

European Fiscal Board

**Assessment of the
fiscal stance appropriate for the euro area in 2023**

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CONTENTS

Foreword	3
Key messages	4
1. Macroeconomic situation and outlook	5
2. Fiscal policy developments	9
3. How to gauge cyclical conditions beyond real-time output gap estimates	13
Graphs and tables	18
Glossary	28

FOREWORD



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When the pandemic struck in March 2020 the Commission proposed, and the Council agreed, to make use of the severe economic downturn clause to enable economic governance to be implemented with the flexibility temporarily required. Together with the ECB's massive monetary accommodation and the adoption of the Next Generation EU initiative, recourse to the clause became a vital part of the crisis response.

However, the clause has been interpreted more widely than the authority it confers to the Commission and the Council. The perception rules had been suspended by a 'general escape clause' clashes with the provisions of the Stability and Growth Pact, and the condition of maintaining fiscal sustainability in the medium run was only assessed in a perfunctory way. Also, the Commission considered the definition of severe economic downturns laid down in EU law too restrictive, and suggested a new criterion: the pre-pandemic output level of the euro area or the EU. This level has in the meantime been surpassed.

In spring 2021, when preparing policy guidance for 2022, the economic recovery from the pandemic was already far advanced. Had it proceeded as projected, it is safe to assume the clause should and would have lapsed at the end of 2022. However, the war in Ukraine, with its impact on the EU economy and public finances through multiple channels, led the Commission to propose making use of the clause for another year. Not all Member States are convinced of this proposal, but the Council is likely to go along. Does this matter for the policy guidelines for 2023? We believe it does matter. The Commission issued mostly qualitative guidance,

differentiated to some extent between two groups of Member States. However, given the extensive interpretation of the severe economic downturn clause, compliance with more specific advice may not improve. After two years of maintaining the position that fiscal support should not be withdrawn prematurely, the Commission is now calling for a 'prudent' orientation of fiscal policy. Its guidance distinguishes between 'high-debt' and 'low/medium-debt' Member States, the former being advised to start a gradual fiscal adjustment to stabilise and reduce debt ratios.

Although the qualitative thrust of the fiscal recommendations for 2023 appears broadly appropriate, it is not clear what it entails for the euro area aggregate. The EFB believes a moderately restrictive impulse would be appropriate in 2023, in view of supply-chain bottlenecks, tight labour markets and persistent inflation pressures. But without quantitative recommendations anchored in agreed fiscal rules and procedures, the appropriate stance is unlikely to be delivered.

In September 2021, when relaunching the EU economic governance review, the Commission President set a clear deadline: reform proposals should be formulated 'well in time for 2023'. While this time reference has been confirmed, the continued recourse to the severe economic downturn clause eases the pressure on the Council to reach an agreement on updating the rules-based system. The identification of a 'common landing area' is proving difficult.

No rules-based system of economic governance can survive unless it provides sufficient flexibility to be used in a transparent and consistent manner. The severe economic downturn clause has provided flexibility in truly extraordinary circumstances. However, the time is approaching fast to shift the focus towards the more regular challenge: contain the long-term trend of public expenditure rising faster than public revenue and prepare for future crises.

KEY MESSAGES

- The severe economic downturn caused by the Covid-19 pandemic was followed by a strong rebound, which was expected to continue well into 2023 with an annual average increase in real GDP of more than 4%. This bright outlook was darkened by the war in Ukraine. Its fallout is now expected to shave around 1.5 percentage points off economic growth in 2022.
- The projected economic impact of the war in 2023 is more modest. Real GDP is expected to increase by 2.3%, above the rates observed in the pre-pandemic years, largely due to robust consumer spending to use bottled-up savings and due to a rise in investment.
- The Commission forecasts inflation to peak in 2022 and then fall back to 2.7% in 2023. However, inflation has been surprising on the upside. Wage growth has been moderate so far, despite the continued fall in unemployment and emerging signs of broader labour shortages.
- The Commission presented two alternative downside scenarios in its spring forecast to illustrate the uncertainty surrounding the economic outlook. Due to the strong momentum carried over from 2021, neither of the two scenarios anticipates that annual real GDP in the euro area will fall in 2022 or 2023.
- While acknowledging that the previously indicated conditions for the use of the severe economic downturn clause are no longer met, the Commission made an “overall assessment” and argued that the clause should still be used for another year, mainly on account of the high degree of uncertainty.
- The war in Ukraine has triggered an adverse terms-of-trade shock that reduces the economy’s real disposable income and affects aggregate supply. Fiscal policy should focus on protecting vulnerable households through targeted and temporary redistributive measures. Conventional demand management would prove counterproductive as it cannot address the causes of the slowdown and would aggravate inflationary pressure, complicating the ECB’s task to keep inflation in check.
- As a result, the EFB regards a moderately restrictive fiscal impulse to be appropriate in 2023. In contrast to past years, the Commission does not provide explicit guidance on the general orientation of fiscal policy in the euro area, but noted that “a broad-based fiscal impulse to the economy in 2023 does not appear warranted”.
- Fiscal consolidation is particularly important for high-debt countries. The targeted support measures brought in in response to energy price hikes should not deter these countries from putting public debt sustainably on a downward trajectory. More prudent fiscal positions would help align fiscal policy and monetary policy and help rebuild fiscal buffers for future crises.

1. Macroeconomic situation and outlook

The Covid-19 crisis has drawn more attention to the euro area fiscal stance. In normal times, the aggregation of national fiscal stances consistent with EU rules is likely to result in a fiscal stance appropriate for the euro area as a whole. However, this is less clear in the wake of large economic shocks, such as the one caused by the Covid-19 pandemic. The recourse to the severe economic downturn clause, in the public debate misleadingly dubbed ‘general escape clause’, allows for flexibility, provided this does not endanger fiscal sustainability in the medium-term. Fiscal policy coordination is needed to manage the use of this flexibility. During the pandemic, the notion of the aggregate euro area fiscal stance has been invoked by some observers to encourage a coordinated fiscal reaction to the crisis. The creation of the Recovery and Resilience Facility (RRF) provided a temporary EU-level instrument that impacts the aggregate fiscal stance.

The crisis put a premium on using precise language to describe the role of fiscal policy in macroeconomic stabilisation. A clear distinction must be made between *fiscal stance* and *fiscal impulse* (see European Fiscal Board, 2021). The European Fiscal Board (EFB) defines the discretionary fiscal stance as the structural primary balance in a given year. As such, it denotes the overall level of fiscal support provided by governments on top of automatic stabilisers. The EFB refers to the annual change in the fiscal stance as the fiscal impulse. The fiscal impulse can also be derived from the expenditure benchmark. The distinction between the fiscal stance and fiscal impulse is particularly relevant when the level of economic activity undergoes significant swings i.e. during major economic downturns and subsequent rebounds. For instance, a negative fiscal impulse might still be consistent with a highly supportive fiscal stance initiated the previous year(s). The fiscal stance and fiscal impulse are analysed against the level and the

expected change in prevailing cyclical conditions.

In 2023, economic growth is expected to slow as the war in Ukraine is holding back the strength of the recovery. After a sharp downturn due to the pandemic, the economy was expected to continue the strong rebound well into 2023. The war has severely clouded this outlook. In its central scenario, the Commission expects real economic growth in the euro area for 2022 to slow to 2.7%, around 1.6 percentage points lower than in its autumn 2021 projections before the war started. For 2023, the Commission projects real economic growth at 2.3%. The ECB and IMF project a similar growth rate, while in more recent forecasts the OECD is somewhat more pessimistic (see Graph 1.3). Despite the negative impact of the war, the baseline scenario still expects economic growth to remain slightly above the rates observed in the pre-pandemic years ⁽¹⁾. Given the exceptionally high degree of uncertainty on the economic outlook, both the ECB ⁽²⁾ and the Commission ⁽³⁾ have included alternative scenarios in their forecast, which are on the downside. The Commission’s simulations illustrate the heightened risk of a sharper slowdown, with growth at or close to zero in 2022 and still 1 percentage point below the baseline projected for 2023.

Strong consumer spending and robust gross fixed capital formation are still expected to be the main motor of growth in 2023. As the remaining lockdown measures linked to the Covid-19 pandemic are being removed, released bottled-up savings paired with strong job creation are projected to boost private consumption. Household spending is projected to contribute more than half of total real economic growth in 2023 and to rise at a rate far

(1) Real economic growth in the euro area averaged 2% between 2015 and 2019.

(2) [ECB staff macroeconomic projections for the euro area, June 2022](#)

(3) Commission Spring Forecast 2022 Thematic Special Topic ‘[Alternative scenarios on the economic outlook](#)’.

above the pre-pandemic average ⁽⁴⁾. Public and private investment is the second main driver of economic growth (see Graph 1.1). Total investment as a percent of GDP is expected to exceed its pre-pandemic level by around 1.5% of GDP ⁽⁵⁾, partly due to the surge in government investment spending, which is stabilising at 3.2% of GDP, nearly ½ % higher than it was before the pandemic. The RRF ⁽⁶⁾ accounts for close to one third of the increase. Moreover, the Commission estimates that the Next Generation EU (NGEU) initiative will lift euro area real GDP in 2023 by more than one percentage point. However, the war in Ukraine is dampening on consumer and business confidence. Real wages are likely to be depressed by the current terms-of-trade shock, which may curtail consumption and impede investment decisions by more than is currently anticipated.

The war in Ukraine triggered a major negative terms-of-trade shock for the euro area. The conflict aggravated existing supply-chain disruptions and led to a sharp increase in energy prices. Prices of other commodities produced by Russia and Ukraine followed suit. This caused a dramatic change in relative prices as imports to the euro area became significantly more costly. As substituting these imports is difficult in the short-term, this deterioration in the terms-of-trade results in a significant loss of real income for the euro area. The question is how that loss will be shared among firms, households and public finances in the different countries. The terms-of-trade shock hit the euro area when aggregate demand was very strong, labour markets were generally tight, and supply bottlenecks inherited from the pandemic were highly persistent. Pre-existing inflationary pressures continued to build rapidly, pushing inflation to rates not seen for decades and forcing some central banks to start a robust round of tightening. To be sure, when

formulating policy advice, it is clear that the problem of the day is not shortage of demand.

Euro area and EU GDP are above the pre-pandemic level but economic growth is expected to be weaker. Based on latest national accounts data, real annual output in the euro area and the EU surpassed 2019 levels already in 2022, and the overhang is expected to increase to around 4% in 2023. As a result, output is projected to recover a substantial share of the ground lost during the pandemic. At the same time, the euro area is unlikely to return to the path of economic expansion observed before the pandemic, especially in light of the additional supply-side shock caused by the war (see Graph 1.2). A recent assessment by the ECB points to constraints in supply chains that had already tightened in 2021 and early 2022 ⁽⁷⁾. These constraints are set to worsen as the war in Ukraine continues.

Not all Member States have been affected in the same way and to the same degree. Overall trade links with Russia and Ukraine are generally modest in the euro area countries. However, dependencies on Russia in specific commodity and energy markets have been put in the spotlight, posing acute challenges for some economies ⁽⁸⁾. Supply-chain disruptions, price hikes and sanctions have clouded the economic outlook for the euro area, but the intensity of the shock varies greatly across Member States ⁽⁹⁾. Overall, the largest downward revisions of economic growth in 2023 compared to the pre-war forecasts took place in eastern and central Europe with downgrades of up to 3% of GDP. All euro area countries are still expected to record economic growth, albeit at a slower pace. Annual real GDP of all euro area countries exceeded 2019 levels in 2022, with the notable exception of Spain, which remains measurably below 2019 levels, while Germany and Italy are

⁽⁴⁾ Both in nominal and real terms.

⁽⁵⁾ 22.4% of GDP in 2023 relative to an average 20.8% of GDP between 2015 and 2019.

⁽⁶⁾ The flagship instrument of Next Generation EU.

⁽⁷⁾ [ECB's supply chain bottleneck indicator](#).

⁽⁸⁾ See [OECD Interim Macroeconomic Outlook, March 2022](#).

⁽⁹⁾ See the [Commission's Box on 'Member States' vulnerability matrix'](#)

practically there. However, in 2023 also these three countries are expected to exceed 2019 levels (see Graph 1.13 and 1.14) ⁽¹⁰⁾.

Unemployment is expected to decline further. Despite the sharp drop in output during the pandemic, unemployment rose only slightly (by 0.3 percentage points). The successful implementation of job retention schemes and other dedicated support measures followed by a swift economic recovery largely explains this remarkably benign outcome. In 2023, the euro area unemployment rate is predicted to fall to 7.0%, the lowest rate on record since the euro was adopted. Moreover, total hours worked, which had been more severely affected during the pandemic, are also expected to exceed pre-crisis levels by 2023. The labour force participation rate briefly contracted by one percentage point in 2020 but rose again by more than half a percentage point in 2022 and is expected to continue rise at a similar rate in the following years (see Graph 1.11). Conversely, in many countries that entered the pandemic with comparatively favourable labour market conditions, unemployment rates are not expected to fall below pre-crisis levels by 2023 (see Graph 1.10). Despite these developments, differences in unemployment rates across countries remain substantial. The massive inflow of Ukrainian refugees into the EU increases the labour supply in several countries but the labour force participation rate of the arrivals remains uncertain. The labour market implications from the war will only become apparent in time.

Signs of broader labour shortages are emerging but the war in Ukraine may create new dynamics. During the Covid-19 pandemic, workers moved away from occupations that were heavily curtailed by the lockdowns and other restrictions. These sectors are now seeking to recruit lost workforce, but they face labour

shortages on the scale usually only seen in specialised and highly sought-after professions. The labour market mismatch is likely to intensify during the green and digital transitions, increasing labour market tightness. The job vacancy rate in the euro area is at a record high and particularly acute in some Member States (see Graph 1.12). However, the war in Ukraine may halt the overheating of the labour market. Sectors heavily reliant on Russian or Ukrainian inputs may experience job losses rather than continued growth, especially if the war escalates further.

The Commission forecasts inflation to drop to 2.7% by 2023 but inflation may continue to surprise on the upside. After several years of subdued rates in the euro area, inflation had started to ratchet up during the recovery from the Covid-19 crisis (see Graph 1.3). This trend was dramatically amplified by the impact of the war in Ukraine. The average headline inflation rate ⁽¹¹⁾ is expected to peak at 6-7% in 2022, largely due to strong increases in energy prices and supply-chain disruptions. In their baseline forecast, the ECB expects inflation to fall to 3.5% in 2023. The ECB views the hikes as largely transitory as they are mostly driven by soaring energy prices. Nevertheless, inflation kept rising above expectation and may continue to do so. This is also reflected in the ECB's latest macroeconomic projections ⁽¹²⁾, which feature an alternative scenarios based on protected war and the euro area to be completely cut from Russian energy exports. In this downside scenario inflation would stay close to 6% in 2023. The ECB does not expect a wage spiral and its forward-looking euro area wage tracker suggests only a modest increase in wage demands for 2022 and 2023 ⁽¹³⁾. However, the ECB acknowledges that the transmission to wages might take time and that the risk of higher

⁽¹⁰⁾ Notably, linear extrapolations of pre-crisis real GDP have to be interpreted with caution as they do not say much about the sustainable level of economic activity, including potential scarring effects after major crises.

⁽¹¹⁾ Measured by the Harmonised Index of Consumer Prices (HICP).

⁽¹²⁾ [ECB staff macroeconomic projections for the euro area, June 2022](#)

than expected second-round effects is becoming more likely. The European Commission projects the annual increase in compensations of employees to rise to close to 3.5% in 2022 and 2023 – far above the rates seen before the pandemic but still on the cautious side given expected inflation.

The near-term economic outlook remains clouded by a high degree of uncertainty.

The economic impact of the war in Ukraine and associated price hikes in energy and other commodities as well as supply bottlenecks are difficult to predict. In these circumstances, and following the example of the ECB, the Commission produced two model-based alternative scenarios to its fully-fledged baseline forecast: an ‘adverse’ and a ‘severe’ scenario ⁽¹⁴⁾. The adverse scenario assumes a 25% additional increase in gas and oil prices while the severe scenario is based on a full-scale disruption of Russian gas imports to the euro area. As the model assumes the shock to occur in the second quarter of 2022, the highest impact is in that year. For 2023, the adverse scenario indicates a slowdown in growth by close to 0.5 percentage points while the severe scenario indicates a downward revision by around 1 percentage point (see Graph 1.15). Though the war overshadows other factors, there are other risks that could nonetheless significantly affect the outlook. In particular, the pandemic is not over yet. The remaining restrictions have been rapidly lifted in most countries, but the emergence of new virus variants cannot be ruled out. Besides, China’s ‘zero-Covid’ policy has already aggravated supply-chain bottlenecks. On the upside, a successful implementation of the RRF and associated structural reforms paired with the green and digital transition has the potential to boost productivity by more than is currently expected.

⁽¹³⁾ [ECB \(2022\) The euro area outlook: some analytical considerations](#)

⁽¹⁴⁾ Commission Spring Forecast 2022 Thematic Special Topic ‘[Alternative scenarios on the economic outlook](#)’.

The output gap is estimated to turn positive by 2023.

As highlighted, the Covid-19 crisis has been special in many regards, foremost in its V-shaped recovery. Although it is dampening economic growth, the war is not expected to fundamentally rewrite the story of economic recovery. According to the real-time output gap estimates in the Commission 2022 spring forecast, 2023 will mark the first year when the euro area economy runs again at or above its potential (see Graph 1.6). The IMF has issued a similar forecast though the estimate is marginally negative in 2023 (see Graph 1.6).

Most alternative indicators of cyclical conditions indicate the same direction.

Various metrics can be used to track the level of economic activity relative to its sustainable trend (see Section 3). Most are currently indicating the output gap perspective of an economy running at above potential. Most indicators suggest that economic activity in the euro area as a whole is already running at a very high level.

Terms-of-trade effects are difficult to capture in commonly used methods to estimate output gaps.

Such shocks may not be adequately internalised in the output gap estimates of the European Commission or other international organisations, which involve Phillips curve relationships ⁽¹⁵⁾. However, unlike energy prices, wages have not yet risen much. At the onset of the pandemic, the Commission and the Council agreed to ad hoc modifications of the commonly agreed method to estimate the output gap to keep potential output as stable as possible ⁽¹⁶⁾. If carried forward, these adjustments effectively dampen the impact of the Covid-19 crises on potential GDP, e.g. by accounting for labour hoarding, limiting the estimated degree of scarring. These factors taken together would imply a possible overestimation of potential output and hence an unwarranted view of the scope for expansionary policies at

⁽¹⁵⁾ The Phillips curve describes the inverse relationship between wage inflation and the unemployment rate.

⁽¹⁶⁾ For more detail see, [EFB Annual Report 2021](#).

the current juncture. In fact, there is strong evidence of a systematic optimistic bias in estimating potential output in real time ⁽¹⁷⁾, which can be partly attributed to political considerations and partly to structural issues in modelling output gaps. This bias results in procyclical fiscal policy during upswings and leads to an insufficient build-up of fiscal buffers before a downturn.

2. Fiscal policy developments

In contrast to previous expectations, the severe economic downturn clause will still be applied in 2023, undermining the rules-based fiscal governance in the EU. In March 2021, the Commission officially communicated that it would take the decision whether to also apply the clause in the next years based on an overall assessment involving quantitative elements, with a return of real GDP to the pre-pandemic level in the EU or the euro area as a whole as the key quantitative criterion⁽¹⁸⁾. This condition has been met since autumn 2021 and the war has not changed that. However, the Commission argued in May 2022 ⁽¹⁹⁾ that the euro area economy has not returned to ‘normal conditions’ and that the severe economic downturn clause should continue to be applied in 2023 but probably not for 2024. The Commission pointed to the heightened uncertainty around the economic outlook, considerable downside risks and the need to respond quickly to potential further escalation of the war. The proposal differs from previous indications on how and when to stop the application of the severe economic downturn clause and underscores the wide margin of discretion the Commission applies in interpreting and applying the EU fiscal rules. (Box 1) If the Commission and the EU

⁽¹⁷⁾ See for example [Martin Larch et al. \(2021\)](#), [European Commission \(2015\)](#), or [Hauptmeier and Leiner-Killinger \(2020\)](#).

⁽¹⁸⁾ [European Commission \(2021\) communication on updated approach to fiscal policy response](#)

⁽¹⁹⁾ [2022 European Semester: Spring Package Communication](#)

legislators cannot reach an agreement on the main elements of reform of the Stability and Growth Pact in time, the Commission should clarify on how it aims to implement the current rules over the next years ⁽²⁰⁾. This would aid forward planning for the Member States and foster transparency.

Headline deficit and debt relative to output are expected to fall from the high levels reached. This progress comes on the back of strong nominal growth and the expected expiry of pandemic crisis- and recovery-related fiscal support measures. The high nominal growth rate, fuelled by inflation, boost government revenues and reduces the debt ratio through the denominator effect. The aggregate euro area government budget deficit is projected to shrink from 3.7% of GDP in 2022 to 2.5% in 2023. The primary deficit is forecast to shrink to 1.1% of GDP, which is a quarter of the level when it peaked in 2021/22. Government debt ratios have also fallen swiftly in 2022 on the back of robust growth and high inflation. Provided no further expansionary measures are adopted, this is expected to continue in 2023 as the debt ratio falls by close to 2% of GDP, pushing the euro area ratio to 93% of GDP.

Fiscal support is expected to further ease in 2023, but remains at a high level and new measures have been taken. At current policies, the structural primary deficit of the euro area as a whole is forecast to shrink to 1.3% of GDP in 2023, down from 2.0% in 2022 (see Graph 2.3 and 2.4). In other words, pending the preparation and adoption of government budgets for 2023, the fiscal impulse is expected to be restrictive for the second year in a row while the fiscal stance remains supportive. Governments are projected to phase out the crisis-related emergency measures and reduce discretionary fiscal support. At the same time, since autumn 2021, EU governments have adopted discretionary new fiscal measures amounting to 0.6% of GDP in order to cushion

⁽²⁰⁾ [EFB Annual Report 2021](#)

Box 1: The severe economic downturn clause

The severe economic downturn clause in the Stability and Growth Pact – in the public debate misleadingly referred to as the general escape clause – was first introduced in 2011. It provides additional flexibility to the quantitative adjustment requirements under the preventive and corrective arms of the Pact. The clause can be invoked in the event of a severe economic downturn in the euro area or the EU as a whole. Recourse to the clause was made for the first time in 2020 in response to the expected economic fallout from the pandemic and associated lockdowns.

The Commission consistently emphasised that, while the clause provides additional flexibility to the quantitative adjustment requirements, it does not suspend the fiscal rules or the procedures set out in the Pact. However, the clause has been interpreted in a very extensive manner amounting to a de facto suspension of most provisions of the Pact ⁽²¹⁾. Moreover, the fiscal sections of the CSRs issued in 2020 were identical for all Member States.

In September 2020 ⁽²²⁾, the Commission concluded that the clause would also be applied in 2021. Though the economy was expected to rebound strongly in 2021, the Commission argued that the uncertainty around how the Covid-19 pandemic would evolve warranted a continued application of the clause.

As the name suggests, the clause should apply during a severe economic downturn ⁽²³⁾, but the Commission and Council converged on a broader interpretation. This underscores the need of having a transparent review mechanism or clear provisions that stipulate the conditions for applying the clause ⁽²⁴⁾. On 3 March 2021, the Commission indicated that the appropriate moment to no longer make use of the clause would be determined by an ‘overall assessment’ with the key quantitative criterion being the level of economic activity in the EU or euro area compared to pre-crisis levels (end 2019).

The spring forecast of 2021 suggested that euro area real GDP would return to its pre-crisis level by the first quarter of 2022 (and even end 2021 for the EU as a whole). Accordingly, the Commission indicated that the clause would continue to be applied in 2022, but not in 2023. This view was maintained in the Commission 2022 winter forecast of 10 February 2022, which indicated that euro area real GDP would return to its pre-crisis level even earlier, and indeed had already done so at the end of 2021. Moreover, most individual EU Member States were expected to exceed their pre-crisis level of real GDP by the end of 2022.

Signs of a possible re-assessment became apparent on 2 March 2022 in the Commission communication on fiscal policy guidance for 2023 ⁽²⁵⁾. On the one hand, the communication reiterated the expectation that the clause would no longer be used in 2023. On the other hand, by announcing qualitative fiscal recommendations for 2023, the Commission effectively excluded a return to conventional budgetary requirements. EU fiscal rules prescribe quantitative adjustments of fiscal variables, which is why qualitative recommendations de facto amount to a continued application of the clause or the introduction of a new form of discretionary flexibility.

On 25 May 2022, when presenting its spring surveillance package, the Commission proposed to recur to the severe economic downturn clause for another year until the end of 2023 ⁽²⁶⁾. The justification was mainly based on the uncertainty surrounding the economic outlook triggered by the war, although the baseline of the Commission’s 2022 spring forecast shows that (i) euro area and EU economic activity had surpassed pre-pandemic levels, (ii) neither the euro area nor the EU was expected to enter a recession in the coming two years; and (iii) the Commission’s own updated sustainability analysis indicated higher sustainability risks in the medium- and long-term in a number of countries. Leaving aside the merits or demerits of this decision, this underscores once more the weaknesses of the current set-up: a wide margin of discretion in applying an important provision of the Pact. Conditions defined in law are replaced by ad hoc conditions which, in turn, are adjusted as circumstances change.

⁽²¹⁾ See [EFB Assessment of the euro area fiscal stance in 2022](#).

⁽²²⁾ [Annual Sustainable Growth Strategy](#) and [Guidance on fiscal policy orientation for 2021](#)

⁽²³⁾ In the context of the Stability and Growth Pact a severe economic downturn was understood as negative annual real GDP growth or cumulated loss of output over a longer period of very low real GDP growth relative to potential GDP (Article 2(2) Regulation 1467/97).

⁽²⁴⁾ See [EFB Assessment of the euro area fiscal stance in 2021](#).

⁽²⁵⁾ Commission Communication ‘[Fiscal policy guidance for 2023](#)’.

⁽²⁶⁾ 2022 European Semester: Spring Package Communication

the impact of soaring energy prices ⁽²⁷⁾. Nevertheless, also the expenditure benchmark indicates a restrictive fiscal impulse (see Graph 2.5). Although fiscal support is set to wane, economic growth is projected to remain robust despite the impact of the war in Ukraine, indicating that the recovery from the Covid-19 crisis is resilient and self-sustaining.

The RRF provides non-negligible support to euro area aggregate demand. Following the current accounting practices, RRF grant-financed expenditure is registered as deficit-neutral in national accounts and does not enter the conventional aggregated structural primary balance since the expenditures are offset by an equivalent amount of RRF grants on the revenue side. However, grant-financed expenditure supports aggregate demand. It is therefore reasonable to account for the impact of the RRF grants on aggregate demand when assessing the appropriateness of the euro area fiscal stance. The grants are expected to effectively enhance the fiscal stance in 2023 by close to ½ % of GDP. The fiscal impulse remains largely unchanged by including RRF grants, due to the nearly equivalent grant-financed support in the previous year.

How to account for pandemic-related fiscal measures will no longer have an impact on the assessment of the fiscal stance as of 2023. How to account for crisis-related temporary emergency measures mattered in past years when comparing the assessment of the fiscal stance issued by the Commission and the EFB. In autumn 2020, the Commission had shifted its communication on the fiscal stance to an adjusted metric. This adjusted fiscal stance excludes crisis-related temporary emergency measures ⁽²⁸⁾. By contrast, the EFB continued to

⁽²⁷⁾ [2022 European Semester: Spring Package Communication](#)

⁽²⁸⁾ These are mainly measures providing direct support to the health sector as well as job retention and firm loss compensation schemes. These were deemed to have a limited impact on aggregate demand due to low fiscal multipliers. See [Commission \(2020\) communication on the](#)

use the unadjusted metric in its assessment highlighting the distinction between the fiscal stance and the fiscal impulse. For 2020 and 2021 the adjustment by the Commission had a significant impact on the communication of the fiscal stance ⁽²⁹⁾, overstating the actual fiscal expansion in 2021. The impact of the Commission's adjustment for temporary measures will fade in 2023 as they are projected to have entirely expired by then. A marginal expansionary impact of the Commission's approach remains on the fiscal impulse as it measures the change of discretionary fiscal support between 2022 and 2023 ⁽³⁰⁾.

In 2022, the Commission continued to issue largely qualitative country-specific guidance to Member States. Just as in 2021, country-specific recommendations published in May 2022 do not give explicit quantitative guidance in the legally binding part. However, in its fiscal recommendations for 2023 the Commission issued some broad goalposts to two distinct groups of Member States. 'Low/medium' debt countries ⁽³¹⁾ should aim for a 'neutral policy stance' by limiting nationally-financed current expenditure growth. 'High-debt' countries were asked to ensure that nationally financed current expenditures grow less than medium-term potential output. Both groups should take into account continued support to vulnerable households and firms that are negatively affected by rising energy costs. All countries should favour public investment, in particular to support the green and digital transitions. Despite

[2021 Draft Budgetary Plans: Overall Assessment.](#)

⁽²⁹⁾ See [EFB Assessment of the appropriate fiscal stance for the euro area in 2022](#) and [EFB Annual Report 2021](#).

⁽³⁰⁾ Since some temporary measures (close to 1/3 % of GDP) are expected to remain in place until 2022, the change in the adjusted fiscal stance in 2023 would be correspondingly less restrictive.

⁽³¹⁾ In the fiscal guidance for 2023, 'High debt' countries = Belgium, Greece, Spain, France, Italy and Portugal. 'Low/medium debt countries' = Austria, Estonia, Germany, Cyprus, Ireland, Latvia, Lithuania, Luxembourg, Malta, the Netherlands, Finland, Slovakia, Slovenia.

some quantitative elements in the country-specific recommendations, the largely qualitative nature makes it impossible to derive an implied recommendation on the aggregate fiscal impulse for the euro area as a whole. Notably, a 23 May 2022 Eurogroup press release noted a broad consensus among Ministers in favour of a neutral fiscal impulse in 2023 ⁽³²⁾.

The current terms-of-trade shock does not call for an expansionary discretionary fiscal response. The war in Ukraine is a major terms-of-trade shock for the euro area. But the associated economic slowdown does not coincide with weakening demand. On the contrary, private consumption and investment remain robust, while fiscal policy is starting from a highly supportive environment. Against this backdrop, conventional demand management would prove counterproductive as it would aggravate inflationary pressure without addressing the causes of the slowdown. Hence, at the aggregate level, a moderately restrictive fiscal impulse in 2023 is warranted. At the same time, fiscal policy can mitigate the impact of the shock on most-affected households through redistributive measures, while continuing a consolidation path. Such a budgetary reallocation should not come at the detriment of nationally-financed public investment, which will continue to be supplemented by RRF grant-financed investments. The aggregation of current national government policies is broadly consistent with the EFB assessment of an appropriate fiscal stance for the euro area as a whole.

While remaining agile, fiscal policies should shift focus towards debt reduction. Most Member States have come out of the pandemic with significantly higher debt ratios, some of which had already been severely high before the pandemic hit. The euro area debt-to-GDP ratio has risen to nearly 100%. At the same time, historically low interest rates and high nominal GDP growth during the recovery are helping

⁽³²⁾ [Remarks by Paschal Donohoe](#) following the Eurogroup meeting of 23 May 2022.

countries reduce their debt without resorting to onerous consolidation. As borrowing costs increase and nominal GDP growth slows, the debt-reducing snowball effect will ease, thereby exerting more pressure on discretionary fiscal policy to reduce public debt ratios. The European Commission's 2021 Fiscal Sustainability Report underscores the risks over different time horizons and highlights the significant fiscal adjustment needs in most high-debt countries ⁽³³⁾. In fact, for 2023, sustainability and stabilisation analyses both suggest that the expected fiscal impulse should be slightly more restrictive than currently projected under a no-policy change assumption (see Graph 2.15). Hence, the draft budgets for 2023 would on average need to bring in some additional adjustments.

The stance of monetary and fiscal policy is changing earlier than expected. In response to the Covid-19 crisis, governments and central banks acted swiftly and pulled in the same direction to act as strategic complements. Monetary policy created space for fiscal policy by maintaining ultra-low interest rates and by launching the pandemic emergency purchase programme (PEPP). Fiscal policy, in turn, sustained aggregate demand and prevented already low inflation to move into deflationary territory. This contrasts with normal times during which fiscal and monetary policy tend to be strategic substitutes in stabilisation efforts. In light of rising inflation rates and potential second-round effects monetary policy is bound to become less accommodative. As economic conditions improve and supply constraints tighten fiscal support to aggregate demand is also less relevant. Overall, fiscal policy should aim for a gradual growth-friendly consolidation and to rebuild the fiscal space in order to be able to react to any future crisis.

Rebalancing the stance of macro policies will be challenging. In light of the current economic outlook, monetary and fiscal policy

⁽³³⁾ The European Commission's [Fiscal Sustainability Report 2021](#)

should remain complementary in the near term, both aiming for a less accommodative stance. However, moving towards a normal policy mix may prove challenging for the ECB, as tapering the asset purchase programmes and raising interest rates will have an impact beyond the private sector. It can also have marked implications for sovereign bond yields. Due to the high level of indebtedness of some Member States, a sharp rise in government bond yields could trigger a reassessment of sovereign risks and have implications for the financial stability of the euro area. These potential side effects could complicate the ECB's communication on simultaneously achieving its inflation objective while maintaining a uniform transmission of monetary policy.

The tangible downside risks call for contingent policy recommendations. The European Commission's adverse and severe scenario published in its 2022 spring forecast is in line with the high degree of uncertainty surrounding the economic outlook. However, if these downside risks were to materialise, supply-side constraints will worsen. An expansionary fiscal impulse would only be warranted if a drop in consumer and business confidence weakens aggregate demand. Otherwise, fiscal expansion could aggravate prevalent inflationary pressure without significantly boosting aggregate demand. Nevertheless, fiscal policy must remain agile and adapt to changes in the economic situation and outlook as necessary.

3. How to gauge cyclical conditions beyond real-time output gap estimates

The assessment of the euro area fiscal stance requires a reasonable estimate of prevailing cyclical conditions. A fiscal impulse is meant 'to lean against the wind' – that is being expansionary during economic bad times and contractionary during economic good times. The output gap - the difference between actual and potential output typically expressed in percent of potential output - is the most commonly used concept to assess cyclical conditions. It features heavily in the European

fiscal surveillance framework. However, real-time estimates of the output gap are surrounded by a high degree of uncertainty mostly because they involve forecasts of key macroeconomic variables and estimates of unobserved cyclical components. This uncertainty has contributed to their politicisation, as it leaves room for ambiguity in interpretation. The EU's commonly agreed methodology (EUCAM), which provides the basis for estimating the output gap, is closely monitored and may be adjusted at the suggestion of the dedicated committee of the Council – the Output Gap Working Group (OGWG). It was modified in an ad hoc fashion in view of the impact of the Covid-19 crisis (see EFB 2021).

Real-time output gap estimates are not directly observable and prone to sizeable *ex post* revisions. Though there is a benefit in using cyclical adjusted fiscal metrics, there is considerable uncertainty around estimates available in real time (OECD 2003, Beetsma and Giuliodori 2010, Cimadomo 2012 or European Commission 2018). Moreover, political biases and the inability to predict recessions lead to a pessimistic bias in output gap estimates and by extension an optimistic bias in structural balances. Given these limitations, many have questioned the usefulness of output gaps in the context of fiscal rules (see e.g. Bruegel 2019).

Alternative measures of cyclical conditions come with their own caveats but can complement each other. If the ambition is to encourage governments to use discretionary fiscal policy to lean against the wind, then an estimate of the cyclical position is necessary. However, the cyclical position is not observable. Irrespective of which cyclical indicator is chosen, they remain mere estimates. Even if an indicator itself was observable with precision in real time, it would still require a reference of what constitutes a neutral/balanced position of the indicator (like potential output in case of the output gap). Moreover, no single indicator can unequivocally capture the cyclical conditions in real time; as the plural suggests, they encompass multiple aspects of the economic cycle such as

the situation of the labour market but, also capital utilisation and other factors. Therefore, combining multiple indicators can be useful.

What are alternative or complementary indicators of cyclical conditions?

Cyclical conditions can be evaluated by a number of complementary indicators. Most measure the state of the labour market or business sector expectations (see Table 3.1). A few are in fact direct inputs to the output gap estimation. Some of the indicators rely on surveys while others are in principle observable but only after a time lag. The following section describes and assesses a selection of indicators with a focus on the years 2021-2023.

Table 3.1: Overview of alternative indicators

Name	Type	Source
Unemployment rate	Observable	AMECO
NAWRU	Non-observable	AMECO
Short-term unemployment	Observable	Eurostat
Vacancy rate	Observable	Eurostat
Wage inflation	Observable	AMECO
Employment expectation indicator (EEI)	Survey	DG ECFIN
Economic sentiment indicator (ESI)	Survey	DG ECFIN
Supply chain bottleneck composite indicator	Mixed	ECB
Composite leading indicator	Mixed	OECD
Plausibility tool	Mixed	DG ECFIN

Based on spring 2022 data, the unemployment rate is currently indicating a continued cyclical improvement. The unemployment rate follows the economic growth cycle with a lag since recruitment decisions and lay-offs do not immediately respond to changing economic conditions. Nevertheless, the impact of past major crises and the recovery are clearly visible (see Graph 3.1). Contrary to past patterns, the Covid-19 crisis has triggered only a marginal increase (0.3%) in the euro area unemployment rate

thanks to the effective job retention schemes rolled out by governments in response to the pandemic. The unemployment rate is expected to shrink below its pre-crisis level to a euro area all time low by 2023. The war has not altered this outlook, provided there are no further surprises such as a gas embargo from Russia, which could have more serious employment implications. The gap to the non-accelerating wage rate of unemployment (NAWRU) is projected to close over the next years – suggesting an economy running above its potential. This projection resembles that of the output gap⁽³⁴⁾. Stark cross-country differences are not limited to the known divergences in unemployment rates themselves; they are also reflected in the gap to the NAWRU (see Graph 3.2). Notably, the NAWRU is not observable and is also prone to *ex-post* revisions⁽³⁵⁾.

Long-term unemployment may obfuscate the assessment of cyclical conditions. The previous graph uses the NAWRU to derive an equilibrium rate to assess the state of the labour market. Another approach is to analyse only short-term unemployment, as it is assumed to follow business-cycle fluctuations more closely than the long-term unemployment rate, which captures more structural elements (see Graph 3.3). Major crises can cause hysteresis effects, leading to ‘scarring’ of the economy, which would show up predominantly in the long-term unemployment rate. However, immediately after a severe crisis, it is challenging to predict whether shifts in unemployment are temporary or whether workers are permanently driven off the labour market. This challenge is particularly acute now due to the nature of the Covid-19 crisis, the impact of the RRF, supply-chain adjustments, green and digital transitions and demographic pressures. Moreover, the war in Ukraine could alter the viability of some sectors and speed up transitions. Current projections indicate that both short-term and long-term unemployment will continue falling.

⁽³⁴⁾ This is logical as the NAWRU is an essential part of the EUCAM output gap estimation.

⁽³⁵⁾ See [Hristov et al. \(2017\)](#).

The labour markets are becoming increasingly tight. During the pandemic workers moved away from occupations heavily curtailed by the lockdowns and other restrictions. Some of these sectors are recovering swiftly and seeking to recruit lost workforce. This is reflected in the job vacancy rate, which denotes the number of unfilled jobs relative to total occupied positions. The rate has been gradually rebounding from its trough after the global financial crisis but it plummeted again during the height of the pandemic (see Graph 3.4). However, by the end of 2021, the job vacancy rate shot up rapidly again. Many Member States are faced with record numbers of unfilled positions. The labour market tightness resonates with a cyclical upturn and an economy running close to its potential but may also reflect other factors (i.e. the digital and green transitions, mobility restrictions, labour and business compensation schemes as well as an ageing society). This trend paired with rising energy prices has caused wage inflation to reach levels not seen since the start of European economic monetary union. The rise in compensation per employee is projected to settle well above 3% in 2022 and 2023. This could be interpreted as a sign of an economy at the risk of overheating but the scale of wage inflation in the coming years remains highly uncertain as it may respond not only to a tight labour market, but also to the terms-of-trade shock, which implies a welfare loss to be absorbed by profit margins or wages.

Confidence indicators signal an above-average benign perception of the current state and outlook of the economic cycle. At the end of 2021, the European Commission's employment expectation indicator (EEI) and economic sentiment indicator (ESI) had reached levels not seen since the adoption of the euro at the turn of the century (see Graph 3.6). In response to the war in Ukraine and soaring energy prices the sentiment has fallen again but remains well above the historic average. The OECD's composite leading indicator aims to establish the cyclical conditions and functions as an early warning system of turning points of the

economic cycle. It combines country-specific findings of confidence indicators, order books, vacancy rates and others. The OECD indicator also heralded the start of economic good times compared to the historic average. Before the war, the indicator had settled above the 100 mark of the index but has since started to fall as the conflict clouded the outlook. Nevertheless, for the time being, the indices remain at a high level, in step with the conventional output gap estimates.

Capacity utilisation in the euro area has nearly recovered to its pre-pandemic level. Unused industrial capacity ratcheted up during the Covid-19 pandemic as part of the economy was heavily restricted and global supply chains were disrupted (see Graph 3.7). At the end of 2021, capacity utilisation rebounded strongly: it is now above the historic average.

The severity of supply-chain bottlenecks has increased rapidly since 2021. Numerous sectors have been drastically impacted by blockages in global supply chains, as best exemplified by the global shortage of semi-conductors during the pandemic. The increase in supply-chain bottlenecks is reflected in many different indicators. The ECB compiles these indicators ⁽³⁶⁾ and applies a dynamic factor model to derive a composite indicator ⁽³⁷⁾. The composite metric of bottlenecks is at a historic high, far above levels observed over the past decade (see Graph 3.8), and it worsened considerably in 2021. The war in Ukraine and partial lockdowns in trading hubs such as Shanghai in spring 2022 will put additional strain on global supply chains, thus likely to push up this index even further.

The Commission's plausibility tool

The European Commission already uses an amalgamation of alternative indicators to conduct a plausibility check of its real-time

⁽³⁶⁾ Ranging from transport and labour market indicators to commodity prices and business-sector indicators.

⁽³⁷⁾ [ECB Economic Bulletin 2/2022, Box 1](#)

output gap estimates. In response to growing criticism from Member States, the Economic and Financial Committee (EFC) in autumn 2016 approved the use of a ‘plausibility tool’ (PT) ⁽³⁸⁾. As the name suggests, it is designed to assess the plausibility of the Commission’s output gap estimates derived from the EU’s commonly agreed methodology (EUCAM). The plausibility tool is based on a simple regression analysis that uses past correlations between the output gap estimates and an array of business-cycle indicators ⁽³⁹⁾ across countries. The regression results are then used to make a central estimate of the output gap and a range around it based on different confidence intervals. These ranges of plausible output gap estimates are produced for each country for the year in question. For a detailed description of the plausibility tool, see the 2018 Annual Report of the European Fiscal Board and for a technical discussion, see Box 1.7 in the ‘Vade Mecum of the SGP’ (2019).

The plausibility tool does not replace the established output gap estimates. If the plausibility tool flags an output gap as implausible, the Commission can apply ‘constrained judgement’. Since the plausibility tool does not provide a single output gap but rather a range, the Commission can judge what it deems the appropriate level of the output gap, provided it lies within the range provided. It is then checked if the alternative output gap would have a meaningful impact in terms of fiscal surveillance. Specifically, the alternative output gap could justify a smaller required fiscal adjustment according to the matrix of requirements or a Member States may become eligible for the structural reform and investment clauses. Conversely, the alternative output gap is not used to calculate the fiscal effort as the

plausibility tool is regarded as an estimate for a single year based information available at the time and not suitable to derive dynamics. Moreover, the tool is applied asymmetrically, meaning it can only lead to lower requirements.

In several cases, the output gap estimates fell outside the plausible ranges, but few had practical implications. The Commission differentiates degrees of implausibility: either clear-cut counterintuitive ⁽⁴⁰⁾ or borderline counterintuitive ⁽⁴¹⁾. Between 2016 and 2021, fewer than 10 Member States were found to have an output gap that was deemed clear-cut counterintuitively positive or not negative enough (see Table 3.2). Clear-cut counterintuitive cases where the production function output gap was estimated to be excessively negative or not positive enough were just as frequent. Borderline cases ⁽⁴²⁾ were three times as common in both directions. The tool is based on past links between business-cycle indicators and output gap estimates. As a result, there is a degree of persistence in the results—i.e. some countries are regularly flagged as borderline cases (see Table 3.2).

The 2021 output gap estimate for the euro area as a whole seems to be plausible. The official output gap estimate for 2021 based on the EUCAM was -2.0% of potential GDP. A replication of the analysis for the euro area as a whole ⁽⁴³⁾ suggests that the plausibility tool centre value is very close to this estimate. Taking the usual plausibility ranges, the estimate was neither clear-cut nor borderline counterintuitive.

The 2023 output gap estimate seems broadly plausible, while acknowledging the high degree of uncertainty. The European Commission does not generate individual plausibility ranges for future years as the plausibility tool is based solely on outturn data. Thus, the Commission simply extrapolates of

⁽³⁸⁾ See [Assessment of the plausibility of the output gap estimates](#) 2017 and Box 1.7 of the [Vade Mecum of the SGP 2019](#).

⁽³⁹⁾ Namely, capacity utilisation in the manufacturing industry, the short-term unemployment rate, wage inflation and elements of confidence indicators focusing on lack of demand. See [Hristov et al. \(2017\)](#) for a detailed description of the methodology and indicators used.

⁽⁴⁰⁾ Based on RMSE90.

⁽⁴¹⁾ Based on RMSE68.

⁽⁴²⁾ Including clear-cut cases.

⁽⁴³⁾ Ireland has been excluded given the sometimes erratic movements of output.

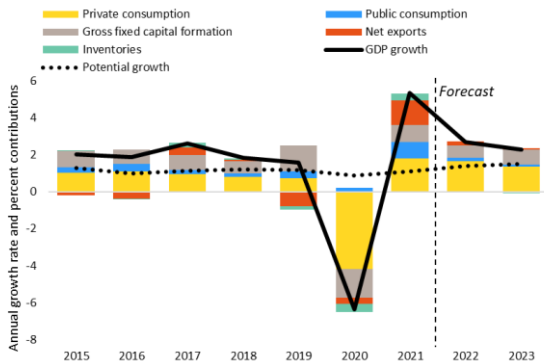
the plausibility ranges when needed. It does provide forecasts for some of the input variables until 2023. Moreover, one can build illustrative scenarios where different assumptions are made for variables where actual forecasts are not yet available, namely long-term unemployment, the capital utilisation indicator and the confidence indicators. In a scenario where these indicators remain at their 2021 value, the plausibility tool's indicates that the euro area aggregate output gap for 2023 is within the plausibility range of the tool, albeit approaching the upper limit (see Graph 3.9 and 3.10).

Overall, most alternative indicators align with the output gap estimates for 2023, given the information currently available. Euro area economic output is expected to reach its potential by the end of 2022. Some indicators still exhibit a small negative gap while others are clearly in 'good times' territory. The plausibility tool indicates that the output gap estimate for the aggregate euro area is plausible for 2021 ⁽⁴⁴⁾. A simple simulation for 2023 also suggest that the Commission's euro area output gap estimate is plausible.

⁽⁴⁴⁾ For some, this is expected as they are part of the output gap estimation itself.

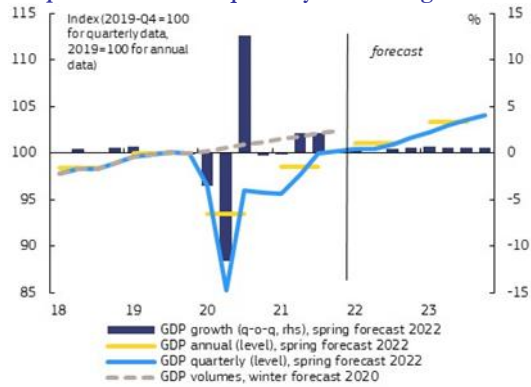
THE MACROECONOMIC OUTLOOK

Graph 1.1: GDP growth and contributions, euro area



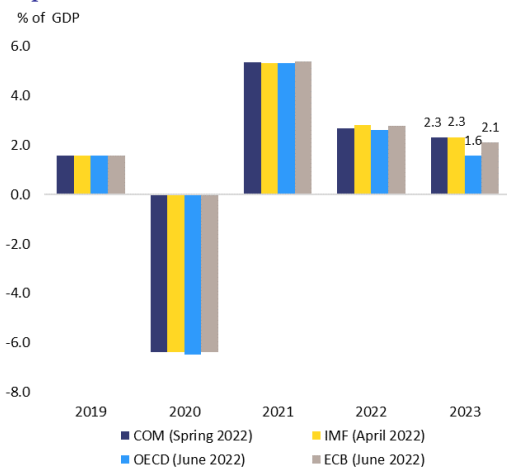
Source: European Commission.

Graph 1.2: Euro area quarterly real GDP growth



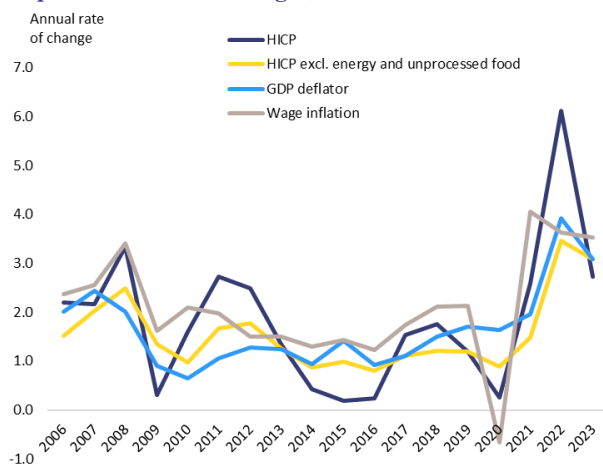
Source: Commission spring forecast 2022 and winter forecast 2020

Graph 1.3: Euro area real GDP



Source: European Commission, OECD, IMF, ECB.

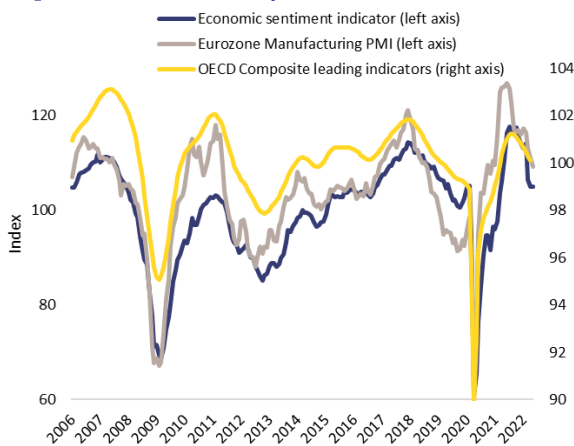
Graph 1.4: Inflation and wages, euro area



Source: European Commission.

Note: Wage inflation = change in compensation per employee

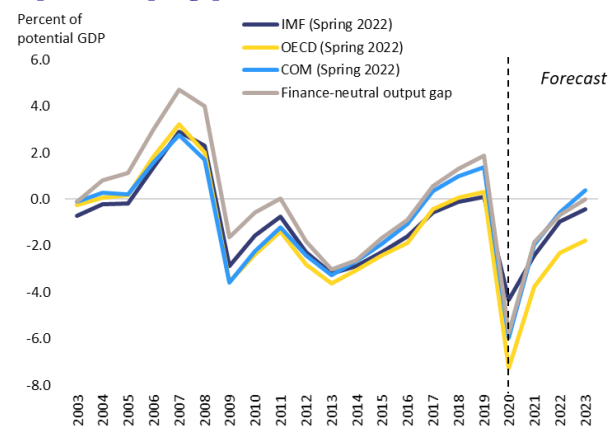
Graph 1.5: Economic survey indicators, euro area



Source: European Commission, OECD, Macrobond, IHS Markit.

Note: Manufacturing PMI scaled by two for visualisation.

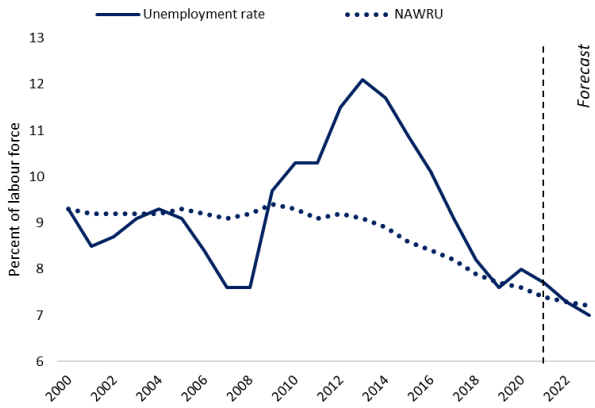
Graph 1.6: Output gap, euro area



Source: European Commission, OECD, IMF.

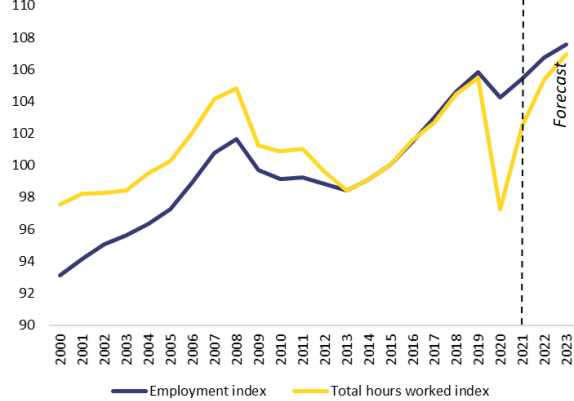
Note: (1) OECD data only includes OECD members, thus 17 euro area Member States (excl. Malta and Cyprus); (2) publication dates OECD (8 June 2022), COM (16 May, 2022), IMF (19 April 2022); (4) The finance-neutral output gap is derived from an extended HP filter that takes into account short-term real interest rates, credit growth and house price inflation.

Graph 1.7: Unemployment rate, euro area



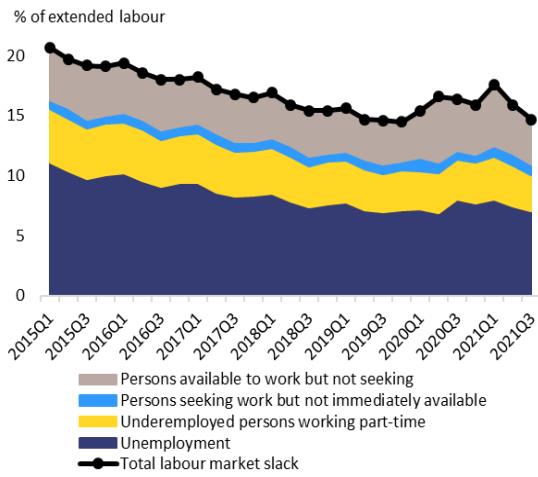
Source: European Commission.
Note: NAWRU refers to the non-accelerating wage rate of unemployment.

Graph 1.8: Employment and total hours worked



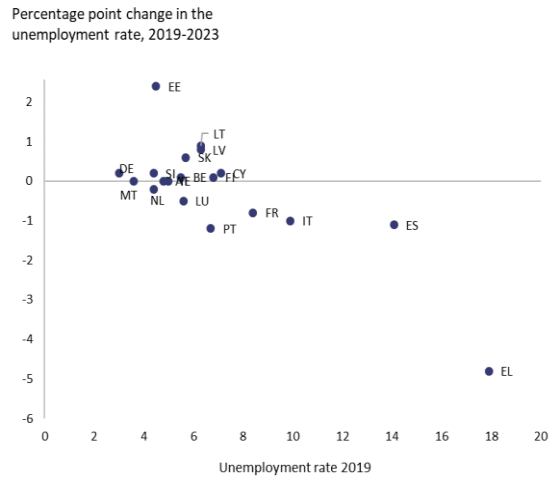
Source: European Commission.

Graph 1.9: Extended measure of labour market slack



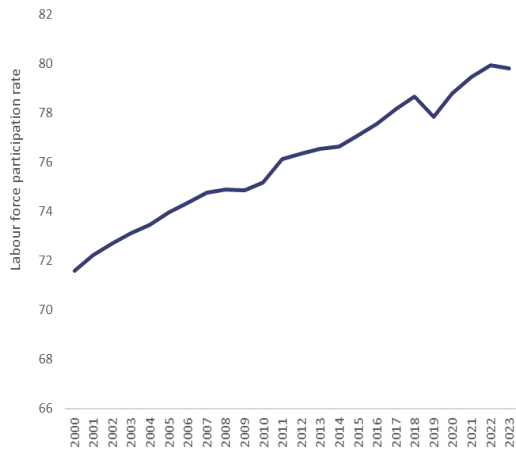
Source: European Commission.
Notes: (1) Age group 15-74 years, as a percentage of the extended labour force (i.e. employed and categories depicted). (2) Underemployed defined as workers in part-time employment who would prefer to increase their work hours.

Graph 1.10: Unemployment across Member States



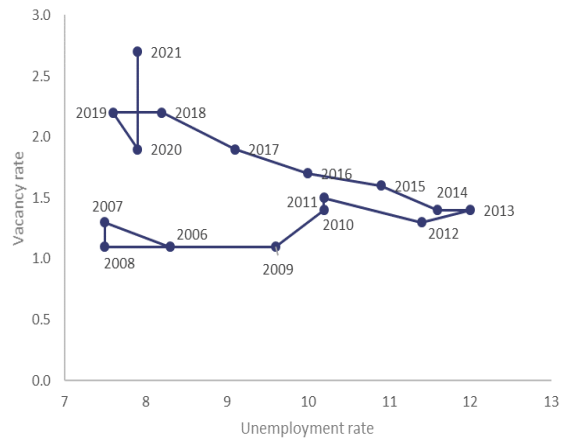
Source: European Commission.

Graph 1.11: Euro area labour force participation rate



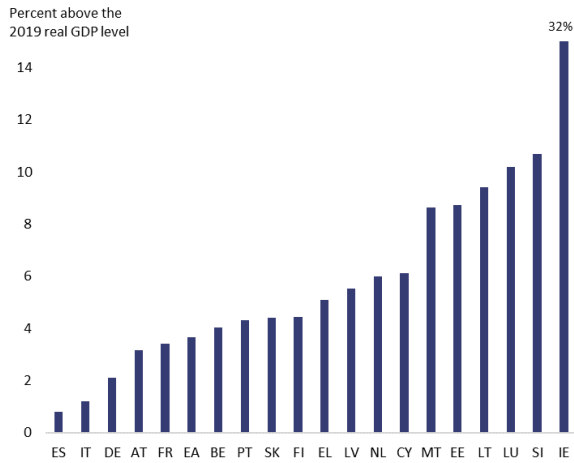
Source: European Commission
Note: Age group 15 to 64 years.

Graph 1.12: Euro area Beveridge curve



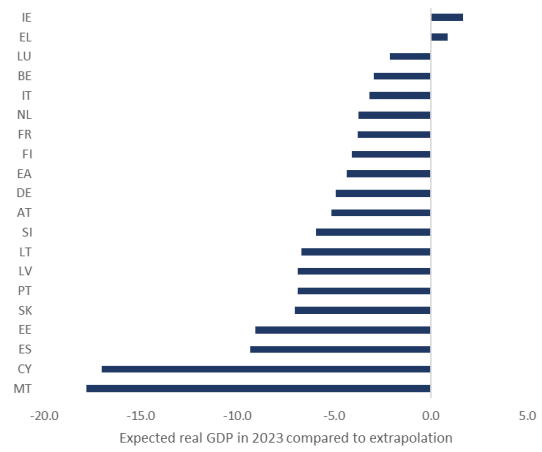
Source: Eurostat.
Note: The Beveridge curve depicts the relationship of the vacancy rate and unemployment rate.

Graph 1.13: Expected real GDP in 2023 over the 2019 level



Source: European Commission.

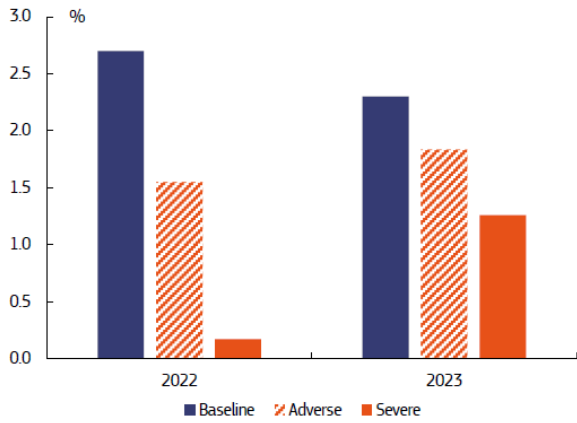
Graph 1.14: Expected real GDP in 2023 compared to extrapolated pre-crisis trend



Source: Own calculations based on European Commission data.

Note: The pre-crisis trend is based on the average real GDP growth rate 2015-2019, which is used to extrapolate 2019 real GDP.

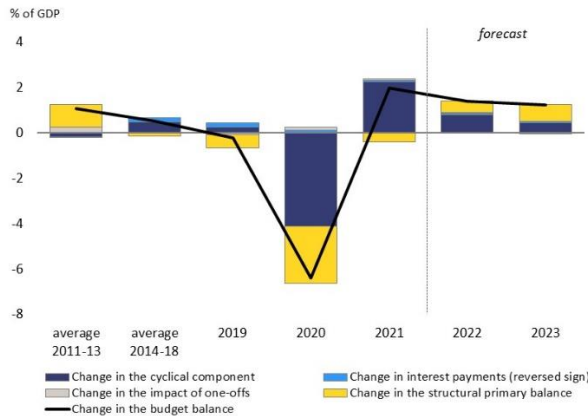
Graph 1.15: Real GDP growth under the Commission's adverse and severe scenario



Source: European Commission.

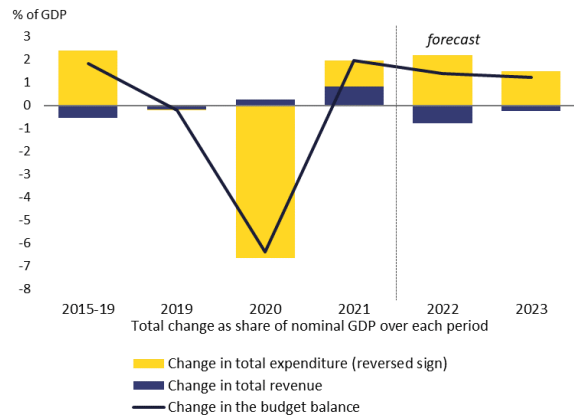
FISCAL POLICY DEVELOPMENTS

Graph 2.1: Drivers of the change in the general government budget balance; euro area aggregate



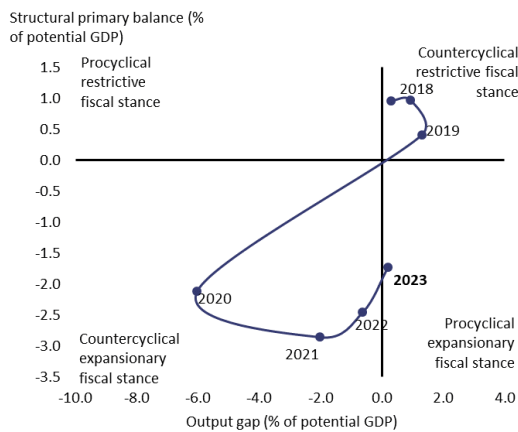
Source: European Commission.
 Note: (1) A decrease in interest payments is shown as an improvement in the headline balance.

Graph 2.2: Government revenue and expenditure; euro area aggregate



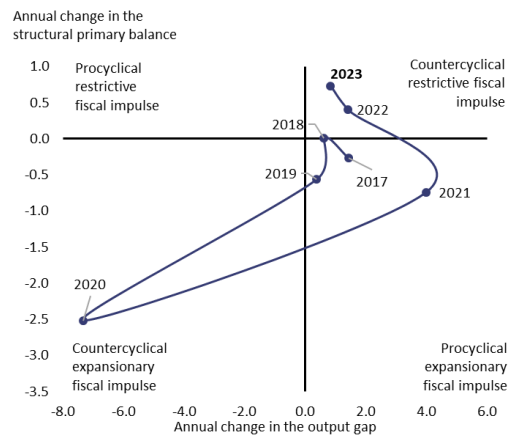
Source: European Commission.

Graph 2.3: Fiscal stance, the structural primary balance; euro area aggregate



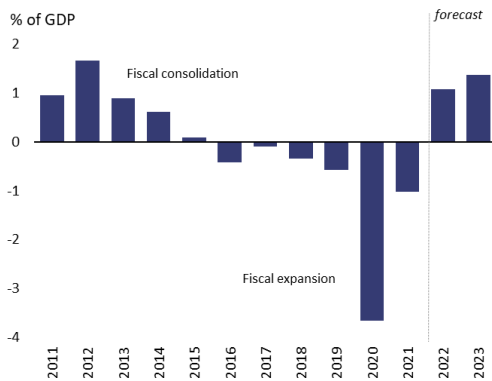
Source: European Commission.
 Note: Fiscal stance includes the impact of RRF grants (based on cash disbursements).

Graph 2.4: Fiscal impulse, change of the structural primary balance, euro area aggregate



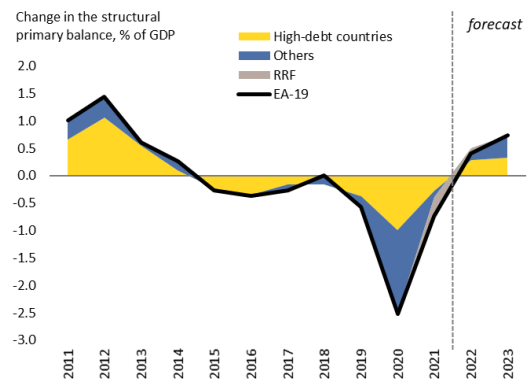
Source: European Commission.
 Note: Fiscal impulse includes the impact of RRF grants (based on cash disbursements).

Graph 2.5: Fiscal impulse as measured by net government expenditure growth relative to medium-term potential growth; euro area aggregate



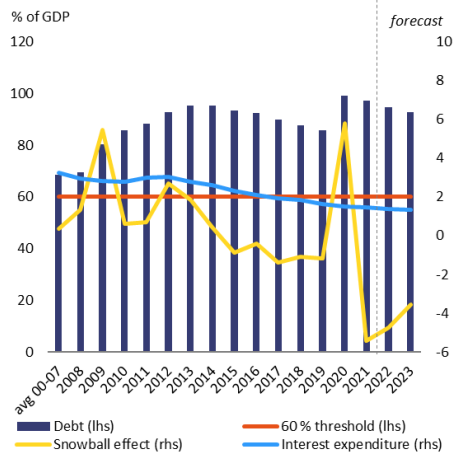
Source: European Commission, own calculations.
 Note: The graph shows the difference between net expenditure growth and medium-term potential growth (see glossary); it is multiplied by the share of expenditure in GDP to be expressed in % of GDP. If net expenditure growth exceeds medium-term potential growth, the fiscal impulse is considered expansionary.

Graph 2.6: Contributions of countries to the aggregate fiscal impulse



Source: European Commission.
 Notes: (1) The group of high-debt countries includes the euro area countries with a debt-to-GDP ratio above 90% in 2021: Belgium, Greece, Spain, France, Italy, Cyprus and Portugal. Others: the remaining countries of the euro area.

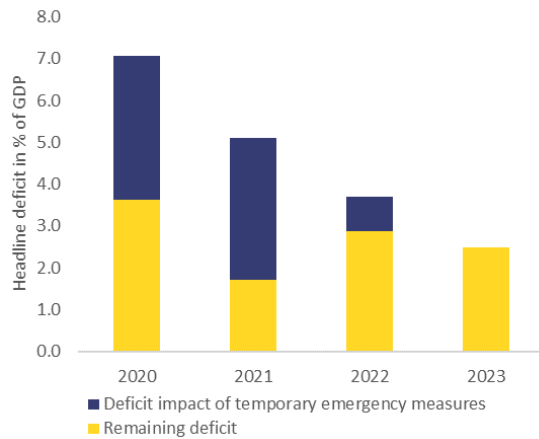
Graph 2.7: Government debt developments; euro area aggregate



Source: European Commission.

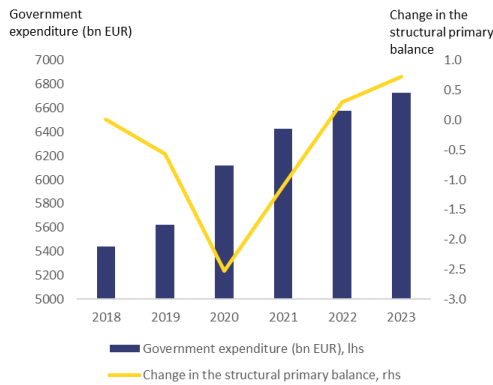
Notes: (1) The snowball effect combines the impact of interest expenditure (blue area) and of nominal GDP growth on the debt-to-GDP ratio: if GDP does not grow sufficiently fast to offset the cost of servicing debt, the debt ratio increases.

Graph 2.8: Direct budgetary impact of emergency measures on the EU headline deficit



Source: European Commission, own calculations.

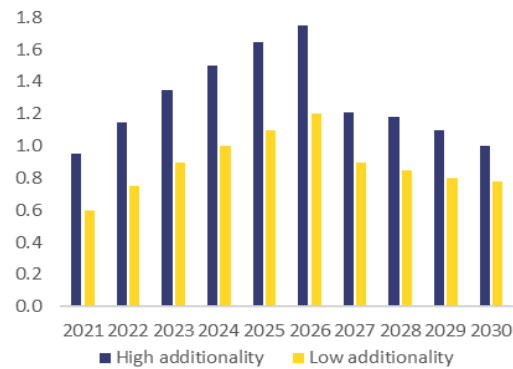
Graph 2.9: Euro area government expenditure and change in the structural primary budget balance



Source: European Commission.

Note: Fiscal impulse includes the impact of RRF grants (based on cash disbursements).

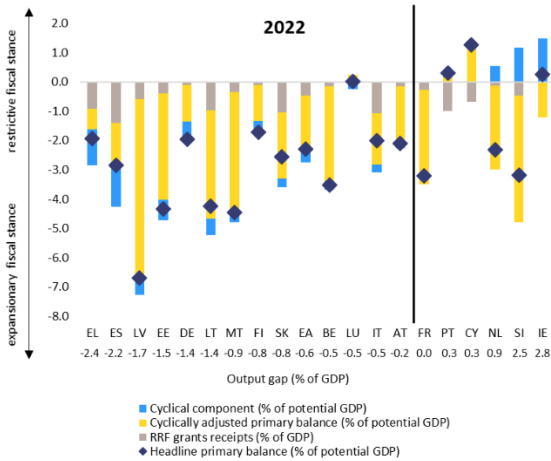
Graph 2.10: NGEU impact on real GDP above no-policy change baseline



Source: European Commission (2020 autumn forecast).

Notes: (1) Based on European Commission QUEST model. (2) Six-year horizon and equal distribution of payments. The original Commission proposal projected a peak in payments in 2023/2024. (3) The high additionality scenario assumes 100% of grants and 50% of loans are used for productive public investment. The low additionality scenario assumes both at 50%.

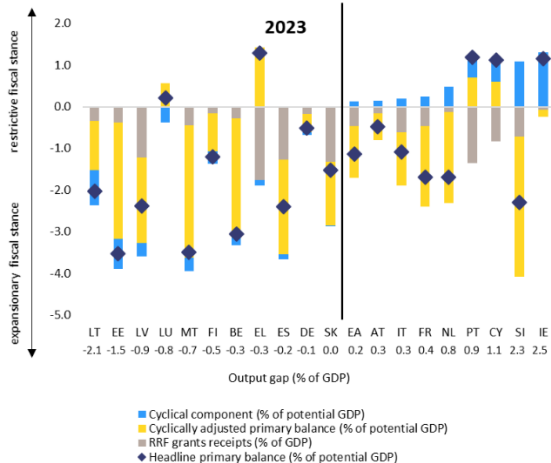
Graph 2.11: Fiscal stance across euro area Member States in 2022



Source: European Commission.

Note: Fiscal stance includes the impact of RRF grants (based on cash disbursements).

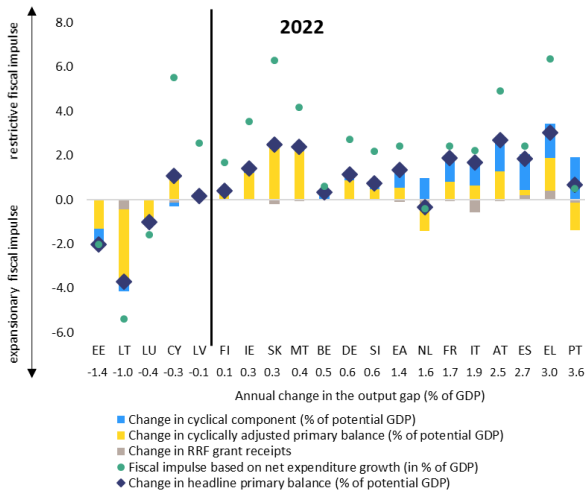
Graph 2.12: Fiscal stance across euro area Member States in 2023



Source: European Commission.

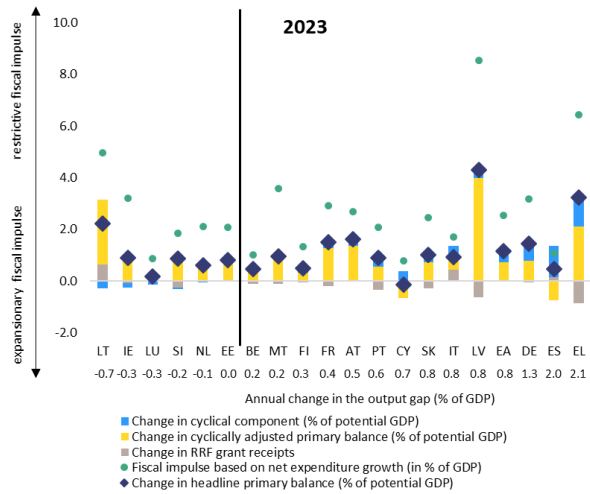
Note: Fiscal stance includes the impact of RRF grants (based on cash disbursements).

Graph 2.13: Fiscal impulse, cyclical conditions and sustainability in euro area Member States in 2022



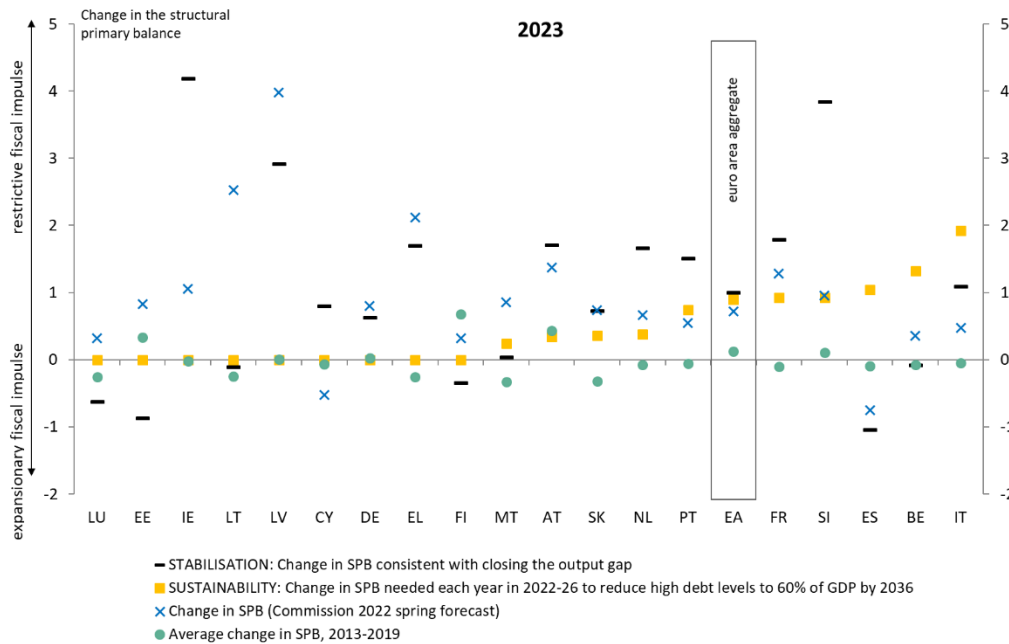
Source: European Commission.
Note: Fiscal impulse includes the impact of RRF grants (based on cash disbursements).

Graph 2.14: Fiscal impulse, cyclical conditions and sustainability across euro area Member States in 2023



Source: European Commission.
Note: Fiscal impulse includes the impact of RRF grants (based on cash disbursements).

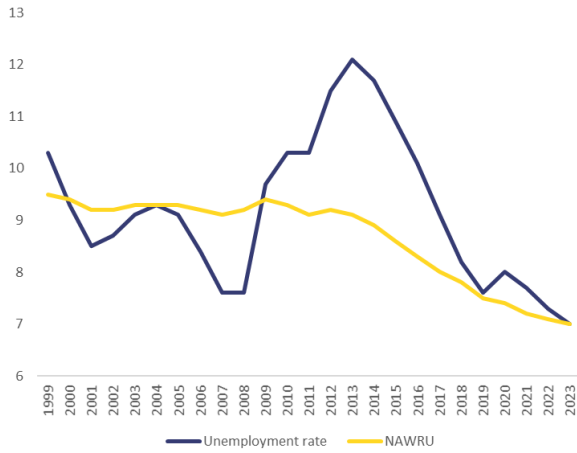
Graph 2.15: Overview: Expected national and aggregate fiscal impulse, stabilisation and sustainability – numbers do not yet reflect the draft budgetary plans of euro area Member States.



Source: European Commission, own calculations.
Notes:
 (1) Countries are ordered by increasing sustainability needs.
 (2) Stabilisation: a neutral fiscal impulse (i.e. letting automatic fiscal stabilisers operate without any additional discretionary measures) is appropriate when the output gap recently changed signs or is expected to narrow at a sufficient pace. If not, the stabilisation point shows the fiscal impulse consistent with a reduction of the output gap by 100% compared to its 2022 level, using a uniform fiscal multiplier of 0.8.
 (3) Sustainability needs are assessed using the Commission’s S1 indicator. S1 measures the total cumulative adjustment needed in 2022-2026, with the last SPB being maintained for another 10 years, to bring the debt-to-GDP ratio to 60% by 2036. For countries where S1 is positive, we assume that sustainability needs are addressed by implementing S1 in a uniform manner over five years, i.e. one fifth of S1 is implemented in 2022.
 (4) In countries where S1 is negative, debt is already below 60% of GDP or expected to fall below it by 2036, therefore no additional consolidation is needed.
 (5) The sustainability estimate for the euro area is approximated by weighing countries by debt levels (in euro).
 (6) While under the adjustment programme, Greece achieved a very high structural primary surplus but since the high surplus was already established in 2012 the figure indicates an average expansion for the given period.
 (7) Data for the stabilisation and sustainability indicator is based on the FSR 2021 and the Commission’s spring forecast 2022.
 (8) Fiscal impulse does not include impact of RRF grants.

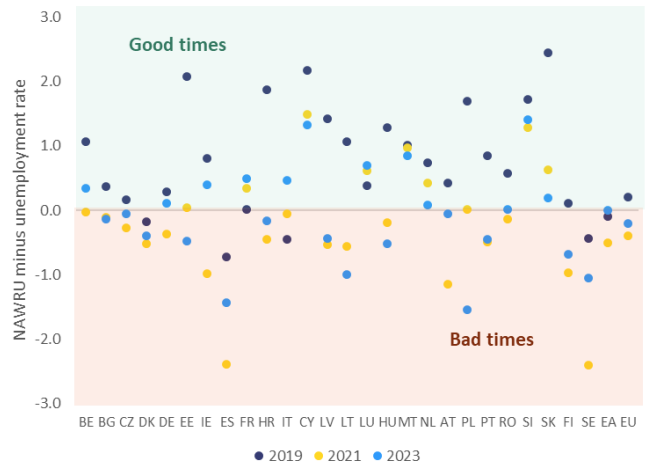
SPECIAL SECTION

Graph 3.1: Euro area unemployment rate



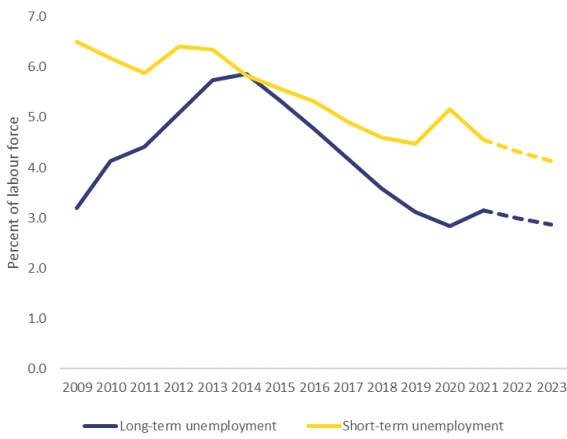
Source: European Commission.
Notes: The NAWRU is the non-accelerating wage rate of unemployment.

Graph 3.2: Gap between unemployment rate and NAWRU by Member State



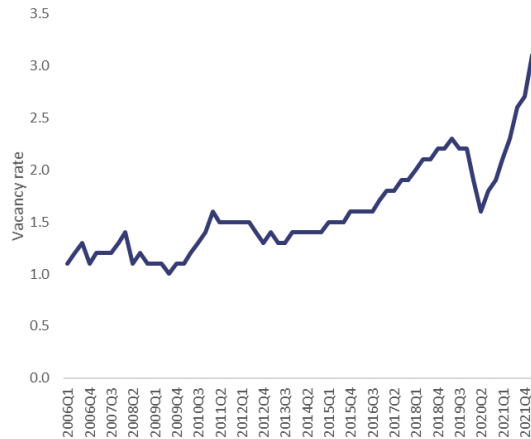
Source: European Commission.

Graph 3.3: Decomposition of unemployment rate



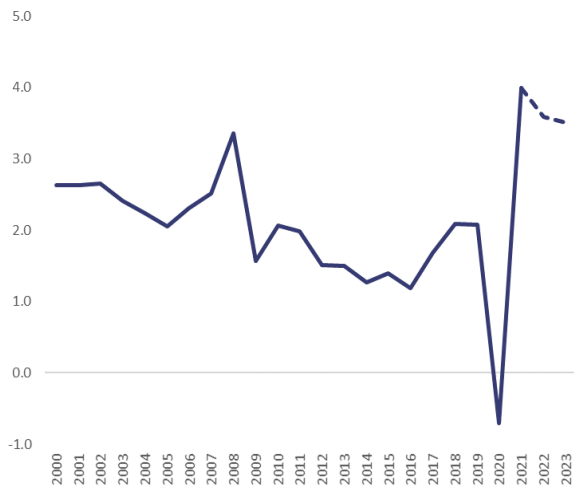
Source: European Commission.
Notes: (1) The long-term unemployment rate is based on seasonally adjusted data from 2021Q3. (2) Data for 2022 and 2023 assume that the share of long-term unemployment is unchanged from 2021.

Graph 3.4: Euro area vacancy rate



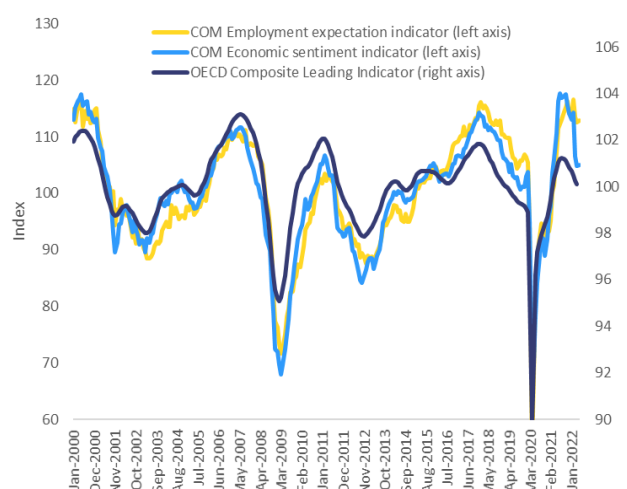
Source: European Commission.
Notes: (1) Vacancy rate for (NACE_r2 B-S) industry, construction and services (except activities of households as employers and extra-territorial organisations and bodies). Data is seasonally but not calendar adjusted.

Graph 3.5: Change in compensation per employee



Source: European Commission.

Graph 3.6: Sentiment indicators for the euro area



Source: European Commission and OECD.

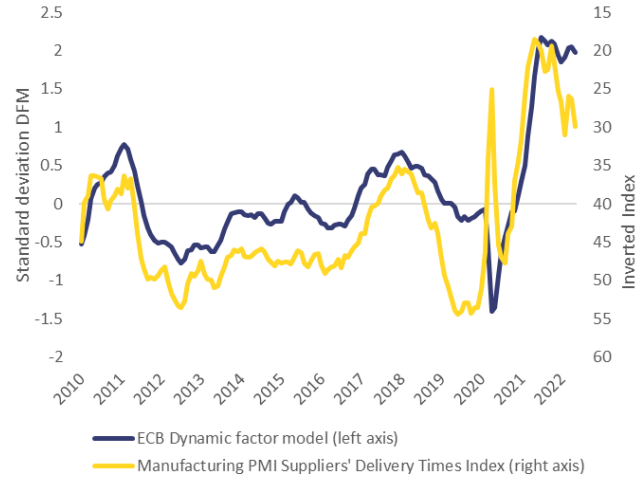
Graph 3.7: Capacity utilisation



Source: European Commission.

Notes: Seasonally not calendar adjusted.

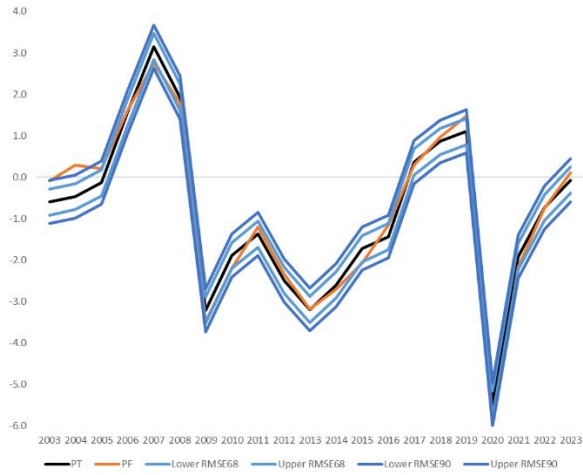
Graph 3.8: Supply chain pressures in the euro area



Source: ECB and IHS Markit.

Notes: (1) Dynamic factor model: standard deviations from the long-term mean. For detailed description see [ECB 2022](#). (2) Latest observations: May 2022.

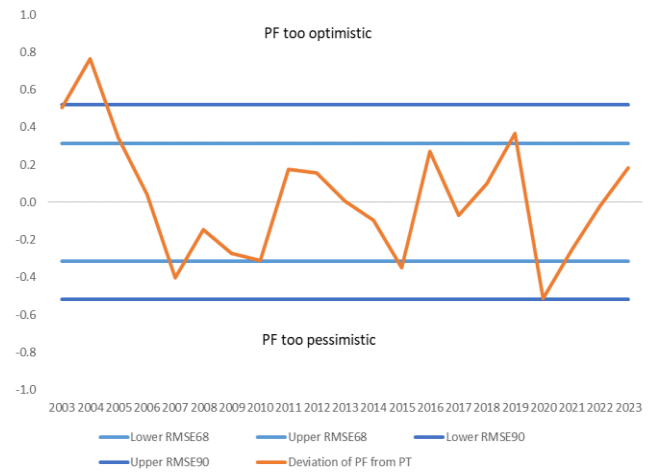
Graph 3.9: Plausibility ranges and euro area output gap estimates



Source: Own calculations

Notes: (1) PF = conventional production function output gap. RMSE = root mean squared error. (2) Data taken from AMECO is based on the spring forecast 2022.

Graph 3.10: Deviations of the plausibility tool from the conventional production function (PF) estimate



Source: Own calculations

Notes: (1) PF = conventional production function output gap. RMSE = root mean squared error. (2) Data taken from AMECO is based on the spring forecast 2022.

Table 3.2: Plausibility tool results over time

RMSE90						RMSE68					
2016	2017	2018	2019	2020	2021	2016	2017	2018	2019	2020	2021
AT	AT	AT	AT	AT	AT	AT	AT	AT	AT	AT	AT
BE	BE	BE	BE	BE	BE	BE	BE	BE	BE	BE	BE
BG	BG	BG	BG	BG	BG	BG	BG	BG	BG	BG	BG
CY	CY	CY	CY	CY	CY	CY	CY	CY	CY	CY	CY
CZ	CZ	CZ	CZ	CZ	CZ	CZ	CZ	CZ	CZ	CZ	CZ
DE	DE	DE	DE	DE	DE	DE	DE	DE	DE	DE	DE
DK	DK	DK	DK	DK	DK	DK	DK	DK	DK	DK	DK
EE	EE	EE	EE	EE	EE	EE	EE	EE	EE	EE	EE
EL	EL	EL	EL	EL	EL	EL	EL	EL	EL	EL	EL
ES	ES	ES	ES	ES	ES	ES	ES	ES	ES	ES	ES
FI	FI	FI	FI	FI	FI	FI	FI	FI	FI	FI	FI
FR	FR	FR	FR	FR	FR	FR	FR	FR	FR	FR	FR
HR	HR	HR	HR	HR	HR	HR	HR	HR	HR	HR	HR
HU	HU	HU	HU	HU	HU	HU	HU	HU	HU	HU	HU
IE	IE	IE	IE	IE	IE	IE	IE	IE	IE	IE	IE
IT	IT	IT	IT	IT	IT	IT	IT	IT	IT	IT	IT
LT	LT	LT	LT	LT	LT	LT	LT	LT	LT	LT	LT
LU	LU	LU	LU	LU	LU	LU	LU	LU	LU	LU	LU
LV	LV	LV	LV	LV	LV	LV	LV	LV	LV	LV	LV
MT	MT	MT	MT	MT	MT	MT	MT	MT	MT	MT	MT
NL	NL	NL	NL	NL	NL	NL	NL	NL	NL	NL	NL
PL	PL	PL	PL	PL	PL	PL	PL	PL	PL	PL	PL
PT	PT	PT	PT	PT	PT	PT	PT	PT	PT	PT	PT
RO	RO	RO	RO	RO	RO	RO	RO	RO	RO	RO	RO
SE	SE	SE	SE	SE	SE	SE	SE	SE	SE	SE	SE
SI	SI	SI	SI	SI	SI	SI	SI	SI	SI	SI	SI
SK	SK	SK	SK	SK	SK	SK	SK	SK	SK	SK	SK

Source: European Commission and own calculations based on Commission plausibility tool.

Note: (1) Countries shaded in red denote those countries where the plausibility tool estimate is lower (more negative or less positive) than the conventional production function method and falls outside the respective confidence interval. Countries shaded in yellow are those where tool's results are higher (more positive or less negative) than for the production function method and fall off the confidence interval. (2) RMSE = root-mean-square error. (3) Underlying data based on Commission spring forecast 2022.

Key indicators for the euro area

Output		LTA ⁽¹⁾	2018	2019	2020	2021	21Q1	21Q2	21Q3	21Q4	22Q1
Economic sentiment	<i>Indicator</i>	99.9	110.9	103.6	88.2	110.7	99.3	110.7	117.1	115.7	111.5
Gross domestic product	<i>% ch. on prev. period</i>						-0.1	2.2	2.3	0.2	0.6
	<i>% ch. on prev. year</i>	1.4	1.9	1.6	-6.4	5.4	-0.9	14.7	4.0	4.7	5.4
Labour productivity	<i>% ch. on prev. period</i>						-2.9	2.2	0.5	2.6	-2.7
	<i>% ch. on prev. year</i>	0.6	0.2	0.3	-4.9	4.2	0.7	12.7	1.8	2.3	2.5
Private consumption		LTA ⁽¹⁾	2018	2019	2020	2021	21Q1	21Q2	21Q3	21Q4	22Q1
Consumer confidence	<i>Balance⁽²⁾</i>	-10	-5	-6.8	-14.2	-7.4	-12.2	-5.5	-4.2	-7.6	-13.6
Retail confidence	<i>Balance⁽²⁾</i>	-8.0	1.1	-0.3	-12.6	-1.9	-14.1	-1.4	4.9	3.1	1.7
Private consumption	<i>% ch. on prev. period</i>						-2.2	3.8	4.5	-0.3	-0.7
	<i>% ch. on prev. year</i>	1.1	1.5	1.4	-8	3.8	-5.4	12.4	2.9	5.8	7.5
Retail sales	<i>% ch. on prev. period</i>						-14.4	9.2	1.2	9.5	-13.9
	<i>% ch. on prev. year</i>	1.2	1.7	2.5	0.3	4.8	2.9	10.8	2.3	3.5	4.1
Investment		LTA ⁽¹⁾	2018	2019	2020	2021	21Q1	21Q2	21Q3	21Q4	22Q1
Capacity utilisation	<i>Level (%)</i>	80.4	83.7	82.2	74.6	81.4	79.2	80.8	83	82.7	82.4
Production expectations (manufacturing)	<i>Balance⁽²⁾</i>	7.8	16	5	-1	20	13	20	23	22	17
Gross fixed capital formation (3)	<i>% ch. on prev. period</i>						0.1	1.4	-0.9	3.1	0.1
	<i>% ch. on prev. year</i>	1.7	3.1	6.8	-7.3	4.2	-5.9	18.2	3.0	3.7	3.7
- equipment investment	<i>% ch. on prev. period</i>						1.8	0.8	-1.8	1.7	1.5
	<i>% ch. on prev. year</i>	2.6	3.8	1.8	-12.3	10.0	7.4	30.8	2.5	2.4	2.1
- construction investment	<i>% ch. on prev. period</i>						0.7	1.8	-0.8	0.1	3.4
	<i>% ch. on prev. year</i>	0.3	3.8	3.3	-4.9	6.1	2.6	18.8	3.0	1.7	4.4
Change in stocks	<i>Contrib. to GDP (pp)</i>	0.0	0.1	-0.1	-0.2	0.2	1.1	-0.6	-0.2	0.4	0.6
Labour market		LTA ⁽¹⁾	2018	2019	2020	2021	21Q1	21Q2	21Q3	21Q4	22Q1
Employment expectations (manufacturing)	<i>Balance⁽²⁾</i>	-7.1	9	-1	-12	8	-2	7	13	15	15
Employment expectations (services)	<i>Balance⁽²⁾</i>	7.8	3	9	8	-4	0	-4	-7	-6	-5
Employment	<i>% ch. on prev. period</i>						-0.1	0.8	1.0	0.4	0.6
	<i>% ch. on prev. year</i>	0.8	1.6	1.3	-1.5	1.1	-1.7	2.0	2.1	2.1	2.9
Employment (000)	<i>ch. on prev. period</i>		10218	8201	-9843	7106	-145	1228	1597	709	752
Compensation of employees (per head, nominal)	<i>% ch. on prev. period</i>						0.3	0.6	2.3	0.9	0.9
	<i>% ch. on prev. year</i>	1.9	2.2	1.9	-0.6	4.4	2.0	7.8	3.7	4.1	4.7
Unemployment rate	<i>% of lab. force</i>		8.3	7.6	8.0	7.8	8.3	8.0	7.5	7.2	
Unemployment (000)	<i>ch. on prev. period</i>		-5490	-3795	1568	-902	410	-805	-639	-568	
International transactions		LTA ⁽¹⁾	2018	2019	2020	2021	21Q1	21Q2	21Q3	21Q4	22Q1
World trade	<i>% ch. on prev. period</i>						2.5	1.4	-0.2	2.8	0.8
	<i>% ch. on prev. year</i>		3.4	-0.4	-5.2	10.3	6.8	21.3	7.7	6.6	4.8
Export order books	<i>Balance⁽²⁾</i>	-17.3	0	-13	-33	-2	-16	-1	4	6	7
Trade balance (merchandise)	<i>Billion EUR</i>		190.7	222.6	234.1	116.6	68.8	38.4	25.9	-16.5	-37.2
Exports of goods and services	<i>% ch. on prev. period</i>						0.9	3.2	1.9	2.7	0.4
	<i>% ch. on prev. year</i>	4.5	3.7	2.7	-9.4	10.8	-0.1	26.9	10.6	8.9	8.4
Imports of goods and services (3)	<i>% ch. on prev. period</i>						1.0	3.3	1.4	4.7	-0.6
	<i>% ch. on prev. year</i>	4.4	3.7	4.8	-9.3	8.7	-5.7	22.2	10.7	10.8	9.1
Prices		LTA ⁽¹⁾	2018	2019	2020	2021	21Q1	21Q2	21Q3	21Q4	22Q1
Headline inflation (HICP)	<i>% ch. on prev. year</i>		1.8	1.2	0.3	2.6	1	1.8	2.9	4.7	6.1
Core inflation	<i>% ch. on prev. year</i>		1.2	1.2	0.9	1.5	1.2	0.9	1.5	2.5	2.8
Monetary and financial indicators		LTA ⁽¹⁾	2018	2019	2020	2021	21Q1	21Q2	21Q3	21Q4	22Q1
Nominal interest rates (3-month)	<i>Level</i>		-0.32	-0.35	-0.42	-0.54	-0.54	-0.54	-0.54	-0.56	-0.52
Nominal interest rates (10-year)	<i>Level</i>		0.40	-0.25	-0.51	-0.37	-0.46	-0.28	-0.45	-0.30	0.1
ECB repo rate	<i>Level</i>		0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Bilateral exchange rate USD/EUR	<i>Level</i>		1.18	1.12	1.14	1.18	1.21	1.21	1.18	1.14	1.12
	<i>% ch. on prev. period</i>						1.1	0.0	-2.2	-3.0	-1.9
	<i>% ch. on prev. year</i>		4.6	-5.2	1.9	3.7	9.4	9.5	0.8	-4.1	-6.9
Nominal effective exchange rate	<i>% ch. on prev. period</i>						-0.6	0.6	-0.8	0.0	
	<i>% ch. on prev. year</i>		4.8	-1.5	3.0	2.2	5.4	4.1	0.4	-0.8	

Sources: European Commission, ECB, CPB Netherlands Bureau for Economic Policy Analysis.

Notes: Data in the table have been taken from different sources available until 9 June 2022 and at different moments in time. (1) LTA = Long-term average (since 1990 or earlier if available). (2) Balance: the difference between positive and negative answers, in percentage points of total answers.

GLOSSARY

Automatic fiscal stabilisers: the way government revenue and spending react in a stabilising manner to fluctuations of output without deliberate government action. As a result, the budget balance as a percent of GDP tends to improve in years of high growth and deteriorate during economic slowdowns.

Country-specific recommendations (CSRs): policy guidance tailored to each EU Member State based on the provisions of the Stability and Growth Pact and the macroeconomic imbalance procedure. The recommendations are put forward by the European Commission in May each year, then discussed among Member States in the Council, endorsed by EU leaders at a summit in June, and formally adopted by the finance ministers in July.

Discretionary fiscal policy: change in the budget balance and in its components under the control of government. It is usually measured as the residual of the change in the budget balance after the budgetary impact of automatic stabilisers and interest payments has been excluded (see also ‘fiscal stance’).

Draft budgetary plans (DBPs): governments submit DBPs to the Commission and the Council to ensure the coordination of fiscal policies among Member States who have the euro as their currency and because the EU Treaty recognises economic policy as ‘a matter of common concern’. They submit their DBPs for the following year between 1 and 15 October. The requirement was set in 2013 with the two-pack reform of the Stability and Growth Pact.

Expenditure benchmark: a mechanism applied under the preventive arm of the Stability and Growth Pact imposing an upper limit on the growth rate of government primary expenditure net of discretionary revenue measures. The objective of the benchmark is to ensure that a country stays at its MTO or on the adjustment path towards it (see also net expenditure).

Fiscal impulse: a measure of the direction and extent of discretionary fiscal policy. In this document, it is defined as the annual change in the structural primary budget balance. It is thus the change in the fiscal stance (see also ‘fiscal stance’). When the change is positive, the fiscal impulse is said to be restrictive; when the change is negative, it is said to be expansionary.

Fiscal space: leeway to run an expansionary fiscal policy. While there is no generally accepted

definition, in this document a country is considered to have fiscal space in year t if its structural balance in year $t-1$ is estimated above its MTO. Barring other considerations, the country may use this fiscal space, i.e. let its structural balance deteriorate at most until it is back at its MTO.

Fiscal stance: a measure of the direction and extent of discretionary fiscal policy. In this document, it is defined as the structural primary budget balance. When the balance is positive, the fiscal stance is said to be restrictive; when the stance is negative, it is said to be expansionary.

General escape clause: See severe economic downturn clause.

Medium-term budgetary objective (MTO): under the Stability and Growth Pact, stability programmes and convergence programmes present a medium-term objective for the budgetary position. It is country-specific to take into account the diversity of economic and budgetary developments and fiscal risks to the sustainability of public finances. It is defined in structural terms (see ‘structural balance’).

Net expenditure: primary government expenditure net of certain items not directly under the control of government (expenditure backed by EU funds and the cyclical component of unemployment benefit expenditure) and using investment expenditure smoothed over four years. It is also net of discretionary revenue measures and revenues mandated by law, and corrected for the impact of one-offs (see also ‘expenditure benchmark’).

Output gap: the difference between actual output and estimated potential output at a particular point in time. A business cycle typically includes a period of positive output gaps and a period of negative output gaps. When the output gap is closed, the economy is in line with its potential level (see ‘potential GDP’). Observations indicate that a standard business cycle usually lasts up to eight years, suggesting that the output gap is typically expected to close roughly every four years.

Plausibility tool (PT): an analytical tool of the European Commission to assess the plausibility of its output gap estimates derived from the EU’s commonly agreed methodology (EUCAM). It is based on a regression analysis that uses a range of complementary indicators of economic slack. It creates a central estimate of the output gap and a

range around it based on different confidence intervals.

Potential GDP: the level of real GDP in a given year that is consistent with a stable rate of inflation. If actual output rises above its potential level, constraints on capacity begin to bind and inflationary pressures build; if output falls below potential, resources are lying idle and inflationary pressures abate (see also ‘output gap’).

S1 indicator: medium-term sustainability indicator published by the European Commission. It indicates the additional adjustment, in terms of change in the structural primary balance, required over five years to bring the general government debt-to-GDP ratio to 60% in 15 years’ time, including financing for any future additional expenditure arising from an ageing population.

Severe economic downturn clause: in the public debate misleadingly referred to as the ‘general escape clause’, it was created in 2011 as part of the six-pack reform of the Stability and Growth Pact. It allows for additional and temporary flexibility with the normal requirements of the preventive and corrective arm of the Pact in the event of a severe economic downturn for the euro area or the EU as a whole, provided that this does not endanger fiscal sustainability in the medium term. A severe economic downturn is defined using average annual real GDP growth or as an accumulated loss of output relative to the potential output for a prolonged period of time.

Stabilisation: economic policy intervention to bring actual output closer to potential output. In the Economic and Monetary Union, this is expected to be achieved, in normal economic times, through the ECB’s monetary policy (for common shocks) and national automatic fiscal stabilisers (for country-specific shocks). When this is not sufficient, discretionary fiscal policy can also play a role.

Stability and convergence programmes (SCPs): Every year in April, EU Member States are required to set out their fiscal plans for the next three years and to submit them for assessment to the European Commission and the Council. This exercise is based on the economic governance rules under the Stability and Growth Pact. Euro area countries submit stability programmes; non-euro area countries convergence programmes.

Strategic substitutes/complements: actions by economic agents are called strategic complements/substitutes when their impact strengthen/weaken one another. In normal times, fiscal and monetary policy in the euro area are strategic substitutes. They have become strategic complements during the Covid-19 crisis.

Structural balance: the headline budget balance corrected for the impact of the economic cycle and net of one-off and other temporary measures. The structural balance gives a measure of the underlying trend in the budget balance.

Structural primary balance: the structural budget balance net of interest payments.

Sustainability of public finances: the ability of a government to service its debt. From a purely theoretical point of view, this basically assumes that the government debt level does not grow faster than the interest rate. While conceptually intuitive, an agreed operational definition of sustainability has proven difficult to achieve. The European Commission uses three indicators of sustainability with different time horizons (S0, S1 and S2) which are complemented by a debt sustainability analysis that includes sensitivity tests on government debt projections and alternative scenarios.

Zero or effective lower bound (ZLB): when the short-term nominal interest rate is at or near zero, the central bank is limited in its capacity to stimulate economic growth by lowering policy rates further. To overcome the constraint imposed by the ZLB, alternative methods to stimulate demand are generally considered, such as asset purchase programmes. The root cause of the ZLB is the issuance of paper currency, effectively guaranteeing a zero nominal interest rate and acting as an interest rate floor. Central banks cannot encourage spending by lowering interest rates, because people would hold cash instead.