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CHAPTER 4

FISCAL POLICY IN THE EURO AREA

DIRECTORATE GENERAL ECONOMICS, STATISTICS AND RESEARCH

AIMS OF THE CHAPTER

The chapter addresses three current fiscal policy debates:

1. Could fiscal policy play a more active role in the current phase of economic recovery in the euro area?

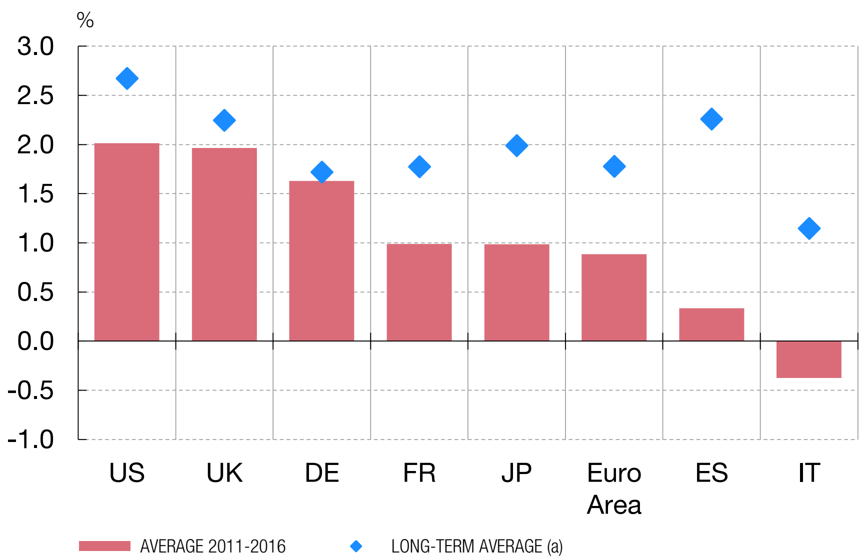
2. Beyond the current conjunctural situation, should the euro area equip itself with a supranational, stabilising budgetary capacity that reinforces national fiscal policies?

3. Is the current euro area budgetary framework appropriate?

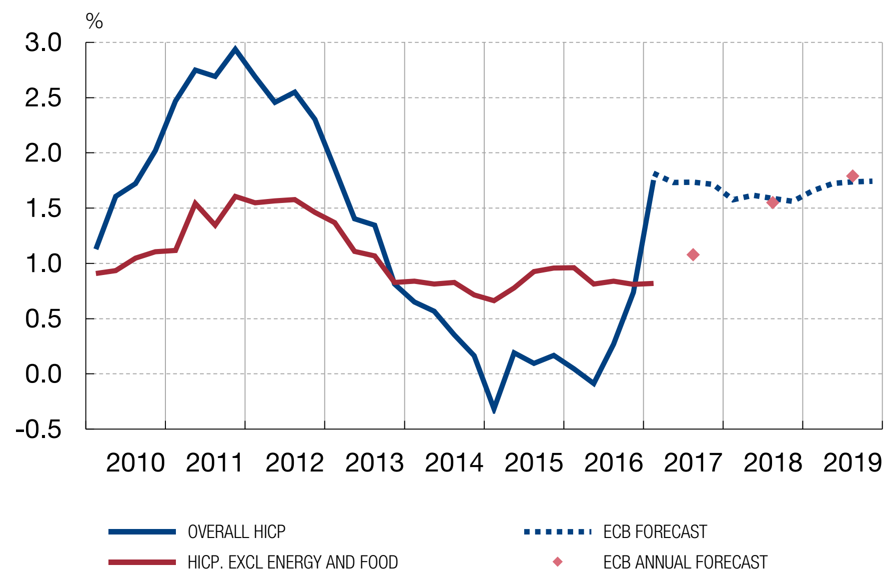
THE ROLE OF FISCAL POLICY IN THE CURRENT SITUATION

Ten years after the international financial crisis broke, the euro area remains in a scenario of moderate growth and low inflation, highly dependent on the extraordinary stimulus stemming from monetary policy. Against this backdrop, a debate has arisen on the role fiscal policy should play to support the recovery.

GDP GROWTH



INFLATION



SOURCES: European Commission, Eurostat, ECB and IMF.

a Average growth: 1980 to 2016.

SYNERGIES BETWEEN MONETARY AND FISCAL POLICY (I)

In the current circumstances there may be positive synergies between monetary policy and fiscal policies. The expansionary monetary policy stance has had a favourable impact on economic and financial variables, contributing to reducing the budget deficit. Moreover, the costs of financing a fiscal expansion are lower in a setting of low interest rates and strong demand for public debt securities.

PUBLIC DEBT INTEREST SPENDING DYNAMICS (2014-2016) AND ESTIMATED DIRECT IMPACT OF THE ECB PURCHASE PROGRAMME

	Interest spending (% of GDP)		Implicit interest rates (%)		Estimated direct impact of the ECB purchase programme (a)
	2014	2016	2014	2016	Savings on interest spending, (2014-2016) % of GDP
Euro area	2.7	2.2	2.9	2.5	
Germany	1.8	1.4	2.4	2.0	0.1
France	2.2	1.9	2.3	2.0	0.3
Italy	4.6	4.0	3.5	3.0	1.3
Spain	3.5	2.8	3.5	2.8	0.9
Netherlands	1.4	1.1	2.1	1.7	0.1
Belgium	3.3	2.9	3.1	2.7	0.2

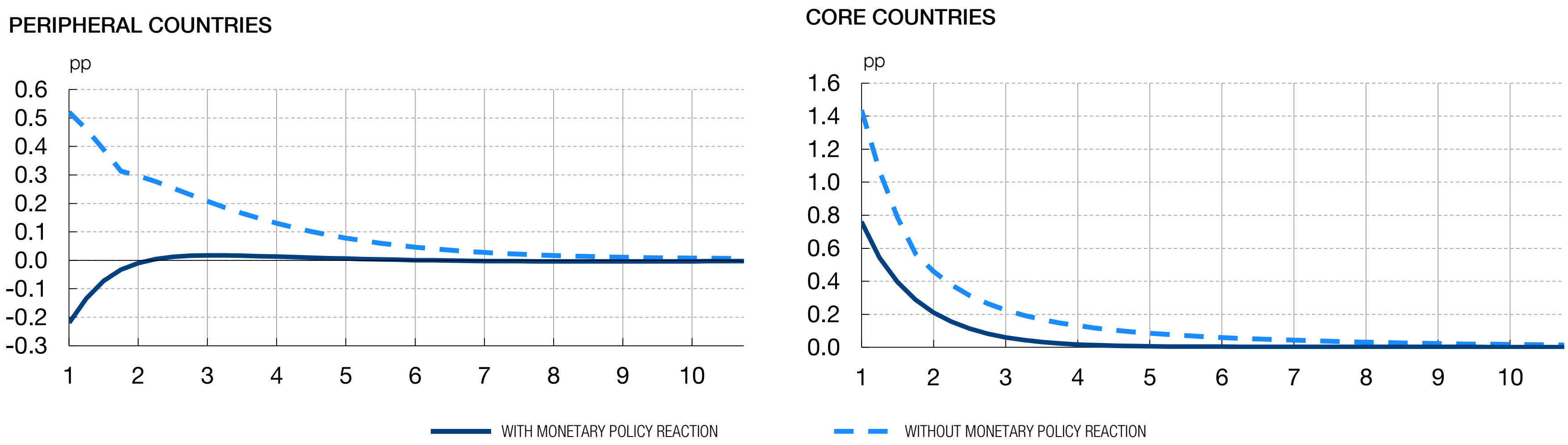
SOURCES: Eurostat and Banco de España.

a Differences with respect to a counterfactual exercise in which, in the absence of the programme, interest rates would have trended in line with what was projected in May 2014 (market forward rates).

SYNERGIES BETWEEN MONETARY AND FISCAL POLICY (II)

In a context of low growth and inflation, an expansionary fiscal policy in the countries with budgetary space may have a greater impact on the euro area as a whole if, in parallel, the central bank maintains the degree of monetary accommodation. In this case, the positive spillover effects from one country to another are strengthened.

MARGINAL EFFECT OF A FISCAL EXPANSION IN THE CORE EURO AREA COUNTRIES ON GDP (a)



a Deviations from the baseline scenario. Simulations of a fiscal expansion of 1% of GDP performed with the model by Ó. Arce, S. Hurtado and C. Thomas (2016), “Synergies between monetary policy and national policies in a monetary union”, Economic Bulletin, October, Banco de España.

FISCAL SPILLOVER EFFECTS

The empirical estimates available show that public investment, advisably targeted on projects with the capacity to improve efficiency and growth in the economy, might be the instrument to implement a coordinated budgetary stimulus policy, on the basis of its expansion in those countries which have sufficient budgetary space.

SPILLOVER EFFECTS OF PUBLIC SPENDING ON GPD (a)

Fiscal Policy Instrument →	Govermment consumption and public investment			Public investment		
	By origin			By origin		
Country of origin of the fiscal stimulus, and impact on the other countries	Impact	1 year	2 years	Impact	1 year	2 years
Germany	0.0	0.2	0.5	0.2	0.9	1.9
France	0.2	-0.1	1.2	0.9	0.5	2.1
Italy	-0.1	0.4	0.9	0.0	0.9	2.2
Spain	0.1	0.8	1.6	-0.2	1.4	2.1
TOTAL	0.0	0.3	1.0	0.4	0.8	2.1

SOURCES: Alloza, M., P. Burriel, y J. J. Pérez (2017), "Coordinated Fiscal Policies in the Euro Area: Revisiting the Size of Spillovers". Banco de España Working Paper, forthcoming.

a The spillover effect by origin reflects the degree to which an increase in public spending in one country affects the activity in the remaining countries. For example, taking the first row of the table, relating to "Germany", the effect by origin of 0.5 after two years indicates that a fiscal expansion based on the combination of government consumption and public investment in this country generates an effect on the remaining euro area countries equivalent to half the initial expansion, while a boost to public investment would generate an effect of 1.9 after two years.

FISCAL SPACE IS HIGHLY HETEROGENEOUS ACROSS COUNTRIES

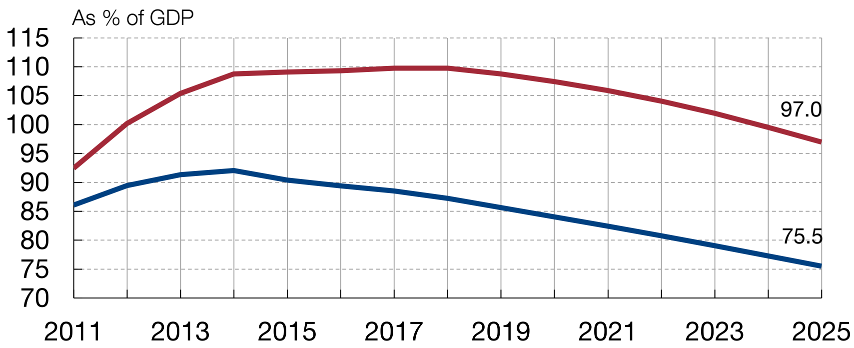
The budgetary space in a good number of countries is limited, given the high levels of debt and the requirements of the rules-based framework.

Against this background, expansionary fiscal measures would only be warranted, without compromising the sustainability of public finances, in a small number of countries with fiscal space.

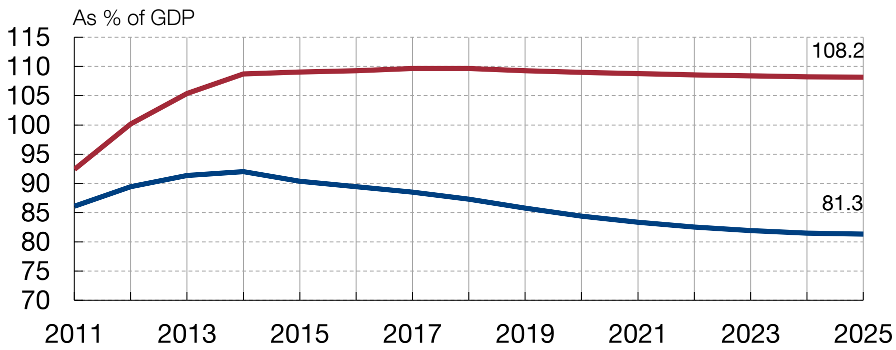
The remaining countries should focus on achieving more growth-friendly fiscal consolidation.

EURO AREA PUBLIC DEBT: CURRENT SITUATION AND DEVELOPMENTS UNDER ALTERNATIVE ASSUMPTIONS (a)

BASELINE SCENARIO



SCENARIO WITHOUT FISCAL POLICY CHANGES



EURO AREA AGGREGATE   AGGREGATE OF SPAIN, ITALY AND FRANCE

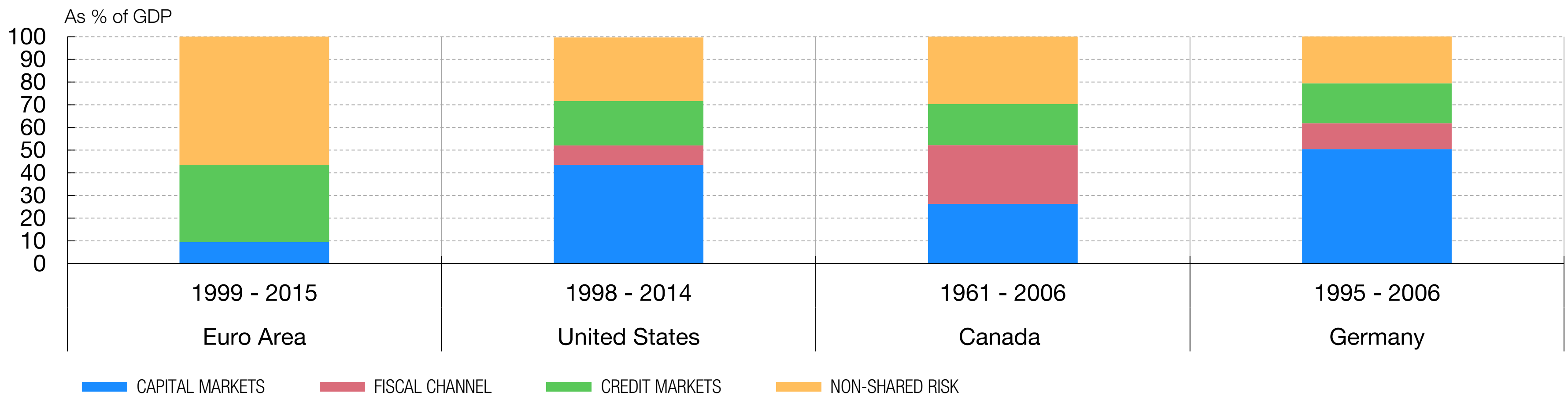
SOURCE: Banco de España.

a In the left-hand panel, it is assumed as a baseline scenario that the euro area countries meet their budgetary targets as set in the European Stability and Growth Pact over the simulation horizon. In the right-hand panel, it is assumed that the fiscal policy stance remains in line with the fiscal policy observed in 2016. The simulations are conducted on the basis of the end-2016 data, the European Commission's medium-term macroeconomic forecasts and the price stability objectives set by the ECB. The details of the simulation tool are described in P. Hernández de Cos, D. López and J. J. Pérez (2017), "Los retos del desapalancamiento público", Documento Ocasional del Banco de España.

THE NEED FOR A CENTRALISED BUDGETARY CAPACITY IN THE EURO AREA

The creation of a fiscal capacity at the supranational level to address aggregate or idiosyncratic shocks would contribute to increasing the scope of fiscal policy in the euro area. The need for these types of instruments is justified by the evidence showing that other more complete monetary unions have more powerful public and private mechanisms to withstand shocks affecting a country or region.

STRENGTH OF RISK-SHARING CHANNELS (a)
INTERNATIONAL COMPARISON



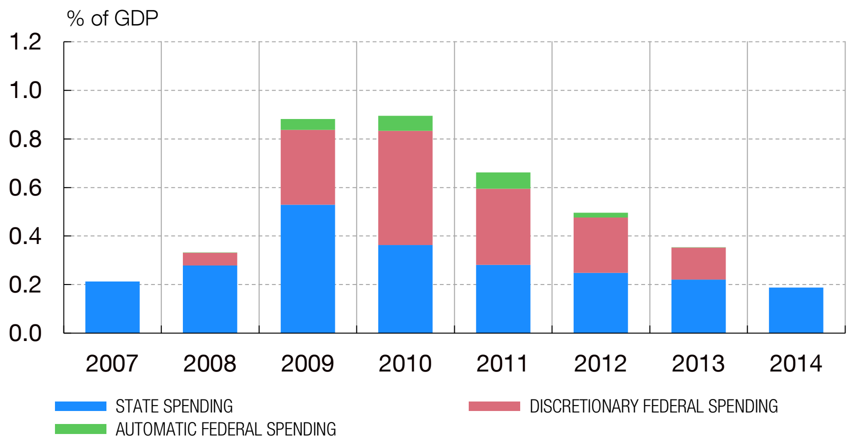
SOURCE: Banco de España.

a Estimated following the methodology of Asdrubali et al (1996), which approximates the percentage of shocks recorded in an economy's GDP that pass through to that economy's residents' income and consumption decisions. The channels that enable the impact of the shocks to be softened are, firstly, the capital markets channel whose strength depends on the income that residents obtain from other countries not affected by the shock because they hold shares in the companies of those countries and obtain income from labour and from other financial assets. Secondly, the shock may be softened by public intervention through fiscal transfers from the federal budget, as in the case of the United States, or from other regions (fiscal channel). Finally, households and firms in that economy may smooth their consumption by resorting to their savings or to the credit market (credit channel).

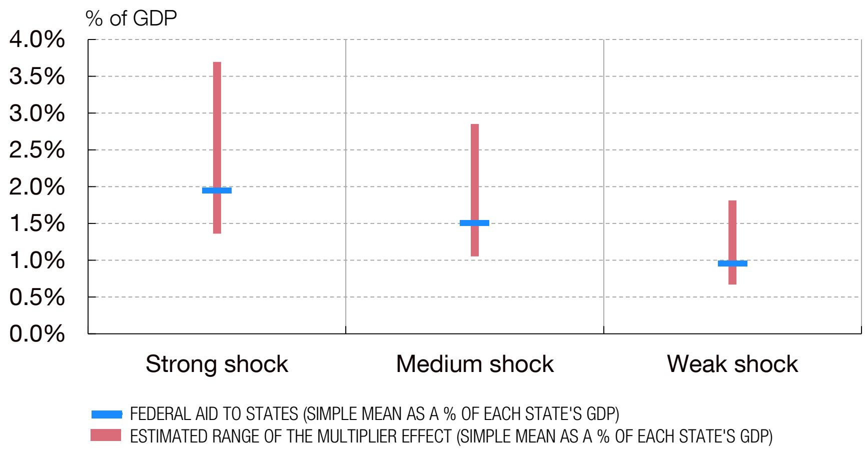
FEDERAL UNEMPLOYMENT INSURANCE IN THE UNITED STATES

For example, the United States has federal unemployment insurance which complements the unemployment coverage arrangements in each State. This fund builds up reserves during expansionary phases and is only activated in crises by means of loans to State accounts or direct transfers to the unemployed, of an automatic or discretionary nature. The impact of these transfers during the recent crisis was notable.

FEDERAL AND STATE SPENDING ON UNEMPLOYMENT TRANSFERS



TRANSFERS AND IMPACT OF THE FEDERAL UNEMPLOYMENT SYSTEM (a)



SOURCES: US Department of Labor, US Bureau of Economic Analysis and own calculations.

a The States are classified in three groups, depending on the size of the increase in the State unemployment rate, in terms of percentage points. The expenses and economic effects are calculated relative to each State's GDP. The range of the multipliers includes a minimum coefficient of 0.7 and a maximum coefficient of 1.9, consistent with the CBO 2010 analysis, *Policies for Increasing Economic Growth and Employment in 2010 and 2011.*

A CYCLICAL STABILISATION FUND FOR THE EURO AREA

The creation of a stabilisation fund in 1999, when certain cyclical conditions were met, would have enabled a risk-sharing capacity (in terms of insurance or fiscal stabilisation) similar to that in the United States to have been achieved, without having committed major resources or permanent income transfers between countries. However, its design would not have obviated the difficulties in estimating countries' cyclical position in real time.

SIMULATION OF THE CONTRIBUTIONS AND FUNDS RECEIVED UNDER A HYPOTHETICAL SCHEME. AVERAGE 1999-2015

% of GNP

	CYCLICAL INSURANCE SCHEMES (based on the output gap) (a)			
	Scheme 1		Scheme 2	
	Contribution	Receipt	Contribution	Receipt
Euro area	1.0	1.0	0.2	0.2
Belgium	1.0	0.3	0.2	0.1
Germany	1.0	0.7	0.1	0.2
Greece	1.0	2.5	0.3	0.5
Spain	1.0	2.1	0.3	0.4
France	1.0	0.5	0.3	0.1
Italy	1.0	1.1	0.2	0.2
Netherlands	1.0	1.2	0.1	0.3
Austria	1.0	0.5	0.1	0.1
Portugal	1.0	1.3	0.2	0.3
Finland	1.0	0.9	0.2	0.2
Memorandum item: Stabilisation capacity	0.37		0.15	

a In Scheme 1, the countries make a set contribution of 1% of GNP and receive a transfer when their output gap is negative. The amount of the benefit is determined on the basis of the country's size, its output gap and the size of the fund. In Scheme 2, the countries make contributions to the fund if they have a positive output gap, while they receive a transfer if the gap is negative. The amount of the transfer and of the contribution of each country is 25% of the size of the output gap. For further details see E. Gordo (2017), "The risk-sharing mechanisms in EMU", forthcoming. The stabilisation capacity refers to the percentage of the adverse shock which is softened with each schema, where 1 would represent the maximum possible percentage (100%).

COMMON UNEMPLOYMENT INSURANCE IN THE EURO AREA

Other papers propose the creation of a common unemployment insurance. The main challenge with this type of fund in the euro area context is to prevent cross-country redistributive effects given the heterogeneity in labour market institutions and in starting unemployment levels.

SIMULATION OF THE CONTRIBUTIONS AND FUNDS RECEIVED UNDER A HYPOTHETICAL SCHEME. AVERAGE 1999-2015

% of GNP

	COMMON UNEMPLOYMENT SUBSIDY SCHEMES (a)			
	Scheme 1		Scheme 2	
	Contribution	Receipt	Contribution	Receipt
Euro area	0.5	0.5	0.5	0.5
Belgium	0.5	0.4	0.4	0.4
Germany	0.5	0.3	0.4	0.3
Greece	0.4	0.6	0.5	0.6
Spain	0.5	1.1	1.0	1.1
France	0.5	0.6	0.6	0.6
Italy	0.5	0.4	0.4	0.4
Netherlands	0.6	0.4	0.4	0.4
Austria	0.4	0.3	0.3	0.3
Portugal	0.5	0.5	0.4	0.5
Finland	0.4	0.6	0.6	0.6
Memorandum item: Stabilisation capacity	0.08		0.02	

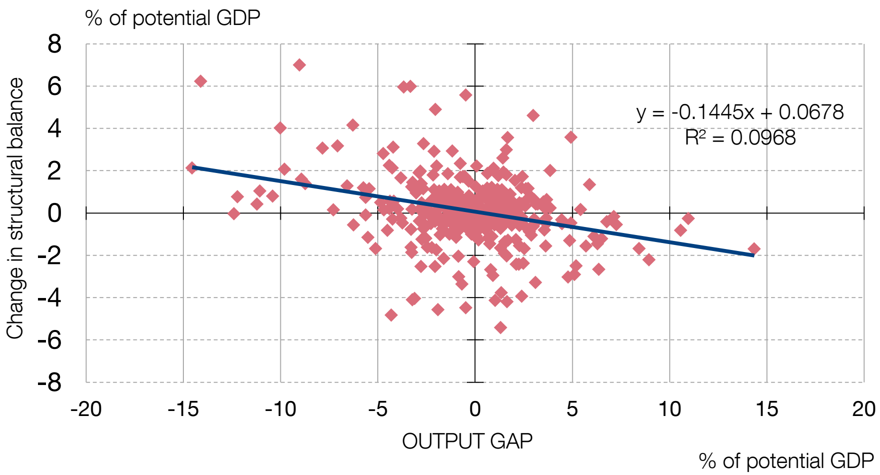
SOURCE: Banco de España.

a In the simulation of both funds, the transfers each country receives are determined on the basis of the level of short-term unemployment and of the average wage in the economy, with a correction factor of 0.8, under the assumption that the unemployed have wages lower than the average. Also assumed are a coverage rate for the system of 0.4% and a replacement rate (level of the benefit relative to the previous wage) of 0.5%. In scheme 1, the contribution is the same for all the countries and varies over time to bring into equilibrium the balance of the fund over an average of five years. In scheme 2, the contribution differs for the countries, with the aim of bringing into equilibrium the country's balance in the fund over an average of five years. For further details see E. Gordo (2017), "The risk-sharing mechanisms in EMU", forthcoming. The stabilisation capacity refers to the percentage of the adverse shock which is softened with each scheme, where 1 would represent the maximum possible percentage (100%).

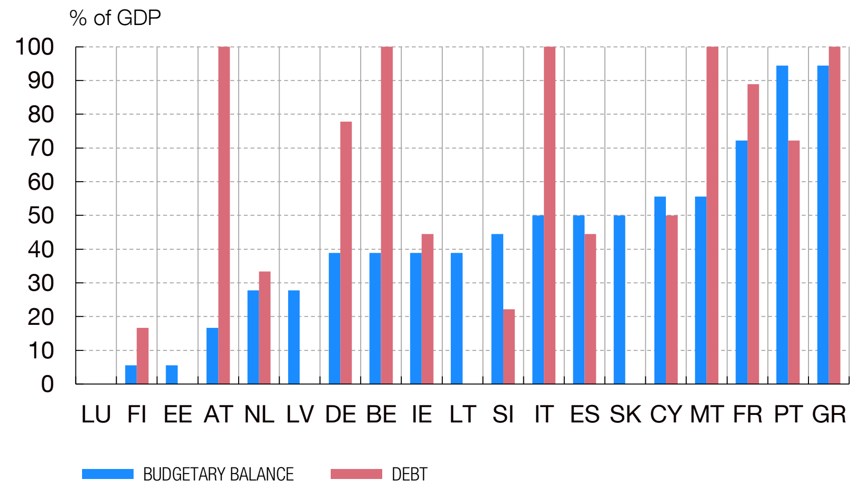
THE FISCAL RULES SHOULD BE SIMPLIFIED

Fiscal policy has broadly been procyclical since the birth of the euro area. Recent reforms have been aimed at correcting these implementation shortcomings. However, the framework of fiscal rules has become very complex, thereby hampering their application. The framework should be simplified and its supervisory and control tools strengthened.

FISCAL POSITION AND OUTPUT GAP OF THE EURO AREA



PERCENTAGE OF FAILURES TO FULFIL THE BUDGET DEFICIT AND PUBLIC DEBT CRITERIA (a)



SOURCE: AMECO.

a Percentage of years between 1999 and 2016 in which the budget deficit was higher than 3% of GDP and the debt ratio was higher than 60% of GDP.

CONCLUSIONS

There are several factors that might, in the current circumstances, justify using fiscal policy in the euro area as an instrument to boost economic activity.

- Monetary policy is acting alone as regards demand-side policies.
- Fiscal policy is more effective in a low-growth, low-interest-rates and low-inflation environment, as is the current situation.
- Fiscal spillover effects in the euro area may be significant.

However, there are significant limits on discretionary measures in the euro area:

- There are no centralised mechanisms for taking action.
- The budgetary position of the countries is highly heterogeneous: “fiscal space" is generally limited, meaning that country- and instrument-based measures must be appropriately structured.

In the euro area, the lesser strength of risk-sharing private and public mechanisms relative to other economic areas highlights the advisability of designing supranational fiscal instruments to withstand adverse shocks.

As to the framework of fiscal rules, some simplification would be appropriate, as would giving a greater weight to the medium-term anchors (public debt and the expenditure rule) and strengthening supervision and control tools.