



Brussels, 16.11.2016
COM(2016) 727 final

ANNEXES 1 to 2

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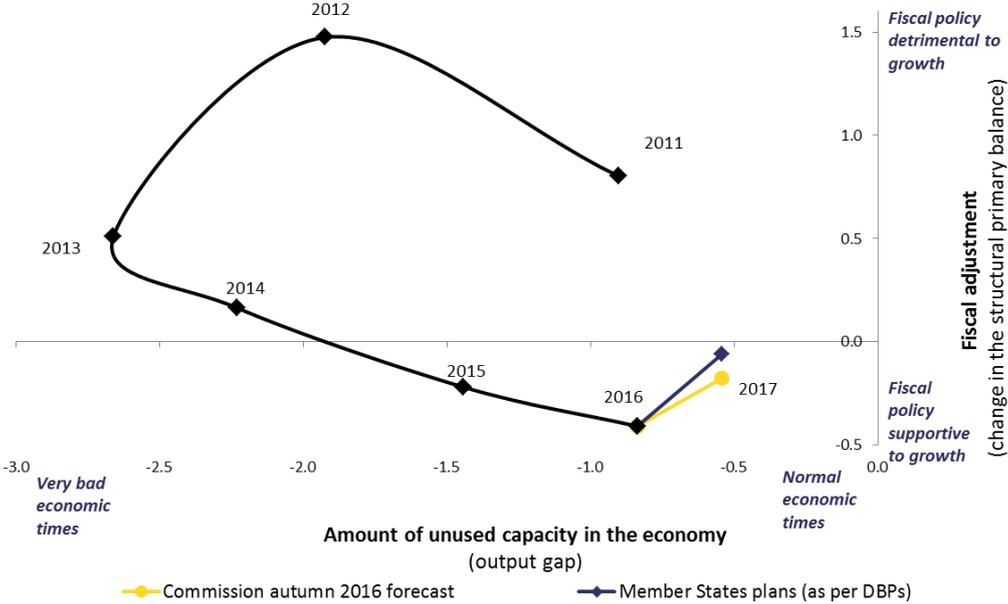
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**COMMUNICATION FROM THE COMMISSION TO THE EUROPEAN
PARLIAMENT, THE COUNCIL, THE EUROPEAN CENTRAL BANK, THE
EUROPEAN ECONOMIC AND SOCIAL COMMITTEE AND THE COMMITTEE
OF THE REGIONS**

TOWARDS A POSITIVE FISCAL STANCE FOR THE EURO AREA

Annex 1. Graphical evidence on the euro area fiscal stance

Graph 1. Euro area fiscal stance over 2011-2017

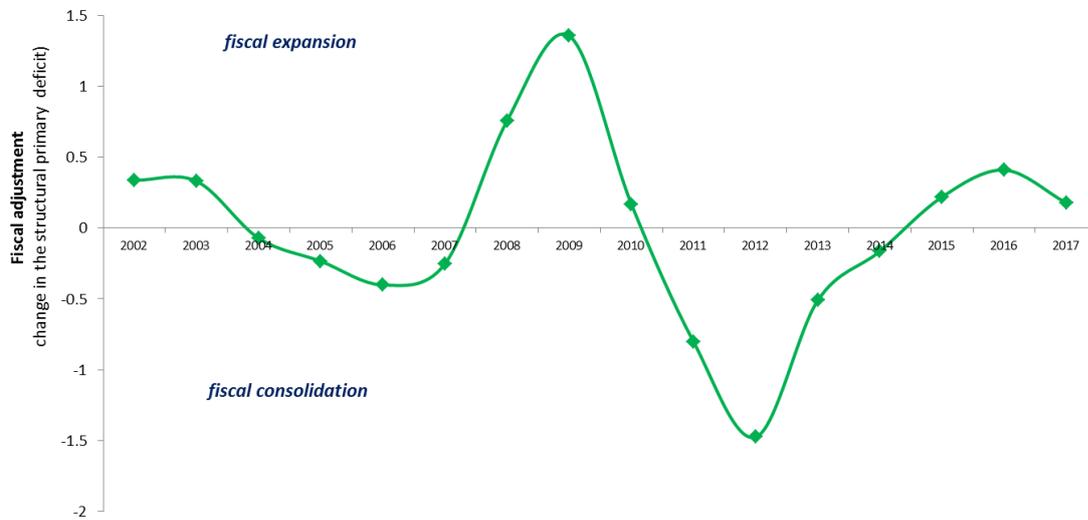


Graph 1 shows the orientation of the euro area's fiscal policy on the vertical axis as measured by the change in the structural primary balance (as in the graph in the main text of the Communication) and the amount of unused capacity in the economy on the horizontal axis. The euro area aggregate displayed in this annex excludes Greece, which is under a stability support programme.

This graph illustrates that while fiscal policy was contractionary in the period 2011-2014 (when the economy was deteriorating), its orientation became neutral and/or slightly supportive in 2015 and 2016 respectively. For 2017, both Member States' draft budgetary plans (DBPs) and the Commission Autumn 2016 Economic Forecast point to a broadly neutral fiscal stance.

The fiscal stance is also often expressed in terms of the change in structural balance (i.e. including interest payments), especially in the context of EU fiscal surveillance. This indicator would point to a slightly less expansionary fiscal policy in 2016 and 2017, since interest expenditure is forecast to have slightly decreased in these two years.

Graph 2. Fiscal stance of the euro area since 2002

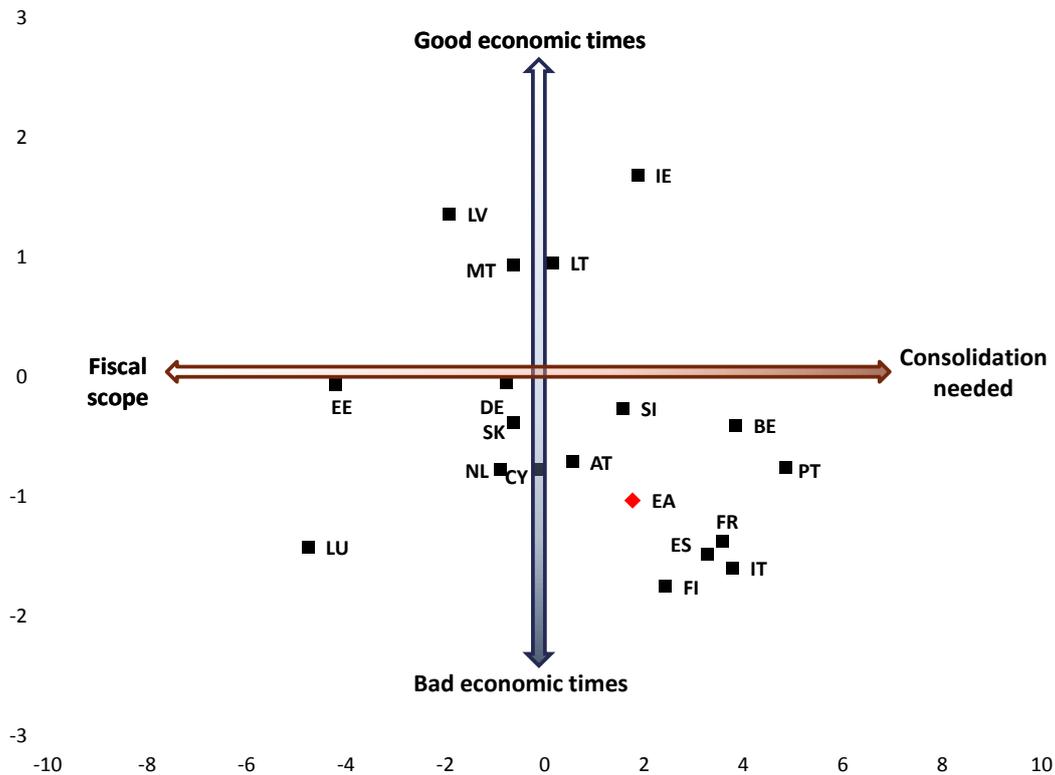


Graph 2 illustrates the fiscal stance of the euro area, i.e. the orientation of fiscal policy at an aggregate level, from a historical perspective.

This is measured by the change in the structural primary balance. The figures shown for the period before 2010 are only a proxy and therefore presented for illustrative purposes only, since they use a different series of "one-offs" measures, defined according to the former national account system ESA1995.

In this graph, a positive value corresponds to a fiscal deficit that is widening (which contributes to a "fiscal expansion"), while a negative value corresponds to a fiscal deficit that is narrowing ("fiscal consolidation"). The euro area aggregate excludes Greece, which is under a stability support programme. The values for 2016 and 2017 are those based on the Commission Autumn 2016 Forecast.

Graph 3. A fiscal map for the euro area in 2016



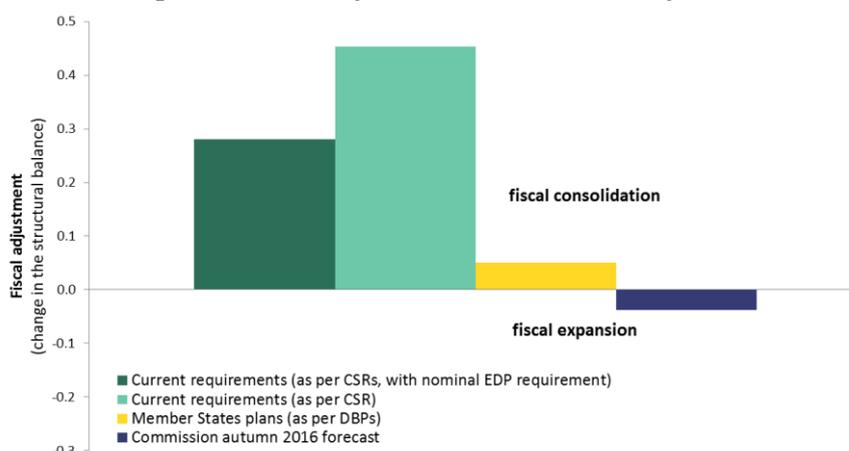
Graph 3 shows both the stabilisation needs (vertical axis, measured by the output gap in 2016) and sustainability needs in euro area Member States (horizontal axis, measured by the standard indicator of sustainability "SI", based on the Autumn 2016 Forecast and using 2016 as the base year).

Good (bad) economic times are measured by the output gap in 2016. Member States located in the top half of the graph (along the 'good economic times' area) are not in need of an expansionary fiscal policy since their economies are already at or above their potential. This is the case of IE, LT, LV and MT. Conversely, those countries located in the bottom half of the graph (along the 'bad economic times' area) face stabilisation needs. In other words, additional support from fiscal policy is needed to consolidate the recovery. This is the case of the euro area as a whole as well as CY, ES, FI, FR, IT, LU, NL, or PT among others.

The stabilisation dimension is complemented with the sustainability one, measured along the horizontal axis. In particular, the right half of the graph shows countries with consolidation needs. This means further consolidation is needed to ensure the sustainability of their public finances. This is the case of BE, ES, IE, FI, FR, IT, SI, and PT. As opposed to that, Member States in the left-hand side of the graph enjoy some fiscal space, which means they can afford an expansionary fiscal policy without jeopardising the sustainability of their public finances. It is the case of DE, EE, LU, LV, MT, or NL. For DE, while the stabilisation need appears fairly limited in 2016, i.e. the output gap is only slightly negative, it is forecast to increase again in 2017, unlike the majority of Member States, especially large economies, which are forecast to move closer to their potential.

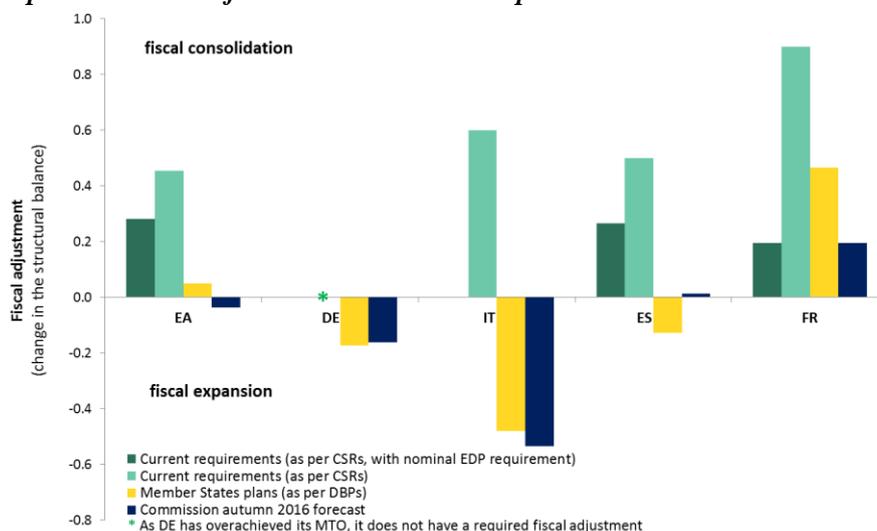
It should be noted that this graph points in opposite directions for a few countries that would benefit from a more supportive fiscal stance in the short term, while being confronted with sizeable fiscal sustainability issues in the longer run. This concerns for instance ES, FR and IT, among others.

Graph 4. Euro area fiscal stance in 2017 (% of GDP)



Graph 4 shows what the fiscal stance for the euro area is likely to be in 2017 as measured by the change in the structural balance, including the change in interest payments¹. Current requirements are the ones reflected in the country-specific recommendations (CSRs) adopted by the Council in July 2016. Since recommendations under the Excessive Deficit Procedure (EDP, i.e. the corrective arm of the Stability and Growth Pact) include both nominal targets and the structural adjustments necessary to achieve them (for instance for countries like France or Spain), the fiscal adjustment required is shown both in terms of the structural requirements specified under the EDP recommendations (pale green) and the structural adjustment that would be necessary to achieve the nominal target in the EDP recommendations (dark green). This graph shows that a full delivery of the fiscal requirements of the CSRs would imply, on aggregate, a restrictive fiscal stance for the euro area in 2017. Similar trends can be assumed for 2018 based on existing fiscal requirements.

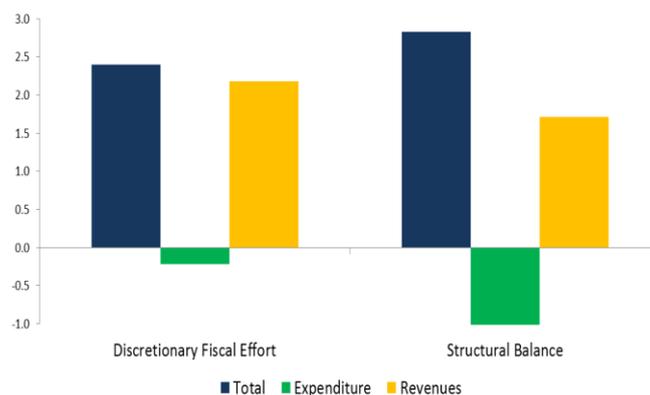
Graph 5. Euro area fiscal stance in 2017: repartition across main economies



Graph 5 shows the current requirements of the CSRs for selected Member States, compared to what their Draft Budgetary Plans (DBPs) present and what the latest Commission Forecast estimates, as measured by the change in the structural balance. As in graph 4, the fiscal adjustment required is shown both in terms of the structural requirement specified under the EDP recommendations (pale green) and the structural adjustment that would be necessary to achieve the nominal target in the EDP (dark green).

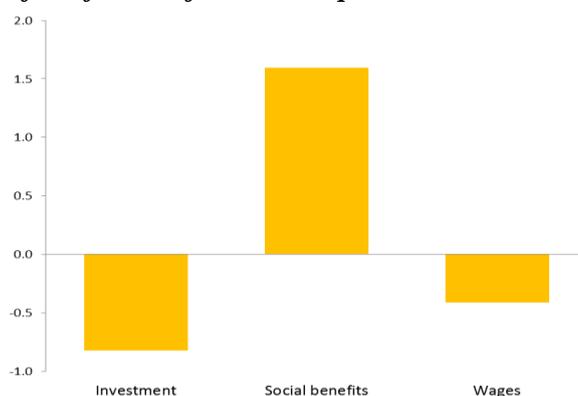
Graph 6. Overall composition of the fiscal adjustment 2011-17, euro area (% GDP)

¹This is a different measure than the one used in the graph of the main text. It is presented here as it is the one used in the EU fiscal surveillance to express fiscal requirements, but it differs slightly from the concept of "primary structural balance", which is a better measure of the fiscal stance (see also Box 1). The latter excludes the annual change in interest payments.

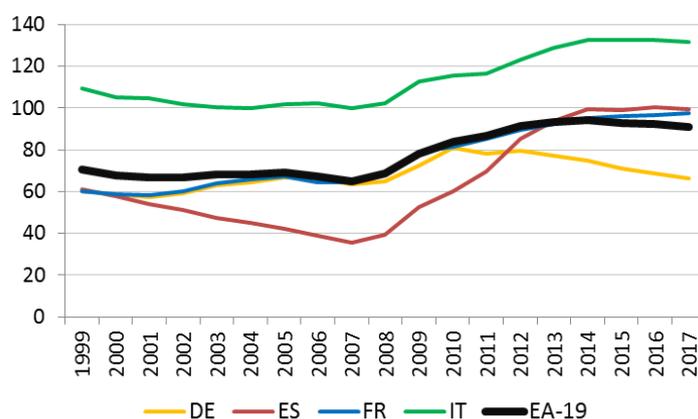


Graph 6 shows the Discretionary Fiscal Effort (DFE), which is another way of estimating the tone of fiscal policy. This is a complementary indicator to the change in the structural (primary) balance. Both the DFE and the change in the structural balance signal that the bulk of the fiscal adjustment undertaken in the euro area over the past years stemmed from revenue increases rather than cuts in expenditures.

Graph 7. Composition of the fiscal adjustment: expenditure side 2009-17, euro area (% GDP)



Graph 7 shows that the compression of government investment was particularly large and played a significant role in the fiscal consolidation. **Graph 8. Government debt-to-GDP ratio since the euro: average and selected Member States (%)**



Graph 8 shows the evolution of government debt as a share of GDP since 1999 for the euro area average and Germany, Spain, France and Italy. On average euro area government debt steadily increased between 2007 and 2014. It started decreasing in 2015 and is expected to continue to do so in 2016 and 2017. The developments of government debt and its overall level are uneven across Member States.

Annex 2. Output and spillover effects of fiscal policy²

The impact of fiscal policy on economic activity and its spillovers across euro area countries is a much debated issue, and it is particularly topical in the current discussion on the appropriate economic policy for the euro area. The model (QUEST) used by the services of the Commission can serve to assess the impact of fiscal expansion in surplus countries on the euro area economy (see In 't Veld 2016). In particular, the simulations consider debt-financed increases in government investment in Germany and the Netherlands. The analysis assumes that monetary policy in the euro area operates in a zero interest rate environment for two years. This is consistent with the European Commission's forecast of euro area inflation remaining low and below target in 2017-18.

The QUEST simulations show that fiscal multipliers (the impact of fiscal policy on GDP) and the spillover effects (the impact on other countries' GDP) are much larger if monetary policy operates in a zero interest rate environment, compared with normal times. If inflation was at target and the euro area economy operating at full capacity ("normal times"), a fiscal expansion in Germany and the Netherlands would logically lead to a tightening of monetary policy, in the sense of a rise of interest rates. This would crowd out private demand and dampen the positive GDP response. GDP spillovers in other euro area regions would be negligible as positive trade spillovers from the fiscal expansion would be offset by lower domestic demand, due to higher interest rates.

However, at the current juncture, with zero interest rates, multipliers and spillovers effects are larger. In the case of high efficiency of public investment, in line with other studies on infrastructure investment, additional government investment of 1% of GDP in Germany and the Netherlands, sustained over 10 years, could raise domestic GDP by 1.1 and 0.9 per cent, respectively. There is a somewhat smaller positive GDP effect for the Netherlands, as the country is characterised by larger trade openness, which implies stronger demand leakage to imports. Over the 10-year horizon, real GDP in Germany and the Netherlands would increase by more than 2 per cent. Long-term GDP effects exceed the short-term impact because government investment raises the productivity of private capital and labour over a sustained period of time (positive supply effect).

In this scenario, the real GDP in other euro area regions (France, Italy, Spain and the rest of the euro area) would increase by around a range of 0.3-0.5 percentage points already after one year. The spillovers derive from the direct trade effect (more exports to Germany and the Netherlands) and some depreciation of the exchange rate (more exports also to the rest of the world).

The impact on public finances in Germany and the Netherlands is not as unfavourable as might be expected, as higher growth would also boost tax returns. Government debt would in fact be less than 2% of GDP higher in Germany after ten years, and a bit more in the Netherlands, while debt ratios in the rest of the euro area would actually fall by around 2 percentage points due to the positive GDP spillover. In case of a permanent increase in public investment, debt ratios in Germany and the Netherlands would actually decline in the long run and the stimulus would become self-financing.

² See In 't Veld, J. (2016): Public Investment Stimulus in Surplus Countries and their Euro Area Spillovers, European Economy Economic Brief 16. See also Blanchard, O., Ch. Erceg, J. Lindé (2015): Jump Starting the Euro Area Recovery: Would a Rise in Core Fiscal Spending Help the Periphery?, NBER Working Papers 21426.