire", *DPAE* no. 18, November.

(8) Under the "European Recovery Plan" enacted to cope with the financial crisis, the European Council of 11-12 December 2008 decided to use the manoeuvring room offered by the SGP to allow a temporary increase in deficits.

(9) The output gap is an indicator of the economy's cyclical position. It is the difference between an economy's actual and potential output, i.e., the output supply that the economy can sustain in the long run without an inflation surge.

2.2 As a result, the euro area fiscal policy has contributed less to economic stabilisation than in most other developed economies

The spontaneous effect of the economic cycle on the primary balance is stronger in the euro area than in the United States, in particular because of higher public expenditures and a higher aggregate tax and social security contribution rate. As a result, the output sensitivity of the balance (defined as the average increase in the balance due to a one-point increase in the output gap, all other things being equal) is around 1/2 in the euro area versus 1/3 in the United States resulting in as much additional spontaneous stabilisation.

Nonetheless, empirical studies suggest that fiscal policy had a weaker economic stabilisation effect in the euro area than in the United States in 1990-2014–a sign that the discretionary component had a distinctly milder stabilising effect. The IMF has built a fiscal stabilisation indicator[10], which measures the sensitivity of the government budget balance to the output gap. The indicator measures the mean variation of the budget balance (in points of GDP) associated with a one-point change in economic activity. It can therefore be used to assess the stabilising effect of fiscal policy. The indicator suggests that fiscal stabilisation was greater in the United States than in the euro area over 1990-2014. The figures are 0.67 for the euro area[11] versus 0.91 for the United States and Japan, 1.06 for Canada and 0.65 for the United Kingdom. In other words, in the period studied, the government budget balance contributed less to economic stabilisation in the euro area than in most other developed economies–despite the greater cyclically-related spontaneous change in the budget balance.

2.3 There are several possible explanations for the euro area's fiscal stance, which, on the whole, has proved inadequate since 1999

Generally speaking, the difficulty in assessing the economy's cyclical position in real time can lead to an inadequate fiscal stance. This problem is not specific to the euro area. For example, during an economic upswing, income growth, wrongly perceived as structural, may be used to finance new expenditures[12]. In particular, the output gap seems to have been underestimated in 2001-2002 and again in 2008–at zero compared with a current estimate of around two points of GDP. Its level did not justify the magnitude of the measures adopted to support the economy. Similarly, the smaller than expected recovery in 2011, together with uncertainties regarding the magnitude of fiscal multipliers and hysteresis effects could lead to a new reading of the optimal consolidation path[13].

The imperfect implementation of the SGP at the top of the economic cycle and the need to reassert its credibility towards the end of the crisis have also played an important role:

- Imperfect SGP implementation paved the way for fiscal expansion in the 2000s. The consequence was an insuficient creation of fiscal manoeuvring room during this generally favourable period[14]. As a result, the euro area entered the crisis with a relatively large structural deficit.
- After 2008, the stimulus packages implemented in response to the crisis and the loss of potential output caused a sharp deterioration in the public finances. This created a strong consolidation requirement, particularly in the peripheral countries that were already running large macroeconomic and fiscal imbalances. This fuelled financial-market concerns over the sustainability of these economies until financial assistance programmes were implemented in Greece and several other countries. To restore market confidence, the euro area Member States decided[15], in regard to public finances, to insist on consolidation and the restoration of the SGP's credibility by strengthening the Pact[16] and implementing it more rigorously.

Moreover, the lack of consideration for a suitable pace of fiscal consolidation at euro area level and its implementation by individual Member States has accentuated the procyclical effect since 2011. In particular, the fiscal manoeuvring room available in some countries has not been used; on the contrary, it has even been increased through fiscal tightening.

(10) IMF (2015), "Can fiscal policy stabilize output?" *Fiscal monitor*, Chapter 2, April.

(11) The indicator provided here for the euro area is a weighted mean of IMF's country-specific estimates for its Member states. There are large disparities between countries (0.84 for France, 0.55 for Germany, 0.59 for Italy, 1.06 for Spain and 0.77 for Netherlands), but the indicator is smaller than that of the US in 4 of euro area's main countries.

(12) See Turrini (2008), "Fiscal policy and the cycle in the Euro Area: the role of government revenue and expenditure", *European Economy*.

(13) However, there is an uncertainty over the estimated loss of potential GDP due to the 2008 crisis. While a temporary negative shock on the economy shock calls for a counter-cyclical fiscal policy, a permanent shock requires consolidation measures to keep the structural balance unchanged-with a view to achieving sustainability in the public finances.

(14) See Eyraud and Wu (2015), "Playing by the rules: Reforming fiscal governance in Europe", IMF *Working Paper*.

(15) See, for example, the conclusions of the ECOFIN Council of 21 February 2012 on the Annual Growth Survey, which marks the start of the European Semester.

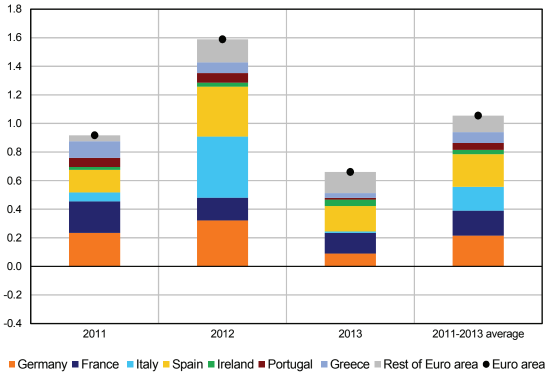
(16) SGP strengthening consisted mainly in introducing in both its arms (preventive and corrective) more detailed rules for monitoring fiscal policy that made greater allowance for current economic conditions, along with tighter control by the Commission and the Council. The enactment of the "Six-Pack" at end-2011 introduced new metrics (expenditure rule, debt criterion) and earlier and more automatic sanctions. The Treaty on Stability, Coordination and Governance (TSCG), which came into force on 1 January 2013, calls for Member States to introduce into their national law a set of procedures ensuring compliance with a structural equilibrium rule. Lastly, the "Two-Pack" reinforces monitoring and coordination in the euro area.

3. A better coordination of fiscal policies since 2011 would have partly alleviated the recessionary effects of consolidation

3.1 Fiscal consolidation was widely implemented in the euro area in 2011-2013, at a time when the economies were highly sensitive to fiscal policy

Between 2011 and 2013, many euro area members, particularly the peripheral countries, enacted large-scale fiscal consolidation plans. During the period, Greece, Portugal, Spain and Ireland implemented fiscal plans that improved their primary structural balances by approximately 10, 8, 6 and 5 points of GDP respectively. Other countries not exposed to market pressure and enjoying milder fiscal constraints also enacted substantive consolidation plans and contributed to the area's fiscal tightening during the period (see Chart 2).

Chart 2: Euro area - contributions to primary structural adjustment (in points of potential GDP)



Source: European Commission, Autumn 2015 forecasts; DG Trésor calculations.

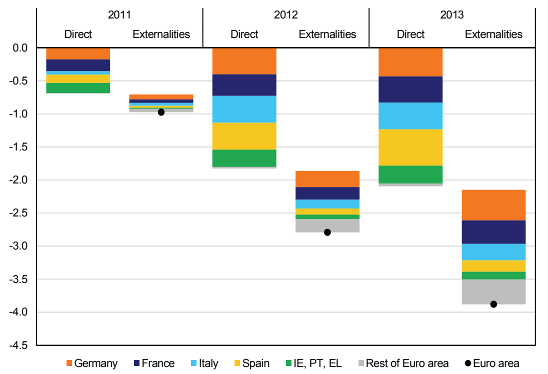
The impact of fiscal consolidation was all the greater because of the strong links between fiscal policy and economic activity during the period:

- **Constraints on monetary policy restricted the capacity for monetary accommodation to the 2011-2013 fiscal shock.** Beyond the fact that the ECB's manoeuvring room was limited by its very low key rates, the Bank's monetary policy transmission channels proved defective. In late 2011 and early 2012, financial fragmentation led to monetary and financial tightening in the countries hardest hit by the crisis–Greece, Ireland, Portugal, Italy and Spain–precisely when they were implementing strong fiscal consolidation. This aggravated the recessionary impact and therefore the effects on their trade partners. Moreover, the deteriorating position of the banking sector in these countries blocked the credit channel. As a result, monetary policy was unable to adequately dampen the fiscal shock.
- **Multipliers are stronger at the bottom of the economic cycle, which was still the case for the euro area as a whole in 2011-2013.** Empirical studies conducted in recent years suggest that the multiplier's size depends on the economy's cyclical position. The multiplier is stronger at the bottom of the cycle for two reasons[17]: (1) a larger proportion of households and firms face liquidity constraints and so adjust their expenditures to the variations in their disposable income; (2) with the economy operating at surplus capacity, a decrease in public investment cannot be offset by the private sector, resulting in a stronger impact on total demand. With a negative output gap estimated by international institutions (European Commission, IMF, OECD) at an average of two points of GDP over the period, the euro area found itself in an economic environment conducive to higher fiscal multipliers.

3.2 The outcome was a significant recessionary impact, amplified by the simultaneous nature of the consolidation plans

The fiscal consolidation carried out in 2011-2013 had a negative economic impact on the euro area, of which more than 40% appears to be due to spillover effects between countries. Using the approach adopted by Jan in't Veld (2013)[18], we can estimate the economic impact of the consolidation plans enacted by several euro area countries in 2011-2013, and we can also distinguish between the effects of domestic consolidation and the negative spillovers of consolidation plans carried out in other Member States (see Box 2 and Chart 3).

Chart 3: Impact of fiscal policy in selected countries on euro area GDP (cumulative, in points of GDP)



Source: European Commission, Autumn 2015 forecasts; DG Trésor calculations.

Fiscal consolidation plans had a major economic impact on all euro area countries in 2011-2013, with a maximum cumulative effect of over 9 points of GDP in Greece, where fiscal consolidation was strongest. Germany and France performed less intensive consolidation, with cumulative primary structural adjustments of 2.0 and 2.2 points of GDP respectively. In both countries as well, consolidation had an estimated negative impact on GDP of 3.2 and 3.5 points respectively. **The overall economic impact on the euro area is estimated at nearly 4 points of GDP, including 1.7 points due to spillover effects**, which thus clearly amplified the negative impact of national consolidation plans.

(17) See esp. Baum et al. (2012), "Fiscal Multipliers and the State of the Economy", IMF *Working Paper*. An estimate for the G7 countries (excluding Italy) found multipliers of 1.3 for a consolidation of expenditures in a negative output gap period compared with 0.8 in a positive output gap period, over a one-year horizon (for a consolidation of revenues, the multipliers are estimated at 0.4 versus 0.0 respectively). Other estimates cited in the study find even greater multipliers of up to 2.6 for a consolidation of expenditures in the euro area. See Batini, Callegari and Melina (2012, IMF *Working Paper*).

(18) Jan in't Veld, (2013) "Fiscal consolidations and spillovers in the Euro area periphery and core", European Commission, *Economics Papers* 506, October

Box 2: **Economic impact of fiscal consolidation in the euro area, 2011-2013**

Using the European Commission's QUEST III model, in't Veld estimates the economic impact of a simultaneous consolidation in Germany, France, Italy, Spain, Ireland, Portugal, Greece and the rest of the euro area, as well as the negative spillovers of these consolidation plans on the other countries. He assumes a consolidation evenly divided between expenditures and revenues, fiscal multipliers of around 0.7-0.8, and the absence of a monetary policy reaction. In the short term, all domestic demand components are impacted by consolidation. The economic downturn is amplified by the inclusion of negative externalities (spillover effects: see §1.1).

We apply in't Veld's coefficients to the consolidation plans actually carried out in 2011-2013 (see Table 2) measured in terms of primary structural adjustments. We can thus estimate the impact on the euro area economy, distinguishing between the effects due to national consolidation and spillover effects. It should be noted that we estimate the impact for a three-year period, so the positive effect suggested by the model from the fourth year onwards is not visible. The model shows that the confidence effects due to the improvement in the public finances and competitiveness gains stimulate exports. The effects are, however, reduced when Member States act simultaneously.

Table 1: Impact of 2011-2013 consolidation plans on GDP (in points of GDP, cumulative)

		2011	2012	2013
Germany	**Total**	**–0.91**	**–2.32**	**–3.16**
	of which spillover effects	–0.27	–0.88	–1.63
France	**Total**	**–1.10**	**–2.43**	**–3.54**
	of which spillover effects	–0.25	–0.89	–1.67
Italy	**Total**	**–0.58**	**–3.28**	**–4.02**
	of which spillover effects	–0.26	–0.81	–1.53
Spain	**Total**	**–1.41**	**–4.67**	**–6.83**
	of which spillover effects	–0.26	–0.87	–1.62
Ireland	**Total**	**–1.29**	**–3.09**	**–5.08**
	of which spillover effects	–0.38	–1.31	–2.26
Portugal	**Total**	**–2.83**	**–6.44**	**–7.51**
	of which spillover effects	–0.39	–1.35	–2.41
Greece	**Total**	**–4.68**	**–8.29**	**–9.33**
	of which spillover effects	–0.24	–1.05	–1.99
Rest of EA	**Total**	**–0.31**	**–1.23**	**–2.28**
	of which spillover effects	–0.28	–1.10	–2.06
Euro area (EA)	**Total**	**–0.98**	**–2.79**	**–3.88**
	of which spillover effects	–0.27	–0.93	–1.73

Source: European Commission, Autumn 2015 forecasts; DG Trésor calculations.

3.3 A milder consolidation by countries with fiscal manoeuvring room would have dampened the economic impact

Given these spillover effects, a milder consolidation in certain countries would have reduced the recessionary impact of the 2011-2013 consolidation for the euro area as a whole. While some Member States were forced to conduct a large-scale fiscal consolidation in 2011-2013, other States could have proceeded at a more gradual pace. For example, Germany–then falling under the SGP's corrective arm–chose to consolidate far in excess of the requirements of the European Council's recommendation for its the Excessive Public Deficit over the period 2011-2013. The November 2009 recommendation called on Germany to carry out a structural adjustment averaging 0.5 points of GDP a year. Germany was thus projected to reach its medium-term budgetary objective (MTO)–a structural deficit of 0.5 points of GDP–by 2013. As the structural adjustment averaged 0.8 points a year for the period, Germany overshot its MTO by 2012. The European Commission estimated the German structural surplus at 0.3 points of GDP in 2013. This fiscal path was even more restrictive than required by the "debt brake" introduced into the German constitution in 2009[19]. If Germany had followed the path recommended by the Council, **its GDP would have been 0.8 points higher by end-2013, and total euro area GDP would have been 0.4 points higher**.

4. A proposal to strengthen the role of aggregate fiscal policy in the European Semester

4.1 The current implementation of the Stability and Growth Pact lacks an overall perspective and is asymmetrical

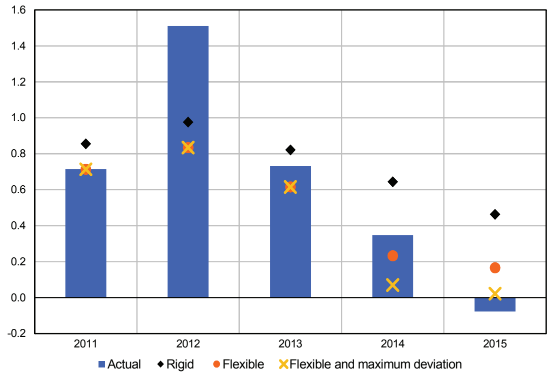
The fiscal consolidation carried out in the euro area in 2011-2013 exceeded the SGP requirement (see Chart 4), particularly in 2012, when certain countries performed a structural adjustment far in excess of what the Council recommendation required. This reflects the asymmetrical character of the SGP, since it allows Member States to consolidate as much as they wish–at a greater pace than recommended by the Council–even if the effects are detrimental to their domestic economies and to the rest of the euro area. Under current arrangements, therefore, the only way to accommodate these effects is to strengthen fiscal policy coordination at euro area level, in particular with regard to the cyclical position of the area's economy and the expected spillover effects.

Admittedly, the Two-Pack (Regulation (EU) 473/2013 of the European Parliament and Council) stipulates that, when Draft Budgetary Plans (DBPs) are being assessed, the European Commission and the Eurogroup shall conduct an overall assessment of fiscal policy in the euro area. **So far, however,**

(19) This would involve, after a transition phase, a structural deficit for the federal government capped at 0.35% of GDP from 2016. In the transition phase (2011-2014), the federal government posted a structural balance approximately 1 point of potential GDP above the level required by the "debt brake" (see Germany's 2015 Stability Programme).

this discussion of the aggregate fiscal stance in the euro area has had no practical consequence. The Two-Pack proved unsatisfactory during its first year of application (2013), since the approach focused on compliance with the Pact's recommendations and did not take sufficient account of the impact on aggregate fiscal policy. The structural adjustment achieved by the euro area as a whole was only slightly below what would have been achieved through a rigid application of the SGP (see Chart 4), amid a recession and a substantial widening of the output gap to minus 2.9 points of GDP.

Chart 4: Fiscal policy manoeuvring room in the euro area under the terms of the SGP (structural adjustment, in points of potential GDP)



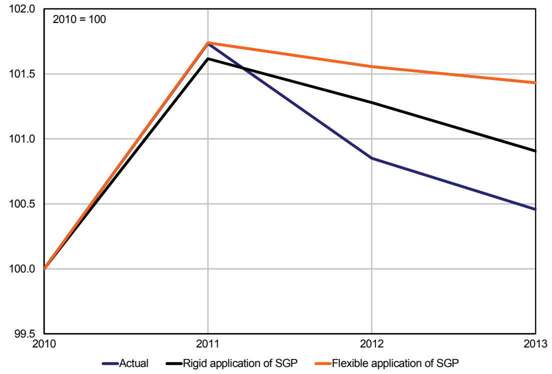
Source: European Commission, Autumn 2015 forecasts; DG Trésor calculations.

How to read this chart:

- The "rigid" scenario assumes that (1) for countries under the SGP's corrective arm, strict compliance with recommendations and (2) for countries in the SGP's preventive arm, compliance with the structural adjustment path required by convergence towards the MTO (or its maintenance).
- The "flexible" scenario assumes compliance with recommendations by countries under a macroeconomic assistance programme and a 0.5 point adjustment for the others under the corrective arm in 2011-2013. In 2014-2015, the Member States perform the minimum adjustment needed to meet a target of the recommendation. Countries under the preventive arm perform the adjustment requested for convergence towards the MTO, taking into account the deviation allowed under the SGP flexibility provisions, which are described in the Commission's Communication of 13 January 2015 (economic situation and clauses on investment and structural reforms)[20]. Before 2015, the only flexibility applied was the one concerning the economic situation..
- The "flexible and maximum deviation" scenario is identical to the "flexible" scenario except for the assumption that countries under the preventive arm use the maximum deviation allowed before entering the procedure for significant deviation, i.e., 0.5 points of GDP over two years..

A more efficient use of the manoeuvring room allowed by the SGP-in particular, the absence of overadjustment by Member States with fiscal manoeuvring room-would have made a milder fiscal adjustment possible during the period, diminishing the impact on the economy and on potential long-term growth. If these margins had been applied from 2011 to 2013 (see "flexible" scenario in Chart 4), the structural adjustment could have been reduced by 0.8 points over the period, and GDP would thus have exceeded its actual level by 1 point in 2013 (Chart 5)[21].

Chart 5: Actual change in GDP (level), and simulations with a rigid or flexible application of the SGP in 2011-2013)



Source: European Commission, Autumn 2015 forecasts; DG Trésor calculations.

In 2014 and 2015, by applying all of the SGP's flexibility provisions and the deviation margins allowed under the protective and corrective arms, the euro area fiscal stance during the period would have been neutral. We note that whereas the fiscal stance could have been less restrictive until 2014[22], the SGP flexibility provisions were fully applied in 2015. By autumn 2014, the Commission described the aggregate fiscal stance for 2015 as "broadly neutral" and regarded it as appropriate, despite the insufficient differentiation of efforts among Member States.

4.2 Euro area governance places growing emphasis on the aggregate dimension of fiscal policy…

The Five Presidents' Report of June 2015 on strengthening the EMU recommends closer coordination of economic policies in the euro area, which the advisory European Fiscal Board established by the Commission could support. In particular, regarding fiscal policy, the report recommends greater emphasis on the aggregate perspective in SGP implementation. In the wake of the report, the European Commission published on 21 October 2015 a package of proposals on euro area governance that could be implemented within the existing treaties. The measures include the creation on 1 November 2015 of a European Fiscal Board acting as economic advisor to the Commission, particularly concerning the appropriate fiscal stance for the euro area. The Board will also be empowered to issue opinions on the fiscal efforts required at national level consistently with the strategy defined for the entire area.

The publication of the recommendation for the euro area now marks the opening of the European Semester and sets the economic policy guidelines for the euro area as a whole. By comparison with earlier years, when it was published at the end of the Semester (at the same time as the recommendation for Member States), the new calendar[23] makes it possible to place greater emphasis on the aggregate dimension of the euro area. For example, the "Council Recommendation" for the euro area published by the Commission on 26 November 2015 stresses the need to coordinate Member States' economic policies because of the

(20) European Commission (2015), "Making the best use of the flexibility within the existing rules of the Stability and Growth Pact".

(21) By the end of the 3-year period, the debt ratio in this scenario would therefore not have been higher.

(22) In 2014, the structural adjustment in the euro area could have been reduced by 0.3 points if the flexibility provisions due to economic conditions stipulated by the SGP and defined in the Commission's January 2015 Communication had been applied, along with the deviation margins allowed under the corrective arm (compliance with the headline deficit target only) and the preventive arm (maximum deviation allowed before triggering the significant deviation procedure). The application of the investment and structural reform clauses would have further reduced the adjustment.

(23) Before the 2016 European Semester, the recommendation for the euro area was published at the end of the Semester (May-June) and concentrated on the implementation of the Broad Economic Policy Guidelines (BEPGs) for euro area Member States.

potentially heavy spillovers. The explicit fiscal objective is thus to avoid a procyclical stance at euro area level. The Commission accordingly recommends a differentiation of the fiscal effort by individual Member States, taking into account their respective position vis-à-vis the requirements under the SGP and their stabilisation needs, as well as spillovers. It also recommends discussing the euro area fiscal stance in time for the preparation and presentation of the Stability Programmes and the Draft Budgetary Plans.

4.3 ...but we can move towards a more integrated governance

One proposal would be to promote an aggregate view of euro area fiscal policy. Under such an approach, at the opening of the European Semester, the desired fiscal stance would be specified in a "Council Recommendation" for the euro area, on a proposal from the Commission, which would aim for a fair balance between economic stabilisation and public finance sustainability[24]. In the course of the European Semester, and as the short-term economic analysis is refined, the stance would be spelled out in greater detail. The final step would be to adapt the aggregate stance to individual countries, and to spell out these adaptations in the country recommendations ahead of the construction of the national Draft Budgetary Plans every autumn.

The timetable for setting the year N fiscal stance could thus be as follows:

- **November N-2:** The euro area recommendation would contain a qualitative indication of the desired fiscal stance for year N.
- **January N-1:** On the Commission's recommendation, the Eurogroup would define the desired aggregate fiscal stance for the years covered by the autumn forecasts, in time for the preparation of the Stability Programmes.
- **May N-1:** On the basis of its spring forecasts, the Commission would propose a distribution by country of the desired fiscal adjustment for year N–based on each country's forecast macro-fiscal conditions and under the constraint of SGP compliance–in order to reach the desired aggregate policy. The new target would then be introduced at State level within the framework of the European Semester, through a revision of the Excessive Public Deficit recommendation for countries under the corrective arm and as part of the Semester recommendations for countries under the preventive arm. Countries having reached their MTOs would not be exposed to possible sanctions, but would receive an explicit fiscal recommendation. One could thus arrive at recommendations for a minimum pace of fiscal adjustment but also, where appropriate, for a maximum pace–for each country. This would promote a more symmetrical approach to fiscal governance.
- **September N-1:** The September Eurogroup would examine the change in economic conditions since May-June, if possible on the basis of new forecasts prepared by the Commission for this purpose. On a reasoned proposal from the Commission–particularly in the event of a major revision in the short-term economic outlook-the euro area fiscal stance targeted for the following year could be adjusted. The national targets set in the recommendations could be revised in consequence, as appropriate.
- **November N-1:** The examination of the Draft Budgetary Plans submitted to the Commission in October would focus on their consistency with the recommended contribution to the aggregate fiscal stance. The "Council recommendation" for the euro area would reiterate the desired fiscal stance for year N and issue an initial opinion on year N+1.

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(24) An indicator such as the one developed by N. Carnot (2014), "Evaluating Fiscal Policy: A Rule of Thumb", European Economy, *Economic Papers* 526, European Commission, could be used for this purpose. The indicator offers a fiscal-effort benchmark designed to strike the right balance between the long-term sustainability of public finances and short-term macroeconomic stabilisation. The indicator can be used to gauge the fiscal stance of a group of countries or of each country individually.

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