EUROPEAN CENTRAL BANK

EUROSYSTEM

Christophe Kamps
Head of ECB Fiscal Policies Division

Reflections on the euro area fiscal stance

CEPS workshop, Brussels, 20 April 2017

Disclaimer: The views expressed are those of the presenter and do not necessarily reflect those of the ECB.

Outline

1. A (very) short history of the euro area fiscal stance
2. Discretionary fiscal policies versus automatic stabilisers
3. Identifying exceptional circumstances
4. The appropriate fiscal stance at the current juncture
5. Conclusions

Delors Committee: background papers

Baer/Padoa-Schioppa "The [1970] Werner Report revisited" (Sept 1988)

"Towards the end of the 1960s there was a remarkable consensus on policy-making. The evidence seemed to strongly confirm the effectiveness of medium-term planning and fine-tuning. In the 1970s the experience with stagflation destroyed this consensus." (p. 58)

"This over-optimistic view of the efficacy of economic management gave rise to a rather mechanistic and rigid approach to policy coordination." (p. 57)

Lamfalussy "Macro-coordination of fiscal policies in an EMU" (January 1989)

"Fiscal policy coordination appears to be a vital component of a European EMU […] with two objectives in mind:

- to allow the determination of a global fiscal policy […]; and
- to avoid tensions arising from excessive differences between the public sector borrowing requirements of individual member countries." (p. 93)

" [...] convergence towards the position of the more fiscally conservative countries would be desirable." (p. 99)

Source: Commission (1989), Collection of papers submitted to the Committee for the Study of Economic and Monetary Union

Delors Committee: background papers

Pöhl “The further development of the EMS” (Sept 1988)

> “[…] it is of outstanding importance for the success of monetary integration for the gradual transfer of monetary policy to the Community level to be accompanied by sufficient progress in the integration of economic and fiscal policy. Isolated steps in the monetary field would overburden monetary policy in political terms and jeopardize the credibility of the process of unification in the longer run.” (p. 155)

> “In order to optimize economic policy as a whole the overall economic objectives […] should be laid down at Community level. Broad agreement would also need to be reached on the policy mix […]. This would also provide a basic guideline for each country’s fiscal policy.” (p. 135)

> “The mandate of the central bank must be to maintain *stability of the value of money* as the prime objective of European monetary policy.”(p. 137)

> “For a European central bank to be able to fulfil its mandate to ensure monetary stability, strict limitations must be imposed on its granting credit to public authorities of all kinds (including Community authorities).”

Source: Commission (1989), Collection of papers submitted to the Committee for the Study of Economic and Monetary Union

1989 Delors report and follow-up

- **Upper limits on deficits**; no binding rules on debt levels; price stability as primary objective of monetary policy; monetary financing prohibition (NB: no mention of no-bail-out clause) → **Maastricht Treaty 1992**
- **Binding rules and procedures** for budgetary and macroeconomic coordination →**SGP 1997/2005/11/13, Fiscal Compact 2012, MIP 2011**
- **Create an EC fiscal assistance instrument** to help countries in temporary difficulties → **EFSM/EFSF 2010, ESM 2011**
- Coordinate budgetary and macroeconomic policies to define an **adequate fiscal policy stance** → **Two-pack 2013**

Assessment of the euro area fiscal stance: legal basis

Regulation (EU) No 473/2013 on common provisions for monitoring and assessing draft budgetary plans, Article 7:

> "The Commission shall make an overall assessment of the budgetary situation and prospects in the euro area as a whole, on the basis of the national budgetary prospects and their interaction across the area […]."
>
> "It [the overall assessment] shall also, as appropriate, outline measures to reinforce the coordination of budgetary and macroeconomic policy at the euro area level"
>
> 'The Eurogroup shall discuss opinions of the Commission on the draft budgetary plans and the budgetary situation and prospects in the euro area as a whole on the basis of the overall assessment made by the Commission."

Assessments of the euro area fiscal stance since 2013

DBP round	Commission	Eurogroup
end-2013 (for 2014)	Broadly neutral fiscal stance, which should contribute to the recovery	The planned fiscal effort for 2014 is broadly appropriate
end-2014 (for 2015)	Absence of fiscal tightening appears a broadly acceptable balance between sustainability requirements and cyclical conditions	Broadly neutral planned fiscal stance reflects a balance between sustainability and current weak cyclical conditions
end-2015 (for 2016)	Neutral aggregate euro area fiscal stance for next year appears broadly appropriate; need to vigorously resume consolidation once the recovery takes hold	Broadly neutral planned fiscal stance reflects a balance between sustainability and stabilisation
mid-2016 (for 2017)	Appropriate to pursue a broadly neutral stance; a modulation should be considered if and as the recovery accelerates or decelerates	Broadly neutral aggregate fiscal stance in 2017 strikes an appropriate balance
end-2016 (for 2017)	A fiscal expansion of up to 0.5% of GDP is considered desirable for 2017	Recalls mid-2016 assessment. Strike an appropriate balance between sustainability and need to strengthen the recovery

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The pre-crisis consensus view: normal versus exceptional times

John B. Taylor (2000), "Reassessing Discretionary Fiscal Policy", *Journal of Economic Perspectives* 14(3), pp. 21-36:

> "Recent changes in policy research and in policy-making call for a reassessment of countercyclical fiscal policy. Such a reassessment indicates that countercyclical fiscal policy should focus on the automatic stabilizers rather than discretionary actions. Monetary policy has been reacting more systematically to output and inflation; long expansions in the 1980s and 1990s demonstrate the effectiveness of such a [monetary] policy. It is unlikely that discretionary countercyclical fiscal policy could improve things, even if there were less uncertainty about fiscal impacts. A discretionary countercyclical fiscal policy could make monetary policy-making more difficult. Rather discretionary fiscal policy should focus on long run issues, such as tax reform and social security reform."

> "Other examples might include stating explicitly how fiscal policy would be used in unusual situations, such as when nominal interest rates hit a lower bound of zero. Such rules for fiscal policy are more difficult to specify and enforce in practice than parallel rules for monetary policy."

The SGP broadly reflects the pre-crisis consensus view

- **The medium-term objective (MTO) is the lynchpin of the SGP**
  - MTO compliance ensures that automatic stabilisers can operate freely in normal downturns without breaching the 3% of GDP reference value
- **Convergence to the MTO is defined in structural terms**
  - Automatic stabilisers can operate around the agreed structural adjustment path
- **The 2011 SGP reform has introduced an 'escape clause'**
  - In periods of "severe economic downturn" for the euro area as a whole
    - under the preventive arm Member States may be allowed to temporarily deviate from the (adjustment path towards) MTO,
    - under the corrective arm EDP deadlines may be extended

  provided that this does not endanger fiscal sustainability in the medium term.

The “escape clause” has not been operationalised (and used) so far

- **The clause was introduced after the fact**
  - The 2008 European Economic Recovery Plan proposed a coordinated fiscal stimulus worth 1.5% of the EU’s GDP
- **The “severe economic downturn” condition is not clearly spelled out**
  - Corrective arm, Art. 2(2): “A negative annual GDP volume growth rate or […] an accumulated loss of output during a protracted period of very low annual GDP volume growth relative to its potential.”
  - Code of Conduct, p.12: “The indicator for assessing accumulated loss of output is the output gap.”
- **Open questions:**
  - What is the trigger point in terms of real growth / level of output gap?
  - Any role for the lower bound on nominal interest rates / low inflation?
  - What is the appropriate stance and who does what/how much?
  - What does the fiscal sustainability proviso mean in this respect?

Towards a fiscal rule for normal and exceptional times?

- **Is it possible to design a rule that works in both normal and exceptional times?**
  - Theory: Schmidt (JEDC 2016) e.g. proposes a rule in which fiscal policy is passive in normal times (automatic stabilisers) but provides stimulus in crisis times to avert an expectations-driven liquidity trap.

- **How to implement such rule in current EMU institutional setup?**
  - Strong correlation between sustainability risks and stabilisation needs.
  - Stimulus in countries without fiscal space could reignite debt crisis.
  - Stimulus in countries with fiscal space may not help other countries if spillovers are small and may not be in line with domestic objectives.

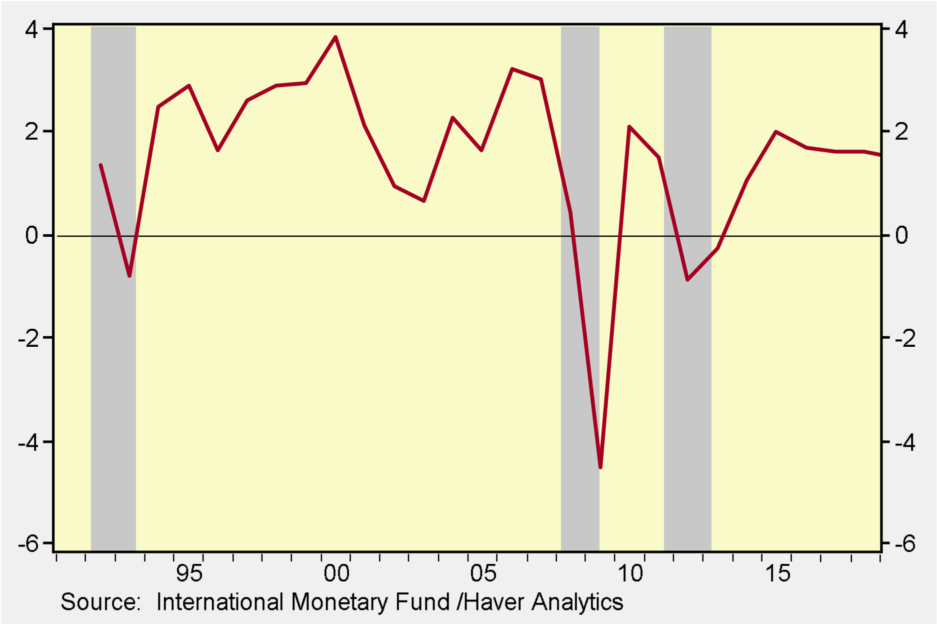
- **Operationalisation of euro area fiscal stance is difficult …**
  - … in the absence of a euro area fiscal capacity
  - A fiscal capacity with stabilisation focus and national fiscal policies with sustainability focus look like two sides of the same coin.

Outline

Real GDP growth and output gap in the euro area

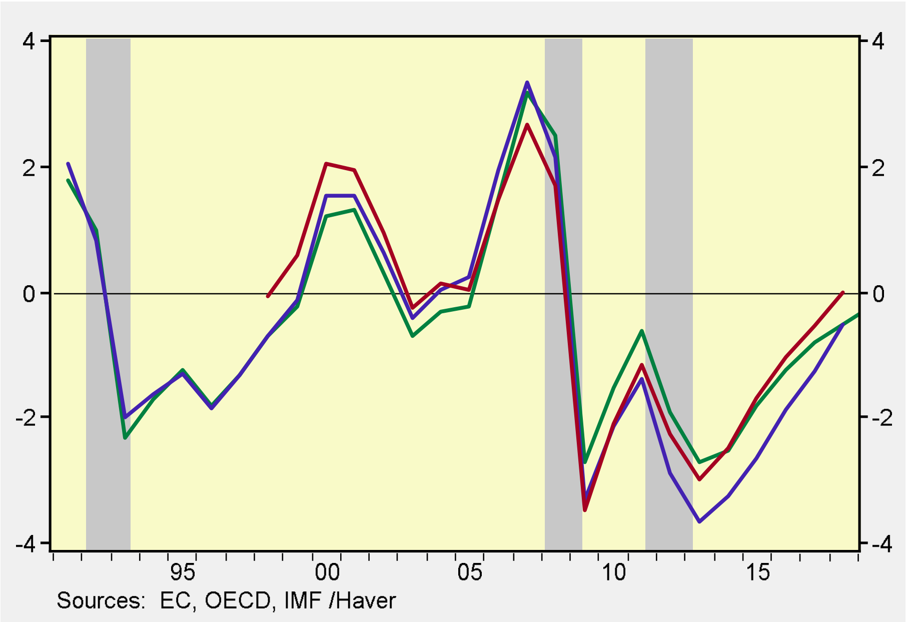
Real GDP growth 1992-2018

(annual percent change)



Output Gap 1991-2018

(percent of potential GDP)

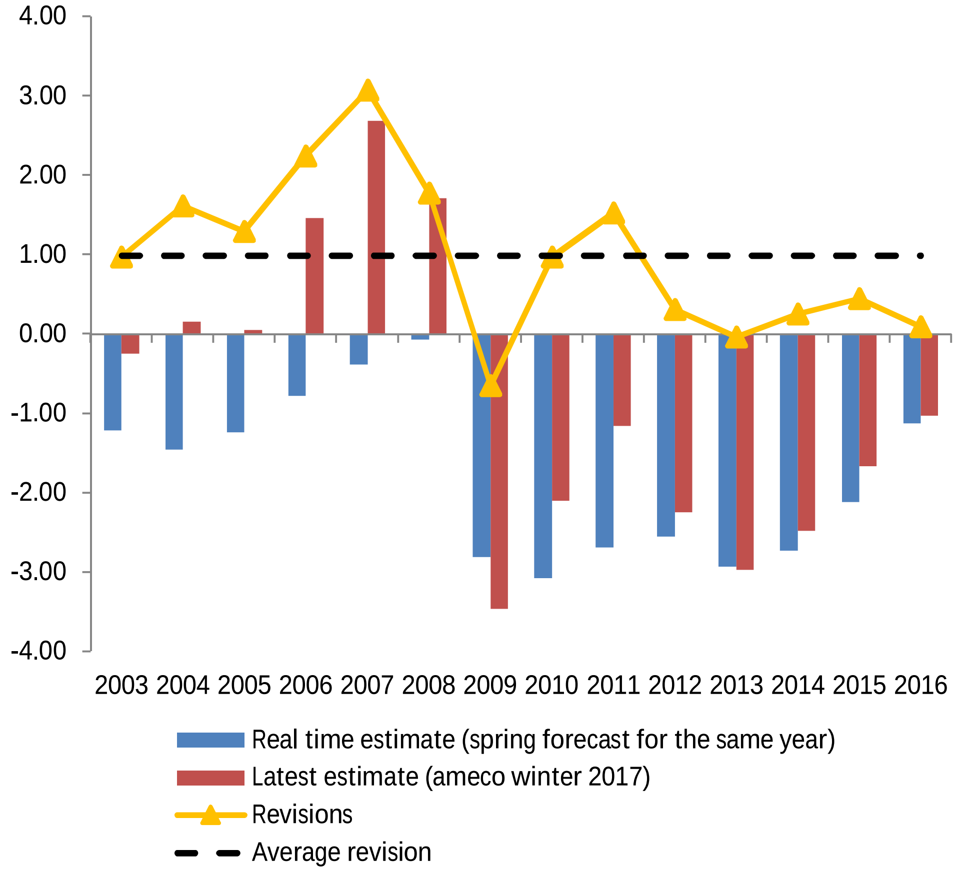


Note: COM (red), IMF (green), OECD (blue)

- 2009 was exceptional in terms of real GDP growth
- 2009 and 2012/13 were exceptional in terms of output gap
- 2017 looks like “normal times” (cf. preventive-arm matrix)

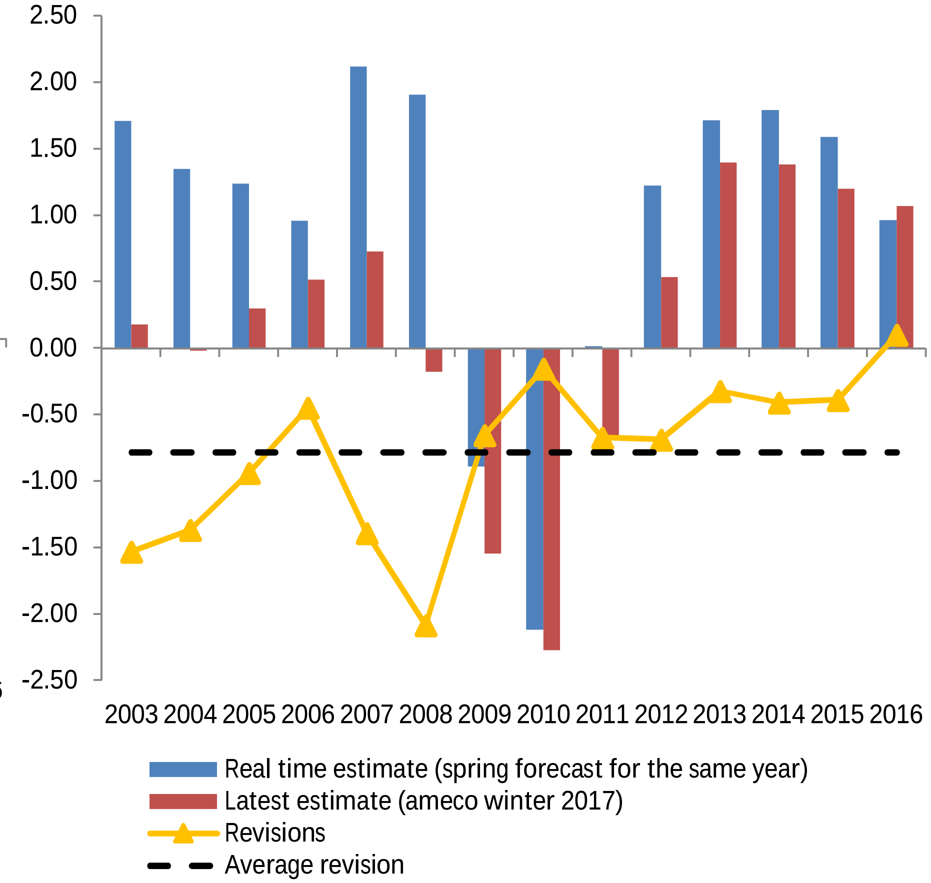
Uncertainty affects assessment of state of economy and of public finances

Euro area output gap: real-time, latest estimates and revisions



Source: AMECO, ECB staff calculations.

Euro area cyclically-adj. primary balance: real-time, latest estimates and revisions



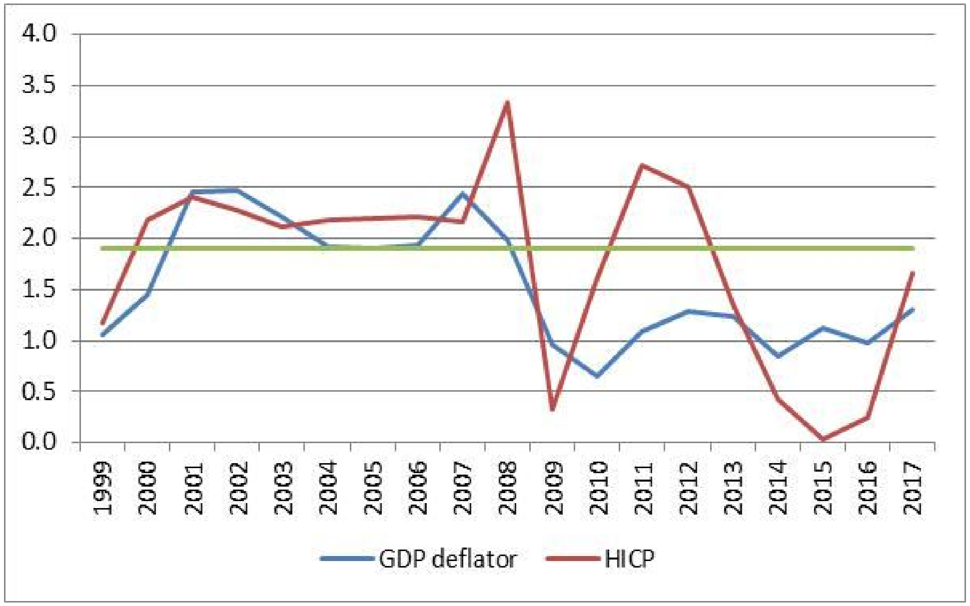
Source: AMECO, ECB calculations

- Real-time output gap missed the pre-crisis boom.

Inflation and monetary policy

HICP and GDP deflator 1999-2017

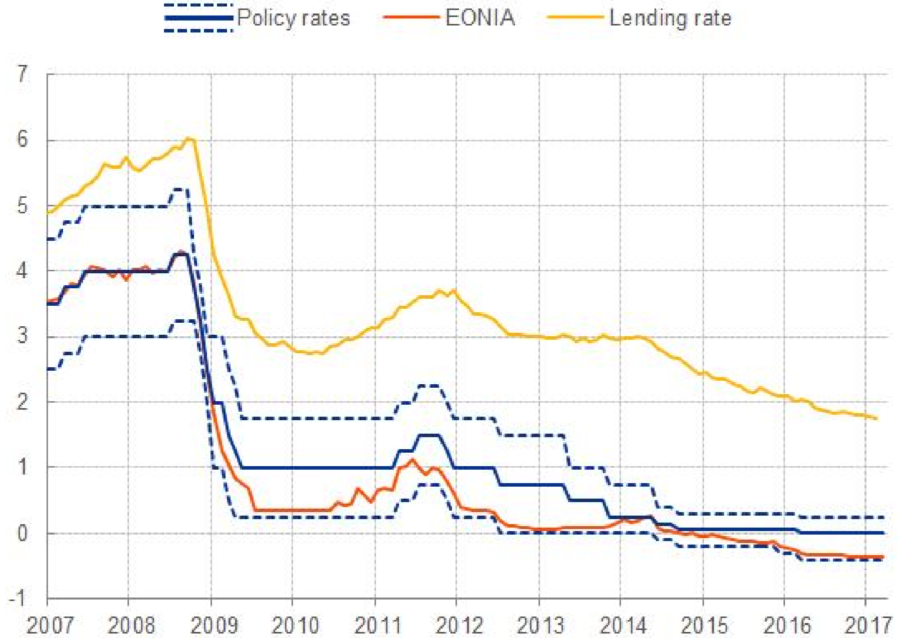
(annual percent change)



Source: AMECO (Winter 2017)

Interest rates 2007-2017

(annual percent change)



Source: ECB

- Monetary policy has remained effective even after the MRO rate hit zero.
- Three main mutually reinforcing instruments: a negative deposit facility rate; an expanded asset purchase programme covering a broad range of private and public securities; and an integrated system of forward guidance.

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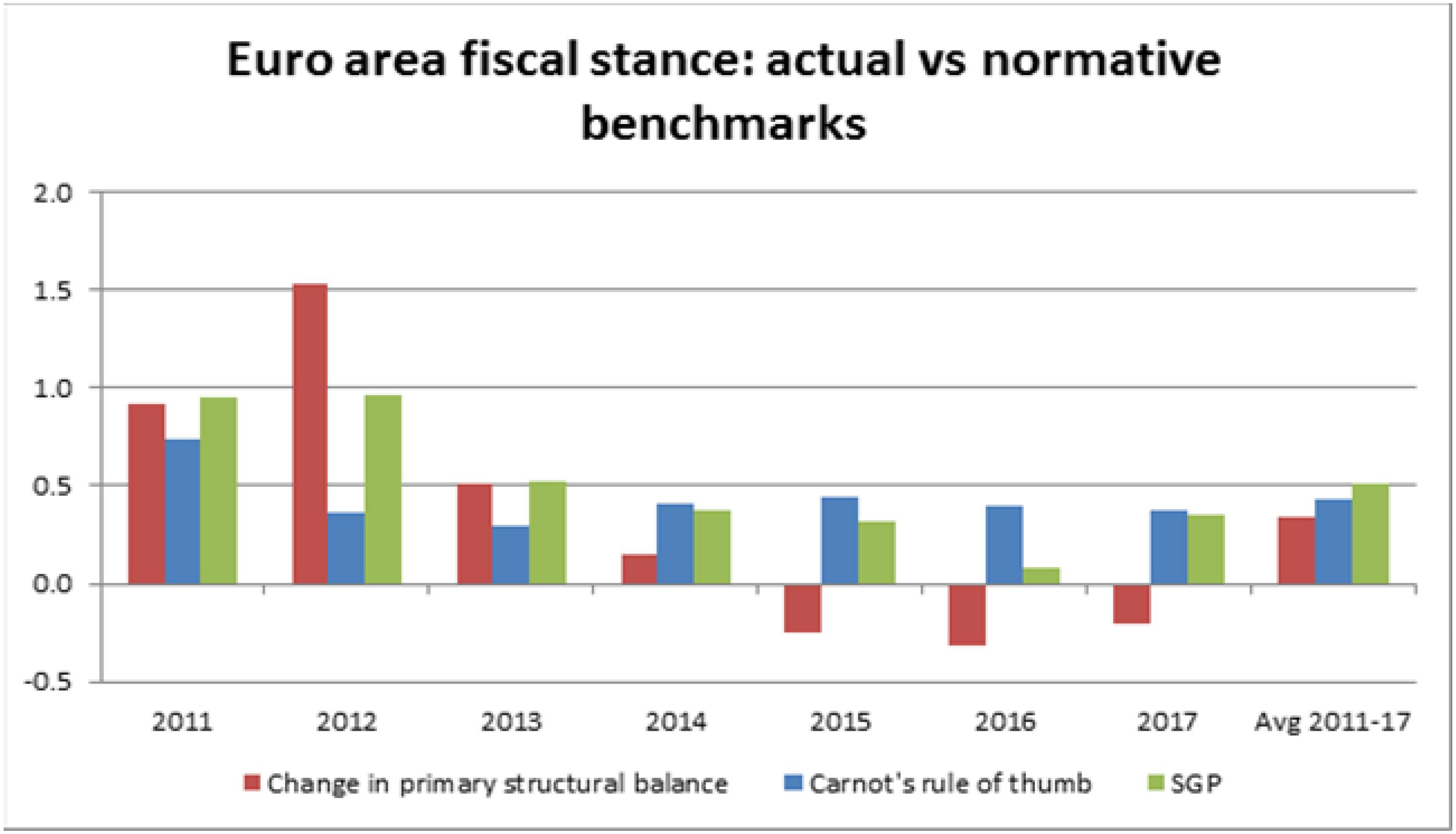
With firming recovery stabilisation needs are gradually receding

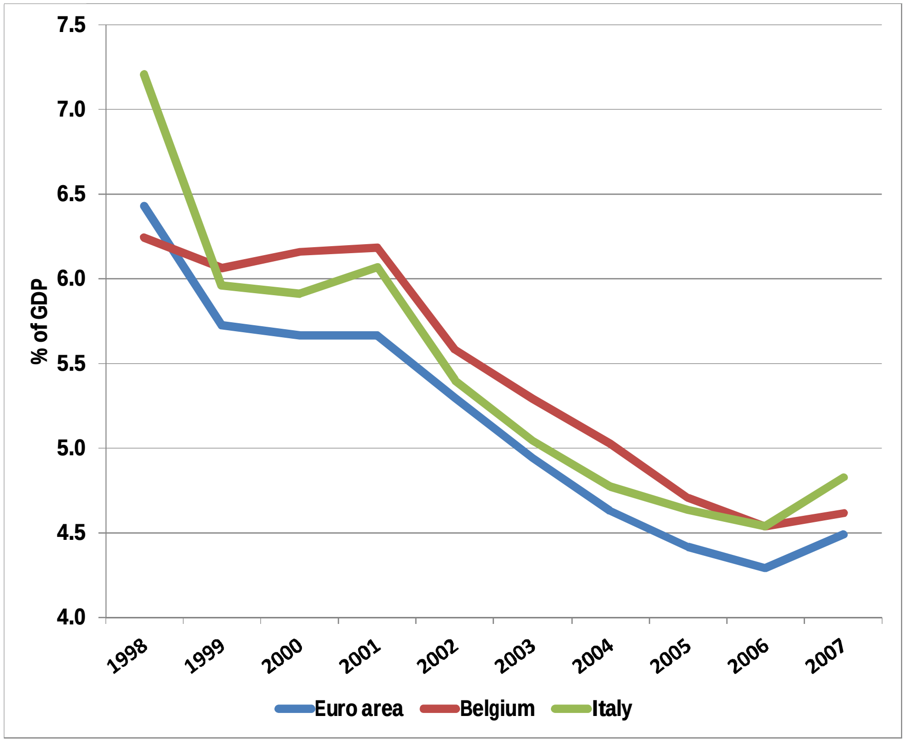


Note: Own calculations based on AMECO data. "SGP" refers to aggregated structural effort requirements, not adjusted for changes in interest payments. If the latter were accounted for "SGP" requirements would be slightly larger in 2011-12 and slightly lower in 2013-17; lower by 0.1 pp on average over 2011-17.

- At present, no conflict between SGP and rules such as Carnot's (2014) explicitly accounting for the stabilisation-sustainability trade-off.

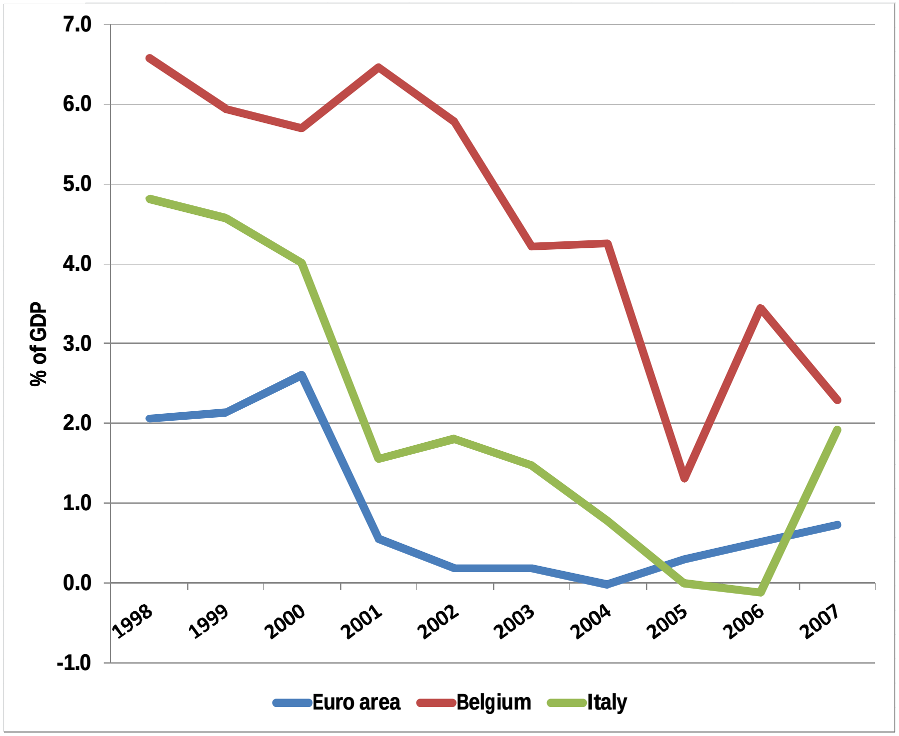
Pre-crisis lesson: use good times to build buffers

Implicit interest rates 1998-2007



Source: AMECO and own computations
Note: Implicit interest rate: general government; Interest as percent of gross public debt of preceding year Excessive deficit procedure (based on ESA 2010)

Cyclically-adjusted primary balance 1998-2007

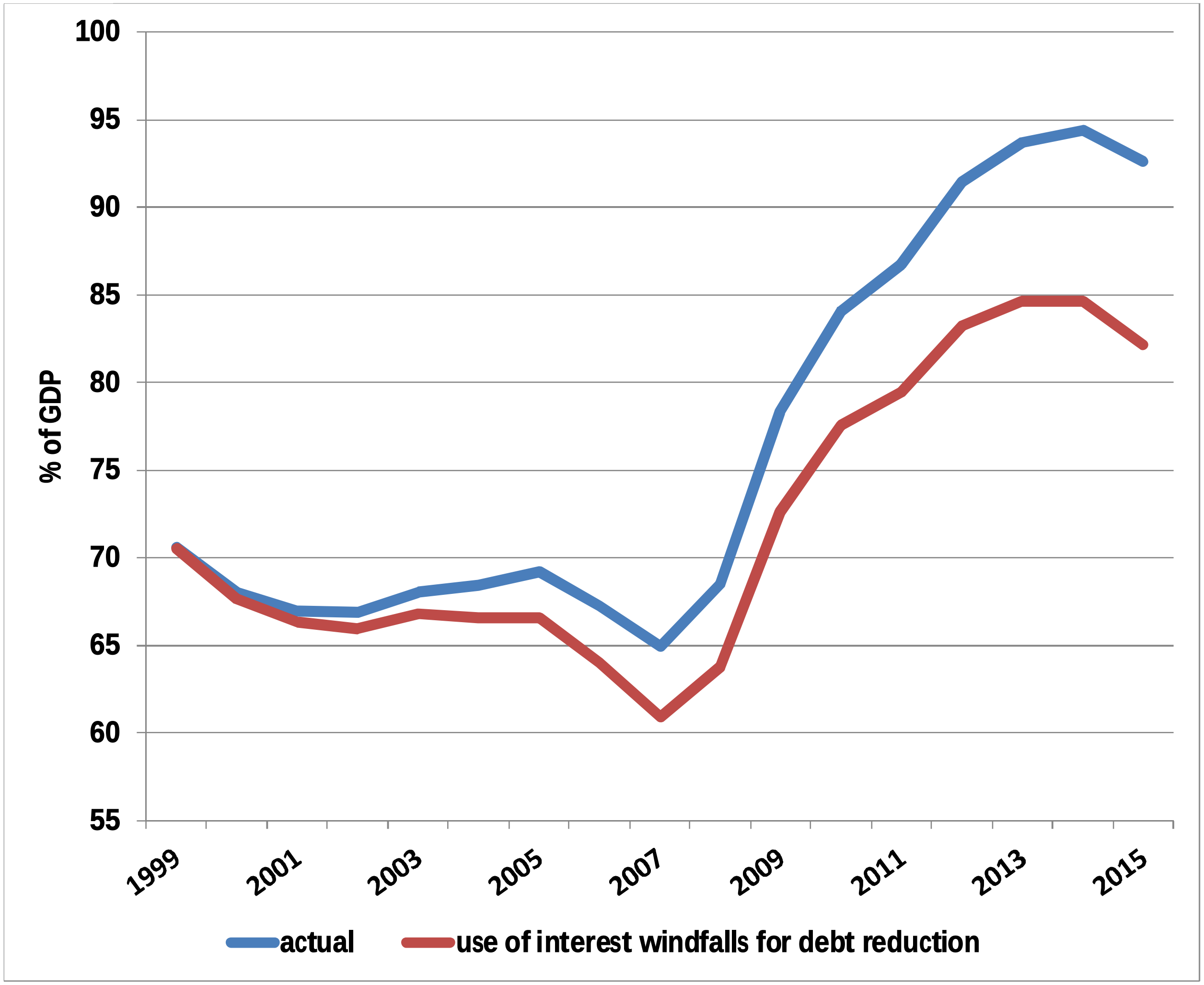


Source: AMECO and own computations
Note: Implicit interest rate: general government; Interest as percent of gross public debt of preceding year Excessive deficit procedure (based on ESA 2010)

- There was a sizeable EMU dividend over the 1998-2007 period in terms of interest savings, which was only partly used for debt reduction.

Faster debt reduction would have increased resilience in the euro area …

Euro area debt developments since start of EMU



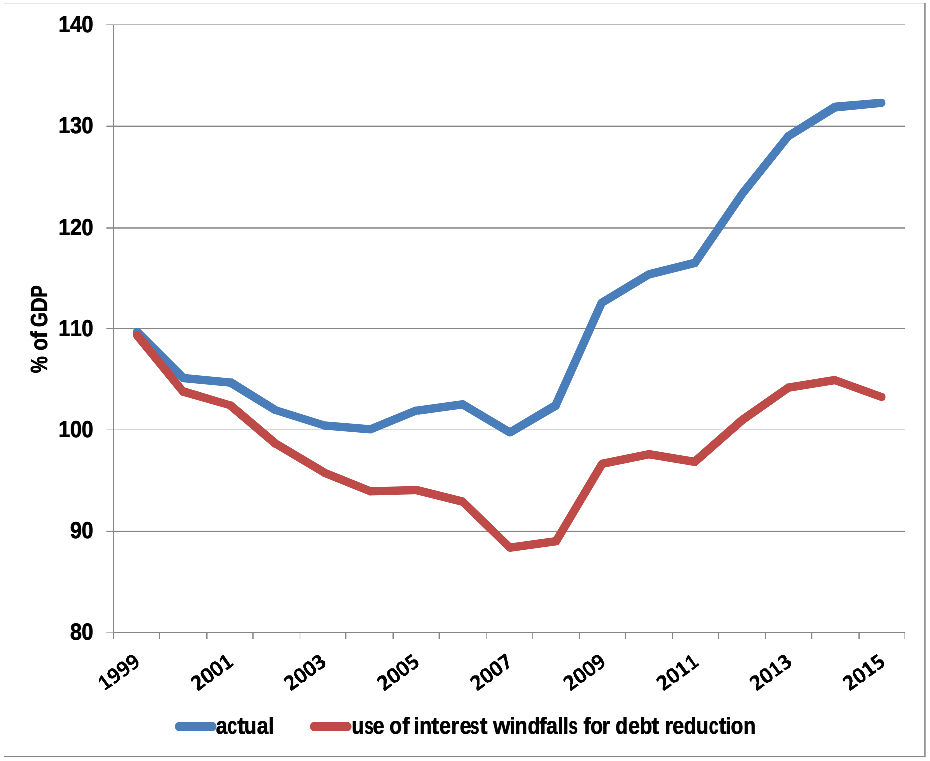
Source: AMECO and own computations

Note: The interest windfall scenario assumes that additional fiscal space related to the decline in the implicit interest rate between 1998 and 2007 is used for debt reduction.

…and in high-debt countries, in particular

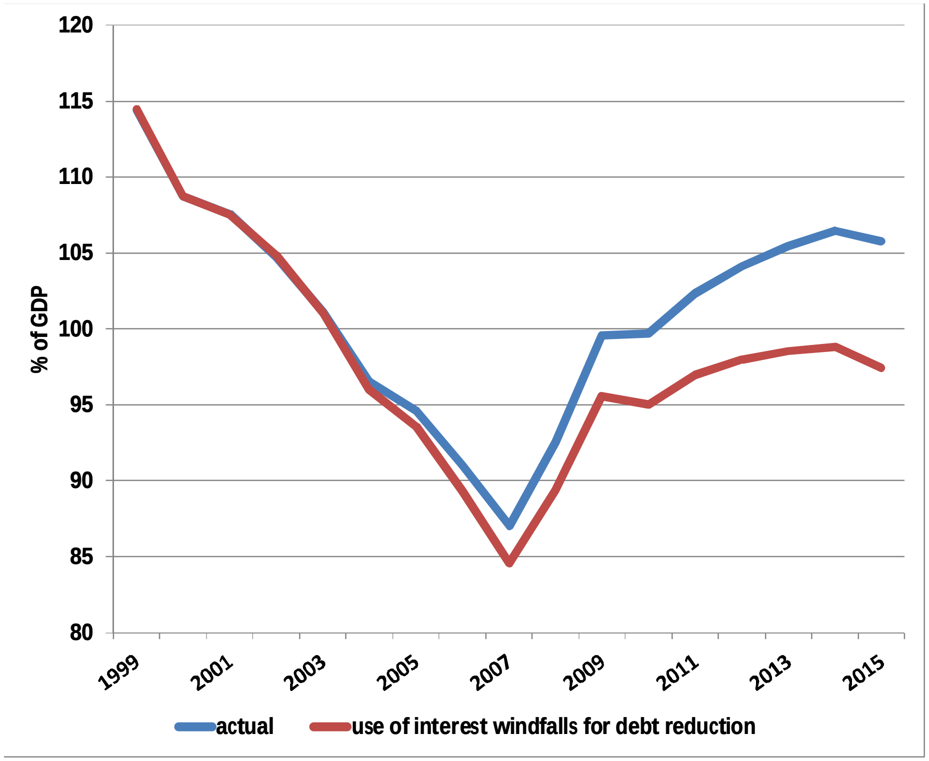
Debt developments since start of EMU

Italy



Source: AMECO and own computations
Note: The interest windfall scenario assumes that additional fiscal space related to the decline in the implicit interest rate between 1998 and 2007 is used for debt reduction.

Belgium



Source: AMECO and own computations
Note: The interest windfall scenario assumes that additional fiscal space related to the decline in the implicit interest rate between 1998 and 2007 is used for debt reduction.

- Faster debt reduction during pre-crisis good times would have reduced the need for pro-cyclical tightening during the sovereign debt crisis.

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Conclusions

- **The euro area fiscal stance is a useful concept**
  - While automatic stabilisers work well in normal times, there may be a need for discretionary fiscal action in deep and protracted downturns.
- **A euro area fiscal capacity could complement national stabilisers**
  - The experience with the EERP suggests that the scope for Member States with high debt sustainability risks to provide stimulus is limited.
  - Stimulus concentrated in countries with fiscal space cannot substitute for an area-wide fiscal capacity unless spillovers are very large.
  - The establishment of a euro-area fiscal capacity requires the restoration of trust in the full and consistent implementation of EU fiscal rules.
- **A more growth-friendly composition of budgets will help everywhere**
  - This works for all countries, regardless of available fiscal space.
- **With the recovery firming the focus will need to shift to building buffers**
  - The low interest rate environment should not be taken for granted.