Box 3

FISCAL POLICY IN THE EURO AREA IN 2020: OUTLOOK AND ASSESSMENT

In October, the euro area countries submitted their draft budgetary plans for 2020 to the European Commission (EC) in fulfilment of their commitments within the European economic policy surveillance framework. According to these plans, the aggregate euro area budget deficit will remain practically unchanged in 2020, at 0.8% of GDP (see Chart 1), while public debt will continue to trend downwards, falling from 86.4% of GDP in 2019 to 85.1% in 2020, assisted by an environment of very low interest rates and moderate economic growth.

The draft budgetary plans indicate that the euro area aggregate fiscal stance will be slightly expansionary for the second consecutive year, so that the area's structural primary deficit will increase by 0.4 percentage points (pp) in 2020 (see Charts 2 and 3).[1] This stance stems from the fiscal policies of the countries that make up the euro area. Specifically, as seen in Chart 3, Germany and the Netherlands plan to ease their fiscal policies in 2020, as they have done in 2019, with a reduction in the primary structural surplus of 0.7 and 0.8 pp of their potential GDP, respectively. Among the largest economies in the area, Italy also proposes to conduct a fiscal expansion. Meanwhile, France and Spain foresee a neutral stance, with a structural deficit that will remain practically unchanged.

In its initial assessment of these fiscal plans, the EC has indicated that eight countries (Belgium, Finland, France, Italy, Portugal, Slovenia, Slovakia and Spain) have a high risk of non-compliance with the requirements of the Stability and Growth Pact (SGP).[2] In fact, a majority of the countries that are failing to meet their medium-term objectives,[3] within the framework of the "preventive arm" of the SGP, or that are not reducing their high levels of debt in accordance with European fiscal rules have discontinued the fiscal consolidation required to rebuild the necessary budgetary room for manoeuvre.

In this context, the European Fiscal Board (EFB) recommended in June a neutral fiscal policy stance for the euro area at aggregate level, on the grounds that the slowdown in the European economy is temporary and output is close to potential. According to this institution, the aggregate neutral orientation of budgetary policy should be the result of appropriate differences across countries, so that those with fiscal space[4] should make full or partial use of it, while the other countries should keep their public finances on a path of improvement in line with SGP requirements.

As detailed above, therefore, the budgetary plans of the countries are not necessarily in line with SGP requirements or EFB recommendations. Specifically, some countries at risk of non-compliance and without any fiscal space, such as Italy (see Chart 4), plan to conduct a budgetary expansion that would contravene EFB recommendations. At the same time, other countries, such as Germany and the Netherlands, that have space available, could conduct a more expansionary fiscal policy and still comply with SGP requirements and EFB recommendations.

The achievement of an appropriate fiscal policy stance in the euro area, resulting from the actions of the individual countries based on the principles discussed above, is especially important in the current context in which, although the accommodative stance of monetary policy has been intensified, signs of activity weakness continue to be discerned and notable downside risks remain. In this respect, in recent months, opinions have been expressed in various quarters emphasising the need to rebalance the economic policy mix and to consider greater fiscal activism at European level, especially in view of the risks to economic growth and the low current cost of public borrowing.[5] In these circumstances, the effectiveness of a possible fiscal stimulus in terms of

1 The primary structural balance is a measure of the budgetary balance that reflects the discretionary decisions of the authorities, since it discounts both the effects of the cycle on the public finances and interest expense.

2 This assessment is set out in the document on the overall assessment of 2020 budgetary plans.

3 The medium-term objective of a member country is the structural balance that such country needs to achieve in order to ensure compliance with the 3% deficit target, taking into account the need to converge towards prudent debt levels and the future budgetary requirements arising from population ageing.

4 Defined as the distance between its structural balance and the medium-term objective (MTO) of the SGP.

5 This call for greater fiscal activism has grown recently. See, for example, L. de Guindos (2019), "Improving macroeconomic stabilization in the euro area", speech at the conference "Global Interdependence Center Central Banking", Madrid, 3 October. The call for flexible use of the SGP contained in the guidance addressed in September 2019 to the Economic Commissioner by the new President of the European Commission should be seen in the same light.

Chart 1
FISCAL OBJECTIVES FOR 2020

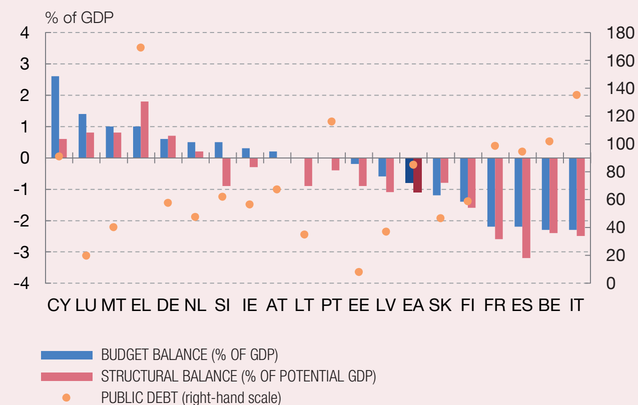


Chart 2
CONTRIBUTION TO OVERALL FISCAL STANCE
OF EURO AREA, BY COUNTRY

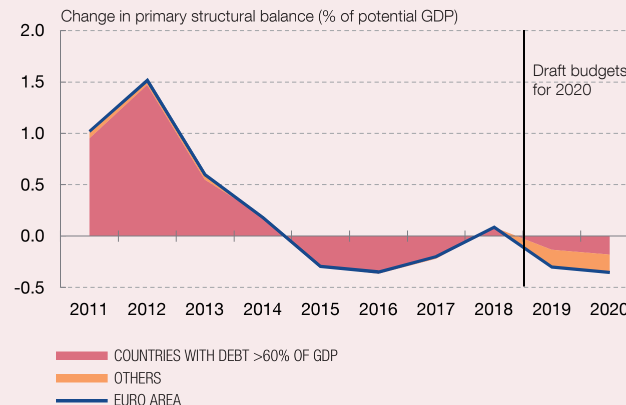


Chart 3
FISCAL STANCE, CYCLE AND COMPLIANCE WITH SGP IN EURO AREA IN 2020 (a) (b)

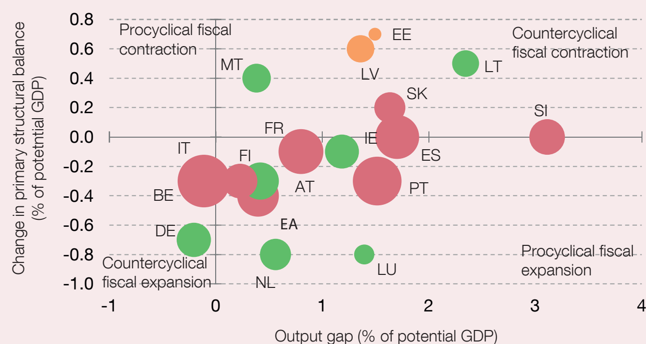


Chart 4
USE OF FISCAL SPACE IN 2020

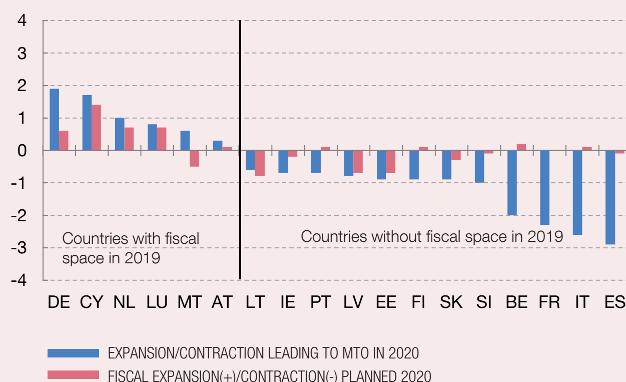


Chart 5
PUBLIC INVESTMENT (GFCF)
Advanced economies

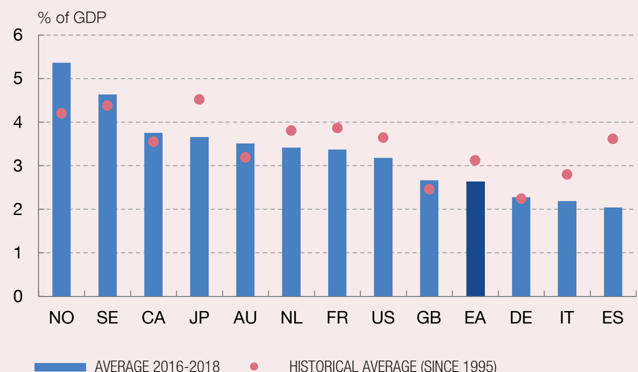
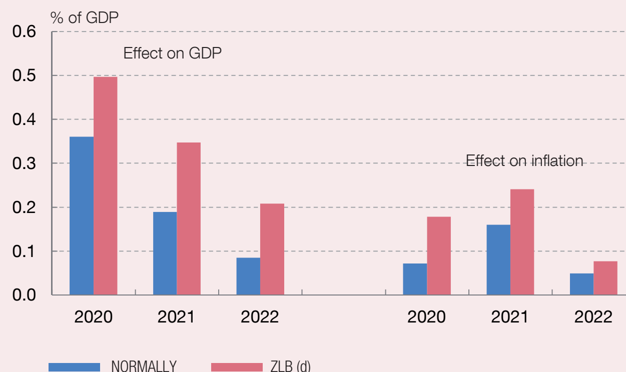


Chart 6
FISCAL EXPANSION IN COUNTRIES WITH FISCAL SPACE
Impact on real GDP and inflation in the euro area (c)



SOURCES: European Commission, OECD and own calculations.

a The size of the circles denotes the level of public debt (as a % of GDP). The colour denotes the risk of non-compliance with the SGP: red (risk of non-compliance), orange (broadly compliant) and green (compliant).
b Data for Greece and Cyprus not included so as not to distort the picture.
c Expansion of public investment in countries with fiscal space in 2019 if all the fiscal space is used. Own calculations, using the NiGEM Global Macroeconomic Model.
d ZLB: zero lower bound (zero nominal interest rates).

growth could be enhanced, insofar as monetary policy is operating at around the effective lower bound on interest rates, so that, in principle, rates would not rise in the event of a fiscal expansion.

Among the instruments available, a fiscal policy focused on boosting public investment could have a significant impact, since this instrument (according to the available empirical evidence) has the most potent associated multiplier effect and the capacity to generate greater effects in the region as a whole and to increase the economy's potential growth.[6] The fact that public investment has suffered a notable decline since the crisis and that its current levels are relatively low in those countries that have budgetary room for manoeuvre, reinforces the argument in favour of this type of strategy (see Chart 5).

However, achieving an improved economic policy mix at European level is extraordinarily complex in the current institutional framework; fiscal policies are designed at national level and there are no mechanisms to help internalise the importance of achieving an appropriate policy mix at aggregate level, apart from the advisory work of the EFB. Consequently, fiscal instruments centralised at euro area level need to be designed to enable a fiscal policy appropriate for the euro area as a whole to be automatically achieved. Certain initiatives that attempt to fill part of this institutional gap, such as the recently agreed budgetary instrument for convergence and competitiveness (BICC)[7] and the current European investment plan (EFSI)[8] should be welcomed.

In order to illustrate the possible macroeconomic impact of a strategy of budgetary expansion within the current limits of the European fiscal policy institutional framework, Chart 6 presents a simulation exercise performed with the NIGEM macro-econometric model.[9] Specifically, a temporary boost to public investment is considered, exclusively in those countries with fiscal space available, assuming it is fully utilised in 2020, with a magnitude of 0.6 pp of GDP for the euro area as a whole.[10] Chart 6 shows two scenarios, one in which there is no monetary policy reaction and interest rates remain unchanged, and another in which there is a monetary policy reaction in accordance with historical patterns, with an increase in interest rates to offset the inflationary pressures resulting from the fiscal expansion. The results of the simulations indicate that an expansionary fiscal policy focused on public investment would raise euro area GDP and inflation, relative to the baseline scenario. Moreover, these estimated impacts would be greater with a monetary policy that keeps interest rates unchanged at their lower bound. In this case (more in line with the current context), the effect on euro area GDP would reach its peak in the first year, with an increase in output of up to 0.5 pp above its baseline level, and slowly fade thereafter.[11, 12] The effect on inflation, in contrast, would be greatest in the second year, when the rate would stand 0.25 pp above its baseline level.

6 See, inter-alia, Banco de España (2017), Annual Report 2016, Chapter 4, "fiscal policy in the euro area"; Ó. Arce, S. Hurtado and C. Thomas (2016), "Policy spillovers and synergies in a monetary union", ECB WP 1942, August; V. A. Ramey (2019), "Ten years after the financial crises: what have we learned from the renaissance in fiscal research?", NBER WP 25531; M. Alloza, P. Burriel, J. J. Pérez (2019), "Fiscal policies in the euro area: revisiting the size of spillovers", Journal of Macroeconomics, forthcoming; M. Alloza, B. Cozmanca, M. Ferdinandusse and P. Jacquinot (2019), "Fiscal spillovers in a monetary union", ECB Economic Bulletin, Issue 1/2019.

7 For an explanation of this instrument, see https://www.consilium.europa.eu/es/policies/emu-deepening/bicc-faq.

8 Although the EFSI has mobilised a significant amount of investment, the European Court of auditors has concluded that for some of the projects financed, EFSI support just replaced other financing (see https://www.eca.europa.eu/en/Pages/NewsItem.aspx?nid=9010).

9 The NiGEM model is built by the UK National Institute of Economic and Social Research. The model documentation is available at https://nimodel.niesr.ac.uk/.

10 Specifically, the fiscal stimuli of Germany (with a figure close to 1.9% of potential GDP), the Netherlands (1%) and Austria (0.3%) would stand out.

11 According to this model, the spillover effects of this fiscal stimulus on the GDP of the large economies of the euro area, such as Spain, Italy and France, are positive, although moderate, amounting to around 0.2 pp of GDP, with respect to the baseline scenario.

12 In line with the empirical evidence, the effects associated with an increase in public investment would be greater, especially in the medium term, than those obtained by simulating a fiscal stimulus through government consumption. In this case, with an accommodative monetary policy, euro area GDP would stand 0.4 pp higher than its baseline level in the first year, but this effect would subsequently fade much more quickly than in the case of a public investment stimulus.