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Towards a Positive Euro Area Fiscal Stance

Supporting public investments that increase economic growth

European **Political Strategy** Centre

Reducing unemployment, strengthening the euro area's growth prospects and ensuring the future resilience of the European economy require better tailored fiscal tools at euro area level. **Today, the limits of the EU's fiscal framework mean that the euro area has had to rely excessively on the monetary policy of the European Central Bank (ECB) to ensure macroeconomic stability**. As these monetary policy tools are increasingly stretched, calls for a more balanced policy mix that includes more supportive fiscal policies have been voiced by the EU – including by Commission President Jean-Claude Juncker in his 2016 State of the Union 'Letter of Intent'[1] and by ECB President Mario Draghi – as well as by a very broad set of stakeholders, from international organisations to academics. Against this backdrop, the Commission presented on 16 November a Communication '*Towards a Positive Fiscal Stance for the Euro Area*', confirming its intention to promote a more supportive fiscal policy in the euro area. Given the challenges that lie ahead and the current economic juncture, there is a strong case for increasing public investments in areas that increase the resilience of the European economy. In short, **there is both a need and a unique window of opportunity for the EU to take action on the fiscal front at this precise point in time**. This increased fiscal responsibility must be implemented in combination with supportive structural reforms and investments, making sure the elements of the 'virtuous triangle' are mutually reinforcing.

Economic Context Calls for Fiscal Expansion

In certain circumstances, such as in prolonged periods of sub-par growth and monetary policy at the 'zero lower bound', there are good reasons to expand discretionary fiscal policy in order to support aggregate demand. The euro area currently meets these criteria, despite recent improvements in the economic outlook.

Low Interest Rates Favour Fiscal Expansion

Some Member States have the fiscal space to engage in an expansionary fiscal policy but they do not use it due to limitations in the Stability and Growth Pact. Yet, there is a strong case for taking advantage of today's very low funding costs to invest in the economy. The largest beneficiary of any fiscal expansion will be the Member State that undertakes it.

Monetary Policy Needs Support

A positive fiscal stance is needed to support the accommodating monetary policy of the ECB, which currently bears the largest burden in terms of stabilising the euro area. The ECB has repeatedly warned of the increasing constraints it faces on the use of monetary tools, calling for a euro area fiscal counterpart to its monetary policy efforts.

Positive Fiscal Stance Reinforces Virtuous Triangle

In combination with reforms and public investments supported by EU-level financial instruments, a positive fiscal stance will support the modernisation of the economy, as additional investments are channelled into strategic areas, opening up new markets and further developing existing ones.

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What is the 'fiscal stance' and what role does it play in the euro area?

The concept of '**fiscal stance**' describes the **discretionary** fiscal policies in a budget.[2] The fiscal stance is considered to be contractionary, expansionary or neutral depending on whether the government decides to decrease (contractionary), increase (expansionary) or leave discretionary expenditures unchanged (neutral). Discretionary fiscal policies exclude components of a budget that are linked to the overall business cycle – so-called 'automatic stabilisers', such as unemployment insurance or social security that automatically start rising/falling as the economy slows/grows – as well as the interest paid on public debt. The fiscal stance is therefore normally captured by **changes in the cyclically-adjusted primary balance**.

In the present architecture, a proper euro area or EU fiscal stance does not actually exist, given the absence of any real euro area or EU-level fiscal instrument to manage the overall fiscal stance of the Member States. The concept of a euro area or EU fiscal stance refers only to the simple arithmetic aggregation of individual Member States' fiscal stances.

Furthermore, **the existing euro area fiscal supervisory framework - the Stability and Growth Pact - is not really conducive to Member States engaging in discretionary fiscal actions and hence cannot deliver on a fiscal stance at EU or euro area level**. This is because it is primarily designed to prevent excessive levels of debt, encourage fiscal consolidation and a budget that is close-to-balance or in surplus over the medium term.

The Stability and Growth Pact and the European Semester can only oblige Member States to undertake a fiscal adjustment if they are facing excessive deficits. **There are no mechanisms to force countries that have the possibility to pursue a positive fiscal stance to actually do so**, even where there is a good case, from a domestic perspective, to encourage a more expansionary fiscal policy, e.g. in countries with an unnecessarily tight – and in some cases counterproductive – budgetary policy. This constraint is also shared by the soon-to-be operational euro area European Fiscal Board.

The Stability and Growth Pact and the European Semester can only **potentially and indirectly** guide Member States to take euro area-wide considerations into account, for instance, via surveillance measures and country-specific recommendations. However, up till now, there has historically been limited success in prodding Member States into action in this field.

As a result, those Member States that **lack any fiscal space**[3] – because their debt levels are such that their debt sustainability would be seriously questioned if they were to engage in an expansive fiscal policy – are recommended to pursue fiscal consolidation, while those Member States that do have fiscal space prefer not to use it and to ensure the medium-term sustainability of their public finances.

The only EU fiscal instrument available is the EU budget, which acts as a structural convergence tool for all EU 28 Member States and lacks any real cyclical component. However, **the upcoming review of the EU budget presents itself as an opportunity to improve the counter-cyclical capacity of the budget**.

Against this backdrop, the burden of ensuring the macroeconomic stabilisation of the euro area and providing economic stimulus to lift it out of the crisis has been largely left to the monetary policy of the ECB. In particular, the ECB has made wide use of its full range of instruments, from lowering interest rates and undertaking long-term refinancing operations, to the signalling effect of outright monetary transactions and asset-purchasing programmes. However, as stressed by ECB President Mario Draghi:[4] '*Monetary policy does not exist in a vacuum. [...] Other policies matter a great deal. They can buttress or dilute the effects of our policy*'. In conclusion, alongside structural reforms, fiscal policy matters for the effectiveness of monetary policy. **The aggregate fiscal policy of the euro area needs to work together with the ECB monetary policy.**

This is all the more important when traditional and unconventional monetary policy tools have been used extensively and given that some of the factors that have helped the current modest upswing in the euro area are expected to weaken, such as the initial boost from a depreciated euro, the low oil prices and the fiscal expansion associated with the influx of refugees in 2016. **It will be crucial to boost domestic sources of growth also with respect to a dramatic increase in external political uncertainty, in light of internal and global developments.**

The need to forge synergies among fiscal, monetary and structural policies was also highlighted in the G20 Leaders' Communique at the Hangzhou Summit: '*Underscoring the essential role of structural reforms, we emphasise that our fiscal strategies are equally important to supporting our common growth objectives*'.[5]

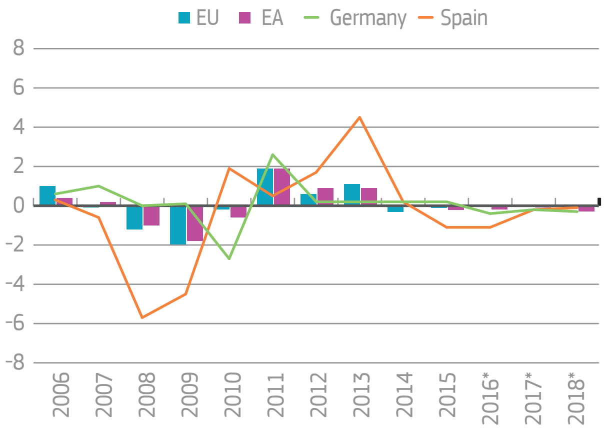
Recent trends in EU, euro area and Member States' fiscal stance

After being contractionary during the sovereign crisis (as shown by the values *above* the 'x' horizontal axis in Figure 1)**, the fiscal stance has been broadly neutral in the EU and in the euro area in 2014 and 2015** (as shown by the values *below* the 'x' horizontal axis, which would refer, for instance, to reducing an existing fiscal surplus by injecting more money into an economy).

This picture is nonetheless heterogeneous among euro area Member States (Figure 1). For instance, crisis-hit Spain was forced to undergo a very contractionary fiscal stance between 2010 and 2014. On the other hand, the largest euro area economy, Germany, pursued a negative fiscal stance until 2015 in spite of significant fiscal space and much more robust economic performance. **Somewhat ironically, it was Spain that shifted towards a more supportive fiscal stance in 2015 and 2016, despite facing much higher medium-term fiscal consolidation needs than Germany.** Looking ahead, neither of these two countries are forecast to put in place strongly supportive stances between 2016 and 2018 – both maintaining neutral to barely positive fiscal stances.[6]

Figure 1: Changes in general government cyclically-adjusted primary balance

(year-on-year)



Source: AMECO; *: forecasts.

As regards the euro area overall – or rather the arithmetic aggregation of the individual fiscal stances of the euro Member States – the fiscal stance in 2016 is also expected to be mildly positive *and* counter-cyclical (i.e. a fiscal action net of the economic cycle, but moving in the opposite direction of this economic cycle). Forecasts based on the first draft budgets for 2017, as submitted by the Member States, suggest that the euro area 2017 fiscal stance will again be *broadly* neutral.[7]

The euro area would benefit from a positive fiscal stance

In its Communication of 16 November 2016, the Commission is calling for a positive fiscal stance for the euro area, in support of the economic recovery and of the monetary policy of the ECB.

From a macroeconomic stabilisation perspective, discretionary expenditure increases are, in most cases, not necessary as a response to a recession because the automatic stabilisers that come into play during an economic slowdown usually cushion the blow. Therefore, these stabilisers should always be encouraged to work fully, to the extent that they do not endanger debt sustainability. In fact, the Stability and Growth Pact, encourages a budget that is close-to-balance or in surplus over the medium term precisely to allow enough fiscal space to let automatic stabilisers function fully during a downturn, with the expectation that the resulting increase in government debt should then be reduced as the economy recovers. The result is a **stabilising counter-cyclical fiscal policy**.

However, a growing body of literature[8] finds that **there are good reasons to expand fiscal policy beyond the automatic stabilisers to support aggregate demand in a country** if: **a)** interest rates are constrained at the 'zero lower bond', **b)** there is sub-par growth, creating a large output gap, and **c)** households are constrained by debt overhang. As it turns out, **all those conditions are today observed in the euro area** (Table 1). Indeed, there is still a large (albeit decreasing) output gap, interest rates have been *below* the zero lower bound since 2015 (and were close to zero between 2012 and 2014) and households are still in need of deleveraging after debt build-up.

These circumstances produce **fiscal multipliers**, i.e. direct and induced effects effects on GDP growth generated by the fiscal expenditure, that are much larger and faster than under 'normal' conditions (Box 1).[9] The result is that an expansionary fiscal policy does not crowd out private investments but actually stimulates them, resulting in further ('second round') GDP growth after the initial stimulus. **This enables the economy to recover, private balance sheets to be repaired and inflation expectations to rise to normal levels.**

Jason Furman, who chairs US President Barack Obama's Council of Economic Advisers, shares this assessment, stating that: '*fiscal policy is often beneficial for effective counter-cyclical policy as a complement to monetary policy*' and that '*discretionary fiscal stimulus can be very effective and in some circumstances can even crowd in private investment*'.[10]

A **positive fiscal stance works with – *not against* – monetary policy in its efforts to stabilise the economy and the financial system following the economic crisis, and to accelerate the moderate growth currently observed in the euro area.**

By stimulating growth, a fiscal expansion at the current juncture would also help to counteract any 'hysteresis effect' that may have started to set in. This effect describes a permanent loss of growth potential that can accompany an economy's ongoing weak performance following a crisis, degrading its production capacity and productivity. An example of this is when a workforce starts losing skills due to high and prolonged unemployment and long periods of under-investment. As pointed out by the International Monetary Fund's (IMF) chief Christine Lagarde: '*The longer demand weakness lasts, the more it threatens to harm long-term growth as firms reduce production capacity and unemployed workers are leaving the labour force and critical skills are eroding. Weak demand also depresses trade, which adds to disappointing productivity growth.*'[11]

An expansionary fiscal stance could help overturn such an effect, although this is not materialising today as the burden of macroeconomic stabilisation is primarily placed on monetary policy, without a matching fiscal policy.

Table 1: Euro area experiences a large negative output gap and negative interest rates

	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018
Output gap (% of potential GDP)	2.0	0.9	-0.2	0.1	0.0	1.4	2.7	1.7	-3.5	-2.1	-1.1	-2.2	-2.9	-2.4	-1.6	-1.0*	-0.7*	-0.2*
Households gross debt-to-income ratio (%)	73.4	75.5	77.9	81.1	85.6	89.5	92.2	93.4	96.1	97.6	97.3	96.8	95.5	94.7	94.0			
Government debt (% of GDP)	67.0	66.8	68.1	68.4	69.2	67.3	64.9	68.5	78.3	84.1	86.7	91.4	93.7	94.4	92.6	91.6*	90.6*	89.4*
Interest rate (3-month, p. p)	4.8	3.3	2.9	2.2	2.5	3.7	4.9	3.3	0.7	1.0	1.4	0.2	0.3	0.1	-0.1	-0.3**		

Source: AMECO, ESTAT, ECB. *: forecasts; **: figures until October 2016

The fact that the stock of euro area public debt is still historically high – albeit slowly decreasing – would normally imply constraints to the dimension of any positive fiscal stance, but, in fact, the very low yields on government debt arising from **supportive ECB monetary policy actions limit immediate concerns about debt sustainability.**

All the above evidence leads to the conclusion that **the euro area would benefit from a period of increased discretionary fiscal spending**. This would also enable fiscal policy to act as an effective counterpart to the ECB's supportive monetary policies.

The need for a more accommodating fiscal stance at euro area level has also been highlighted by the IMF in its last 'Article IV' consultation, where its Executive Board encourages '*the authorities to pursue a more balanced policy mix through growth friendly fiscal rebalancing, use of fiscal space where available, and an expansion of centralised investment schemes or funds for common projects.*'[12] The Organisation for Economic Cooperation and Development (OECD) also comes to this conclusion, saying that '*countries with fiscal space should use fiscal stimulus to support aggregate demand*'.[13]

Beyond international organisations and respected academics, the view that the EU needs a new take on fiscal policy is also widely shared by the business and financial community. A representative of a leading global investment banking firm concludes: '*We remain anchored in the past, and we continue to apply today the same pre-crisis rules and heuristics about fiscal policy, ignoring the fact that we no longer live in that world. […] This call for a more active fiscal policy is not a call for fiscal irresponsibility. […] Once growth and inflation pick up in a sustainable manner, it will be the time for fiscal consolidation. But, for now, with interest rates expected to be very low for a very long period of time, fiscal policy will have to be the main economic policy to support growth in the foreseeable future.*'[14]

How to deliver on a positive euro area fiscal stance

In the absence of a **dedicated euro area instrument** for fiscal stabilisation, a **short-term solution** could be composed of two pillars. Firstly, it should **encourage expansionary fiscal policy of individual Member States**. This would imply that euro area countries with sufficient **fiscal space** to increase fiscal expenditures in a sustained manner over the medium term would need to do so. This is essentially a matter of collective responsibility and discussion in the Eurogroup.

But promoting a more supportive fiscal stance is also about the quality of the expenditure that goes with it. Therefore, **discretionary public spending should be closely aligned with the EU's strategic objectives** in areas of digitalisation, energy transition or mobility. Where possible, public investments should be supported by modern financial tools that enable the leveraging of private spending, e.g. through blending spending vehicles. An example of such an integrated approach is the **European Fund for Strategic Investments** (EFSI), which has proven to be an effective tool for supporting investments towards the EU's strategic objectives. The EFSI is also flexible enough to be combined with existing EU and national financial instruments, and open to contributions from those Member States that have sufficient fiscal space in the medium term.

The starting point is therefore to look at those countries that do have sufficient fiscal space in the medium term. Table 2 shows the availability of fiscal space for the euro area Member States (except for Cyprus and Greece).[15] Similarly to Figure 1, a negative value indicates available fiscal space. Fiscal space can be defined by

Box 1: Abnormal circumstances increase fiscal multipliers

Intense discussions around the speed of fiscal consolidation and the role of fiscal policy in the current economic environment started when fiscal stabilisation in euro area crisis countries coincided with a higher than expected fall in GDP.

Firstly, Blanchard and Leigh's very influential 2013 research – written while Olivier Blanchard was still the IMF's Chief Economist – finds that the so-called 'fiscal multipliers' (i.e. the effect of fiscal expenditure on GDP) are likely to be larger than expected under crisis circumstances or when there is a large slack (i.e. a negative output gap) in the economy. Looking at G7 economies (excluding Italy), Baum et al. show that, while fiscal multipliers differ across countries, they tend to be larger in downturns than in expansions. Based on US data, Auerbach and Gorodnichenko found that fiscal multipliers associated with government spending can fluctuate from being near to zero in normal times to about 2.5 during recessions. Erceg and Lindé, however, find that the size of the multipliers decreases with the size of the fiscal expansion.[16]

Secondly, Delong and Summers found that when interest rates are constrained by the zero nominal lower bound, discretionary fiscal policy can not only be highly efficient as a stabilisation policy tool but may also reduce long-run debt-financing burdens. Because of the binding zero lower bound on nominal interest rates, **central banks cannot cut interest rates to offset the negative short-term effects of a fiscal consolidation on economic activity**.[17]

Thirdly, as Eggertson and Krugman show, when households with an overhang of debt are forced into rapid deleveraging (so-called 'balance sheet recession'), their spending depends on current income rather than on expected future income, and investment may also depend more on current than on future profits. This means that **deficit-financed expenditure will not be offset by savings increases and will therefore result in a larger multiplier of the initial stimulus**. Also, the need to reduce debt overhang may mean that even a zero nominal interest rate will not be low enough to induce spending, suggesting that **monetary policy alone cannot stimulate GDP growth further.** The role of fiscal expansion is then to sustain output and employment while private balance sheets are repaired, as the government can pay down its own debt after the deleveraging period has come to an end. Furthermore, a strong fiscal response not only limits the output loss from a deleveraging shock; it also, by staving off debt deflation (through raising inflation), limits the size of the shock itself. Consequently, they suggest that **a temporary rise in government spending will lead to increased spending on the part of liquidity-constrained debtors**. Brendon and Corsetti, in an extensive literature review, summarise the numerous papers that make a similar case, showing that **the fiscal multipliers associated with increased government spending in a context of increased savings are potentially much larger when the zero bound is binding than during normal times**.[18]

the possibility to expand (expansionary fiscal stance) without endangering fiscal sustainability. In this paper, sustainability is defined more precisely by the capacity for public debt to attain the 60% of GDP reference value in the medium run.

While no euro area member faces short-term fiscal pressures (chiefly thanks to ECB supportive policies), **seven actually also have medium-term fiscal margin of manoeuvre** (indicated in % of GDP), namely: **Estonia** (4.2% of GDP), **Germany** (0.8% of GDP), **Latvia** (1.9% of GDP), **Luxembourg** (4.8% of GDP), **Malta** (0.6% of GDP), **Slovakia** (0.6% of GDP) and **the Netherlands** (0.9% of GDP). On the other hand, medium-term fiscal adjustment needs – which can be seen as **a negative fiscal space** – are close to 4% of GDP in large economies like **France and Italy**, even when the considerable level of flexibility allowed by the Stability and Growth Pact, already used by those countries, is taken into consideration.[19]

The seven above-mentioned countries with available fiscal space represent **more than 37% of the combined euro area GDP**, with Germany alone standing for almost 29%. Their combined available fiscal space for a stimulus would amount to 0.32% of the euro area GDP (although this is on the conservative lower bound of the estimates of the Commission Communication, which go from 0.3% to 0.8% of GDP, with a recommended 2017 fiscal stimulus of 0.5% of GDP). Germany would be responsible for the lion share of this fiscal impulse (namely 0.22% of the euro area GDP). **Pursuing this available fiscal space would help growth in the euro area and recalibrate the emphasis currently placed on monetary policy**, while not being a silver bullet on its own.

As for those Member States with no fiscal space, they can and should use interest savings from the accommodating monetary policy to reduce their debt stock, build up buffers and **restructure their expenditure and their taxation revenues in more effective ways.**

Table 2: Available fiscal space in euro area Member States

	Overall short-term risk category	Overall medium-term risk category	Fiscal consolidation needs (+) / proxy for fiscal space (-)[20]
Estonia	LOW	LOW	-4.2
Germany	LOW	LOW	-0.8
Latvia	LOW	LOW	-1.9
Luxembourg	LOW	LOW	-4.8
Malta	LOW	LOW	-0.6
Slovakia	LOW	LOW	-0.6
Netherlands	LOW	LOW	-0.9
Austria	LOW	MEDIUM	0.6
Lithuania	LOW	MEDIUM	0.2
Belgium	LOW	HIGH	3.9
Finland	LOW	HIGH	2.4
France	LOW	HIGH	3.6
Ireland	LOW	HIGH	1.9
Italy	LOW	HIGH	3.8
Portugal	LOW	HIGH	4.9
Slovenia	LOW	HIGH	1.6
Spain	LOW	HIGH	3.3

Source: European Commission, '*Fiscal Sustainability Report - 2015*', 2016 and DG ECFIN

Indeed, efforts should not be limited to the expenditure side of national budgets. **Taxation** can change economic decisions and thereby affect economic growth. A well-managed taxation system takes account of the mobility of the tax base and provides the right incentives for economic activity to expand. For instance, research suggests that increasing the right taxes – consumption taxes, for instance – might actually increase long-term GDP, provided that the increased room for fiscal policy is used to cut labour taxation later on.[21]

More broadly speaking, some of the key priorities for Member States as identified by the IMF in a recent publication are that '*countries should undertake growth-friendly fiscal rebalancing, boosting public investment and reducing high marginal tax rates on labour and capital, accompanied by cuts to unproductive spending and steps to broaden the tax base*'.[22] Of course, the starting points of Member States differ widely and their individual situations need to be taken into account when designing a growth-friendly expenditure and taxation mix.

Towards a win-win fiscal stance

As stated earlier, any **discretionary spending should be closely aligned with the EU's strategic objectives** and, where possible, oriented towards investments that can generate **positive spill-over effects** in other Member States in terms of enhanced growth and job creation, as well as new cross-border business opportunities. This is **a fundamental criterion when considering any fiscal stimulus with euro area-wide effects.**

Recent studies confirm both the positive effect of public investments on the domestic economy and the existence of cross-border spill-over effects. In't Veld[23] finds that a 1% GDP increase in public investment, simultaneously in Germany and the Netherlands, would, **already in that same year**, raise GDP by 0.85% in Germany and 0.7% in the Netherlands, and by 1.3% over 10 years, while GDP in France, Italy, Spain and the rest of the euro area would be around 0.3% higher. Elekdag and Muir[24] also show that a two-year government investment increase of 1% of GDP in Germany in a zero lower-bound situation boosts both domestic demand in Germany (by around 1%) and in the rest of the euro area (by between 0.2% to 0.3%). Kollmann et al. and the German Ministry of Economic Affairs[25] come to similar findings, highlighting a very important point: **the largest beneficiary of any fiscal stimulus is always the Member State that undertakes it**.

The degree in which other economies benefit from the stimulus depends on the structure and intensity of the economic links they have with the country pursuing the supportive policies. For instance, the German Bundesbank finds that, after correcting for the composition of trade with other euro area countries, the positive spill-over effects in other euro area countries are somewhat lower (and, conversely, the positive impact of the stimulus in Germany increases even further). The spill-over effect increases with the share of the fiscal expansion spent to increase and improve production capacities via, say, capital goods and machinery (as opposed to public consumption items, which are mostly sourced domestically) and with the exports share of the partner country to Germany in those goods.[26]

Notwithstanding this, **the higher levels of growth generated by these investments also help to support fiscal sustainability**, thereby improving on those estimates. Importantly, these positive results depend on certain conditions, namely **that monetary policy remains supportive while the fiscal expansion is pursued**.[27] This also highlights the **complementary roles of monetary and fiscal policies must play in supporting the euro area economy**.

Beyond fiscal expansion, expenditure policies should be designed in a growth-friendly way. Expenditures that increase an economy's endowment of production factors (labour and capital) and/or their productivity contribute the most to increasing potential growth. This kind of spending lifts all boats and should be prioritised, even when its impact needs time to unfold and hence does not lend itself to short-term political consideration. Such expenditure includes, for instance, public infrastructure investments in transport and communications, as they set favourable conditions for private investments. Investments in education and training (which, together with other spending categories such as active labour market policies, are associated with improved human capital and skills), R&D (which is associated with technological development and innovation) and healthcare (which increases both the quantity and the productivity of labour, by increasing the number of years of healthy life) also have a positive impact on potential growth.[28]

The Commission has identified a number of **priority areas** that would benefit from increased spending in its latest country-specific recommendations. For many countries, they tend to be in areas such as education and research, which are important areas, although largely related to domestic government current spending and thus with more limited immediate spill-overs to other Member States. Nonetheless, the Commission has also identified additional annual public investment requirements for Germany of 0.5 % to 1 % of GDP (15-30 billion euro) in **infrastructure projects, such as transport,** which have **much larger positive economic effects in the other Member States**.[29] The Commission also points to the very significant public investment gap faced by the Federal Republic, as do the ECB and the IMF[30]: Public sector gross fixed capital formation in Germany as a proportion of GDP has been declining since 2008 and is significantly below the euro area average.

As today's historically low funding costs make investments feasible that would normally be uneconomical, **there is now an even broader case for investing in the modernisation of our economies to prepare for future challenges.** Together with Member States, the EU has opened a number of promising channels through which investments can have a maximum impact. This includes using novel financial instruments such as the European Fund for Strategic Investment (also known as the 'Juncker plan'), as well as ongoing initiatives to deepen the internal market in Digital, Energy and Financial Services, such as the Capital Markets Union (whose aim to create deeper and more diverse financial markets in the EU would directly support investment). **The internal market has been a major growth and convergence engine for most of the EU's existence, and can reclaim this role if the Member States are willing to lend full political support for the implementation of these initiatives.**

Conclusions

The euro area fiscal stance has only very recently turned mildly positive after having been contractionary between 2011 and 2013, and broadly neutral since then. The bulk of recent literature points to a series of conditions under which discretionary fiscal actions would yield larger benefits than under normal circumstances. The euro area currently meets most of these conditions, suggesting **it would benefit from additional supportive fiscal actions**. This call has been voiced by both the EU – via the Commission and the ECB – and a by very broad set of stakeholders, from international organisations to internationally respected academics.

However, currently most Member States that do have fiscal space are not making full use of it, whereas debt sustainability concerns outweigh the benefits of an expansionary fiscal policy in others. The result is an aggregate euro area fiscal stance that is not supportive enough considering the economic environment in which the euro area finds itself today. Consequently, the burden of macroeconomic stabilisation is placed almost entirely on monetary policy, which is overstretched.

The most effective way out would be the creation of a dedicated fiscal tool that would enable the effective enforcement of a real euro area fiscal stance. However, the more feasible alternative in the short term, is to **encourage a more expansionary fiscal policy** in euro area countries with sufficient **fiscal space, combined with greater and more coordinated public investments that contribute to the long-term resilience of the economy**, supported by EU-level instruments.

Over the past two years, the Commission has called on Member States to redouble their efforts along the principles of the 'virtuous triangle' of boosting investment, pursuing structural reforms and ensuring responsable fiscal policies, and, in doing so, to put the focus on social fairness and delivering more inclusive growth. It has also followed the approach of making best use of the flexibility provided for in the Stability and Growth Pact to ensure that the common fiscal framework is supportive of the EU's jobs and growth agenda, in particular as regards investment and structural reforms, while better reflecting the cyclical situations in individual Member States.[31] The recommendation to deliver a more expansionary fiscal stance is a step further in this direction. It would contribute to a broader rebalancing of the policy mix of the euro area, between monetary and fiscal policy, as well as with regards to the role and responsibilities that each Member State should play in its own recovery and the recovery of the euro area.

Furthermore, the discussion on the appropriate fiscal stance for the euro area as a whole is further embedded in the efforts to complete the **Economic and Monetary Union**, as part of the follow-up to the Five Presidents' Reports of June 2015, which is now in its first phase of 'deepening by doing'. Assessing the euro area as a single entity, as if there were a finance minister for the euro area, is of key importance to ensure a stronger and more sustainable growth path. Other developments of importance include the recent establishment of the European Fiscal Board to regularly provide independent advice to the Commission on the appropriate fiscal stance and the reflection on a macroeconomic stabilisation function for the euro area.[32]

Adopting a more positive fiscal stance will lead to benefits both for the domestic economy of the countries concerned, as well as to spill-overs in other Member States and to a strengthened financial and fiscal stability in the euro area. **Regardless of their respective fiscal space, all Member States can**

improve the growth-friendliness of their budgets by focusing public expenditure on areas that increase the economy's endowment of production factors (labour and capital) or their productivity and rearrange their taxation systems in a way to minimise the negative impact on incentives for private sector activity. **All of this can be done fully within the current rules of the Stability and Growth Pact**.

The shift towards a more broadly positive euro area fiscal stance and more growth supporting policies can of course be gradual, but **the opportunities afforded by the unique set of circumstances we are currently facing should not be missed.**

Notes and References

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5. G20 Leaders' Communique Hangzhou Summit, 5 September 2016, http://europa.eu/rapid/press-release_STATEMENT-16-2967_en.htm: The statement indicates that a globally coordinated fiscal stimulus is far more effective than individual country actions (the same, of course, holds true for euro area individual fiscal actions).
6. This conclusion is supported by both the Commissions forecasts (European Commission, '*Report on Public Finances in EMU – 2015*', Institutional Papers No 14, December 2015) and the draft budgetary plans of the Members States: the one for Germany for 2017, for instance, can be found here.
7. European Commission, '*European Economic Forecast, Autumn 2016*', Institutional Paper 38, November 2016.
8. See, among others: Auerbach, A. and Gorodnichenko, Y., *'Measuring the Output Responses to Fiscal Policy'*, American Economic Journal, 4(2), pp. 1-27, 2012; Batini, N., Eyraud, L., Forni, L. and Weber, A., '*Fiscal Multipliers: Size, Determinants, and Use in Macroeconomic Projections*', IMF, 2014; Bénassy-Quéré, A., '*Short-Term Fiscal Spillovers in a Monetary Union*', CEPII Working Paper n° 13, 2006; Blanchard, O. and D Leigh, D., *'Growth Forecast Errors and Fiscal Multipliers'*, IMF Working Paper 13/1, 2013; Erceg, J. and Lindé, J., '*Is there a Fiscal Free Lunch in a Liquidity Trap?*', International Finance Discussion Papers, No 1003, Board of Governors of the Federal Reserve System, 2010; and Saito, I., '*Fading Ricardian Equivalence in Ageing Japan*', IMF Working Paper No. 16/194, 2016.
9. See Taylor, J., '*Reassessing discretionary fiscal policy*', Journal of Economic Perspectives, Vol.14, No 3, pp. 21-36, 2000; Caudal, N., et al., *'A budget for the euro area'*, Trésor-Economics No. 120, 2013; Bénassy-Quéré, A.,*'No Euro Area Budget Without Eurobonds'*, Mandariaga Foundation, 2013; Furceri, D. and Zdziennicka, A., '*The Euro Area Crisis: Need for a Supranational Fiscal Risk Sharing Mechanism?*', IMF, 2013; as well as the **Box** on 'Abnormal circumstances increase fiscal multipliers' for a more detailed discussion.
10. Furman, J., '*The New View of fiscal policy and its application*', Voxeu.org, 2 November 2016, http://voxeu.org/article/new-view-fiscal-policy-and-its-application.
11. Lagarde, C., '*We Need Forceful Policies to Avoid the Low-Growth Trap*', IMF Direct, 2016.
12. International Monetary Fund, '*Euro Area: 2016 Article IV Consultation*', IMF Country Report No. 16/219, July 2016, https://www.imf.org/external/pubs/ft/scr/2016/cr16219.pdf.
13. OECD, '*Euro Area – Economic forecast summary*', June 2016, http://www.oecd.org/eco/outlook/euro-area-economic-forecast-summary.htm.
14. Ubide, Á., '*The case for an active fiscal policy*', Voxeu.org, 11 October 2016, http://voxeu.org/article/case-active-fiscal-policy.
15. The European Commission has a legal obligation to assess the fiscal situation of the euro area and its Member States. Namely, the Regulation on draft budgetary plans, adopted in 2013 as part of the so-called '2-pack' (Regulation 473/2013, Article 7), states that: '*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, relying on the most recent economic forecasts of the Commission services. The overall assessment shall include sensitivity analyses that provide an indication of the risks to public finance sustainability in the event of adverse economic, financial or budgetary developments. It shall also, as appropriate, outline measures to reinforce the coordination of budgetary and macroeconomic policy at the euro area level. The overall assessment shall be made public and shall be taken into account in the annual general guidance to Member States issued by the Commission […] 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…*'.
16. See footnote 9 for further references. Blanchard and Leigh (2013) results have been partially challenged by Möhlmann and Suyker (Möhlmann, J. and Suyker, W., '*An Update of Blanchard's and Leigh's Estimates in Growth Forecast Errors and Fiscal Multipliers*', CPB Background Document, 2015), who used the same methodology on more recent data, and find that, although during the credit crisis of 2009-2012, fiscal multipliers were indeed larger than normal, this result does not hold for the more recent 2013-2015 period.
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19. ECB, 2015, estimates ‘fiscal space’ using a similar definition to that of European Commission (‘*Fiscal Sustainability Report - 2015*’, op. cit., 2016) for EU Member States between the 1990s and 2014, and finds that while some countries (Belgium, Denmark, Finland, France, the Netherlands, Sweden) had episodes of very low or no fiscal space during the mid-1990s, they later managed to rebuild fiscal space. However, partially due to the shock of the Sovereign crisis, several countries (notably Cyprus, Spain, Greece, Italy, Ireland, Portugal and Slovenia) had very low or no fiscal space in 2014, with **Italy as the only country which had no or very low fiscal space throughout this whole period**.
20. The Commission short-term fiscal sustainability indicator (called **‘S0 Indicator’**) looks at short-terms threats to fiscal sustainability (see European Commission, ‘*Fiscal Sustainability Report - 2015*’, op. cit., 2016). On the other hand, its medium-term sustainability indicator is a combination of the results of debt sustainability analysis –which can be thought of a measure of sensitivity to shocks- and of a so called **‘S1 indicator’** (which shows the additional adjustment required over 5 years in government primary balance as a percentage of GDP to reach the EU Treaty reference value of 60% debt to GDP). A modified version of the S1 indicator prepared for the Communication ‘Towards a Positive Fiscal Stance for the Euro Area’ is used here as proxy for the size of the available fiscal space as a share of GDP.
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