

European Fiscal Board

**Assessment of the
prospective fiscal stance appropriate for the euro area**

20 June 2017

Composition of the European Fiscal Board

Niels THYGESEN

Chair

Professor Emeritus of International Economics at the University of Copenhagen and former adviser to governments and international institutions, Denmark

Roel BEETSMA

Member

Professor at the University of Amsterdam and Vice-Dean of the Faculty of Economics and Business, The Netherlands

Massimo BORDIGNON

Member

Professor and Director of the Department of Economics and Finance at the Catholic University of Milan, Italy

Sandrine DUCHÊNE

Member

General Secretary of AXA France in charge of audit and compliance, France

Mateusz SZCZUREK

Member

Former Finance Minister, teacher at Warsaw University, and EBRD Associate Director, Poland

https://ec.europa.eu/info/business-economy-euro/economic-and-fiscal-policy-coordination/european-fiscal-board-efb_en

Comments on the report should be sent to:

Martin Larch

Head of Secretariat of the European Fiscal Board

European Commission

Office CHAR 13/49

B-1049 Brussels

Email: martin.larch@ec.europa.eu

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Prof. Niels Thygesen

Chair of the European Fiscal Board

Foreword

Fiscal policy is a powerful instrument of macroeconomic policymaking. If used appropriately and with the necessary degree of prudence, it can help stabilise economic activity by mitigating the impact of recurring economic booms and busts on employment and income. If used inappropriately, it may add to the volatility of economic activity, lead to an unhealthy accumulation of government debt and weigh on the effectiveness of monetary policy.

In the euro area, fiscal policy is a prerogative of national governments, while the budget of the European Union is required to balance its accounts annually and is too small to serve as a fiscal stabilisation tool for the euro area as a whole. In order to minimise the risks of fiscal policies undermining the common stability-oriented monetary policy, national fiscal policies are expected to observe common rules, known as the Stability and Growth Pact (SGP).

The key objective of the SGP is to direct national governments towards safeguarding the long-term sustainability of public finances while letting automatic stabilisers dampen temporary swings in national economic activity. In the late 1980s and early 1990s, when the euro area governance framework was agreed, an appropriate fiscal stance for the euro area as a whole was assumed to arise from the sum of national fiscal policies. The underlying argument was that, as long as Member States faithfully abided by the commonly agreed rules, automatic fiscal stabilisers would also ensure an appropriate degree of stabilisation in the euro area as a whole. In hindsight, we have had to

realise that (i) economic shocks may become too large to be dealt with by national automatic stabilisers and centralised monetary policy; and (ii) cross-country spill-over effects of fiscal policy are not internalised by national governments and are likely to become larger when monetary policy is facing the zero lower bound of nominal interest rates, as is the case right now. In recent years, it has become apparent that the pursuit of national policies does not necessarily lead to an outcome that works for the currency area as a whole. In 2015 and 2016, national fiscal policies added up to a broadly neutral fiscal stance for the currency area as a whole while available economic indicators pointed to a persistent and considerable degree of economic slack and the European Central Bank (ECB) was overburdened with sustaining the economy by avoiding deflation.

The advisory European Fiscal Board (EFB) was launched in autumn 2016 as part of the broader effort to enhance the EU's economic governance framework as outlined in the Five Presidents' Report of June 2015. The EFB consists of five international experts appointed on the basis of merit and expertise. One of its two main tasks is to form an economic judgment on the appropriate fiscal stance at the euro area level, against the background of EU fiscal rules⁽¹⁾. By doing so, it should generate debate on aspects of the euro area governance framework.

This document contains the EFB's first advice on the prospective fiscal stance appropriate for the euro area. The advice will be issued once a year for the following year. While the fiscal stance of individual Member States has received regular attention at national and European level, the euro area as a whole has been a virtual entity, the result of a simple statistical aggregation. The EFB will look at the euro area as a single entity.

¹ The full mandate is detailed in Commission Decision (EU) 2015/1937 establishing the European Fiscal Board as amended by Commission Decision (EU) 2016/221.

The underlying motivation is not to fine-tune discretionary fiscal policy interventions, something that proved to be impractical. Rather, since the euro area is more than the sum of its parts, assessing developments from the aggregate perspective adds value to the policy debate. In line with its advisory role, the EFB's assessment aims to provide input to Member States' budgetary plans for the forthcoming year and to the Commission's and the Council's assessment of them.

The notion of a euro area fiscal stance was not a central piece in the original Maastricht governance framework, which was mainly focused on sustainable national public finances. It gained strength during the 2008-2009 crisis, with a coordinated fiscal stimulus commonly agreed by the Member States in the European Economic Recovery Plan. Although the notion is certainly more relevant at times of crisis, the need for monitoring also at other times whether the sum of national fiscal policies adds up to the best possible aggregate outcome for the euro area as a whole will arise more regularly. In the unusual current situation where monetary policy is likely to remain very accommodating for some time still, national fiscal policies have become

more effective both within and across borders. At the same time, improving the sustainability of national public finances remains central and must be pursued vigorously at a time of steady growth.

The EFB's other key task is to assess the application of the EU fiscal rules. The fact that, in its first public document, the EFB is providing advice on the euro area fiscal stance rather than looking at how the commonly agreed rules for national fiscal policymaking are observed must in no way be understood as a preference for one task over the other. The Board's choice is determined by the sequencing of policy decisions in the annual governance cycle of the European Semester: advice on fiscal policy making for the year ahead needs to be shared before Member States start preparing their budgets. Similarly, a reasoned judgment of how EU fiscal rules have been applied over the course of the annual EU governance cycle can only be formed once the relevant decisions have been taken and carefully assessed. This is why the Board will publish its annual report in autumn with our analysis of how existing rules were applied during the preceding annual EU surveillance cycle.

1. MACROECONOMIC SITUATION AND OUTLOOK

A steady but subdued-inflation recovery has taken hold in the euro area. In the face of a relatively wide range of internal and external headwinds — including the UK’s vote to leave the EU, geopolitical tensions, and terrorist attacks — real GDP continues to follow a fairly steady albeit measured pace of growth in the euro area. In 2016, it increased by 1.8 %, posting the third positive reading since the end of the double-dip recession in 2013. As in the preceding years, growth has been mostly driven by private consumption. Price and wage developments have been exceptionally muted. Both headline and core inflation have been well below the ECB’s target; in 2016, inflation, as measured by the annual increase of the harmonised index of consumer prices, stood at 0.2 % and core inflation, which excludes energy and food prices, stood at 0.8 %. Leaving aside low energy prices, very moderate wage growth has been an important contributing factor. Real unit labour costs were still declining in 2016, although at a much slower rate than in previous years.

The pace of recovery has been slow compared to both past experience and other economic areas. Slow and protracted recoveries are to be expected after major financial market dislocations like those of 2008 and after. The correction of massive imbalances accumulated in the run-up to the post-2007 crises has not been fully completed and weighs on the pace of economic growth. However, the euro area has also been lagging behind other developed economies including the US, which initially was at the centre of the global economic and financial crisis. Euro area real GDP returned to its pre-crisis level only in 2015, while in other advanced economies that experienced a post-2007 banking crisis, output was back to the pre-crisis level three years earlier⁽²⁾.

The economy of the euro area is deeply scarred by the crisis years. Investment spending, essential to future growth, posted a particularly sharp and persistent drop during the post-2007 downturn. It started growing again with the general economic recovery in the euro area but still falls markedly short of pre-crisis trends. This is mostly because of ongoing deleveraging of firms and households, subdued expectations of future growth and persisting elements of uncertainty. While access to credit no longer seems to be an obstacle to investment, the high level of non-performing loans in the euro area banking sector encumbers financial intermediation and monetary transmission. Labour market conditions have also improved over the course of the recovery, as evidenced by the declining rate of unemployment. However, the number of jobseekers, especially those out of work for a year or more, remains high as a percentage of the labour force. Albeit declining in 2016, involuntary part-time employment also remains high, accounting for over 30 % of total part-time employment.

The shortfall of total euro area domestic demand relative to GDP is large. In 2016, the euro area current account recorded a surplus of around 3.3 % of GDP. This sizeable surplus is the result of a profound adjustment process imposed by the post-2007 crises. In the pre-crisis period (2000-2007), the current account of the euro area was broadly balanced as deficits in some countries were counterbalanced by surpluses in other parts of the single currency area. It started recording increasing surpluses in the aftermath of the 2008-2009 downturn with a sharp compression of aggregate demand, mainly in countries that had been running sizeable current account deficits before. The depreciation of the euro in 2015 provided additional impetus by helping exports.

Euro area trends mask substantial differences between countries. 2016 was the

² These countries include Switzerland, Japan, Sweden, the UK and the US; see Ruscher, E.

and Vašíček, B. (2015), ‘The euro area recovery in perspective’, *Quarterly Report on the Euro Area*, Vol. 14, No. 3, pp. 6-18.

first post-crisis year in which all euro area countries, including Greece, recorded non-negative real GDP growth. However, the pace and the profile of the economic recovery have varied greatly between participating Member States; growth is stronger and more broad-based in countries like the Netherlands and Spain, and more subdued and fragile in France and Italy. The recovery in Germany is broadly in line with the euro area average but longer lasting and much more solid in terms of overall labour market performance. Germany is also the largest contributor to the euro area current account surplus.

Monetary policy has been facing the zero lower bound of policy rates; it is likely to remain accommodative. Since late 2014, the ECB has reduced its interest rate on the main refinancing operations to near zero, and the interest rate on the deposit facility was set negative. In the context of persistently low inflation and a weak economic recovery, in March 2015 the ECB launched its expanded asset purchase programme. Asset purchases have slowed since April 2017, but they are intended to be carried out until at least the end of 2017. While the ECB's asset purchases may expire then, the Governing Council of the ECB has recently stated that it expected *'the key ECB interest rates to remain at their present levels for an extended period of time, and well past the horizon of the net asset purchases'*.

Accommodative monetary policy significantly enhances the effects of fiscal policy and cross-country spill-overs. The impact of discretionary fiscal policy on domestic demand is expected to be significantly higher when monetary policy is accommodative and interest rates are kept near the zero lower bound. Importantly for the euro area, this also increases cross-country fiscal spill-overs, strengthening the case for coordination⁽³⁾.

³ Simulations with the European Commission QUEST macroeconomic model show that, at the zero lower bound of nominal interest rates, the domestic GDP effect of a fiscal expansion,

Moreover, fiscal stimuli are generally found to be more effective when many households face financial difficulties. The effects of fiscal expansion are more limited in normal times when policy rates rise, the exchange rate appreciates and the financial situation of households normalises.

Economic sentiment has been improving, but growth forecasts remain broadly stable.

The latest confidence and activity indicators are well above historical averages. Nevertheless, most forecasters expect the measured pace of economic recovery recorded in the past two years to continue in 2017 and 2018. Available projections for real GDP growth are around 1¾ % per year in both years. The relative contribution of investment is assumed to edge up only marginally. Headline consumer price inflation, which picked up at the end of 2016 and early 2017, mainly on the back of rebounding energy prices, is projected to recover from the unusual lows of preceding years, but to still average below the ECB's inflation target; with core inflation lower still. Unemployment is expected to continue its descent, yet to remain considerably higher than in the US and other non-euro area economies, keeping wage growth contained.

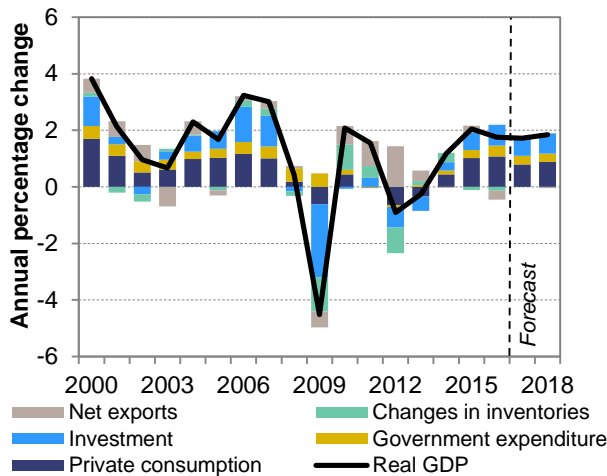
The current outlook is surrounded by substantial risks. On the external front, the timing and size of key economic policy initiatives on the part of the US administration remain unclear. This also holds true for measures that may have beneficial or adverse effects on the rest of the world, e.g. major US tax reforms or trade initiatives. Another

e.g. an increase in government consumption, is around 40 % to 50 % higher when implemented jointly in all euro area countries as compared to when a country acts alone. Estimates obtained by other institutions are in the same order of magnitude. See In 't Veld, J. (2013), 'Fiscal consolidations and spill overs in the Euro Area periphery and core', *European Economy — Economic Papers*, 506 and In 't Veld, J. (2016), 'Public Investment Stimulus in Surplus Countries and their Euro Area Spill Overs', *European Economy — Economic Briefs*, 16.

persistent factor of uncertainty in the global environment is the ongoing rebalancing of the Chinese economy; abrupt shifts in that process would have important repercussions for the euro area. On the domestic front, the risk profile has been unchanged for a number of quarters: the UK's decision to leave the EU, the strength of populist and anti-EU/euro parties in some

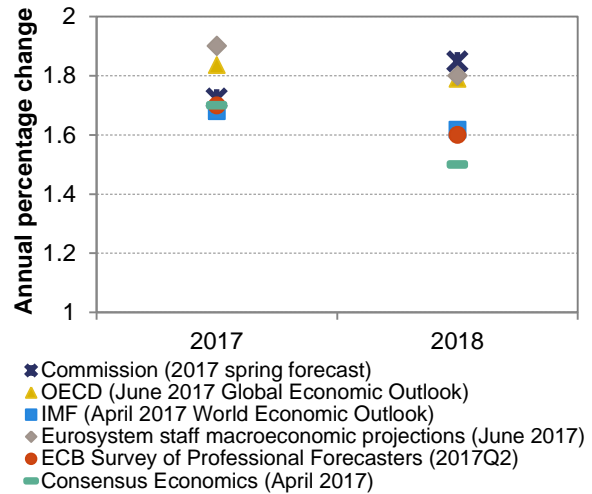
Member States, and remaining vulnerabilities in the euro area banking sector feature among the most prominent downside risks. One of the few upside risks is a stronger investment cycle. Favourable financing conditions and a high rate of capacity utilisation could lead to stronger investment growth, if and when the economic and political environment remains stable.

Graph 1.1: Euro area real GDP growth and its components



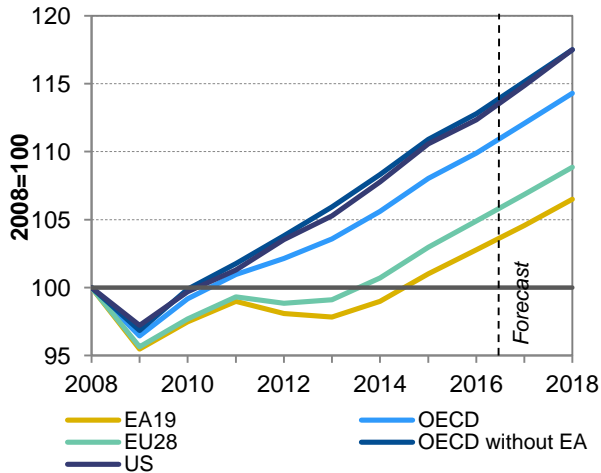
Source: Commission 2017 spring forecast

Graph 1.2: Real GDP growth in the euro area: range of forecasts



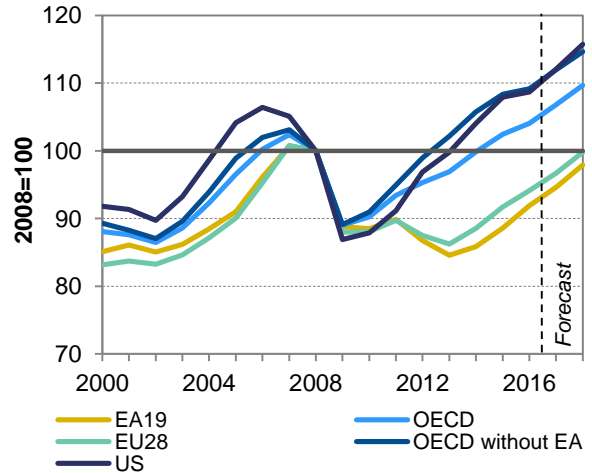
Note: OECD data corresponds to EA16 (excl. CY, MT and LT).

Graph 1.3: Real GDP (index)



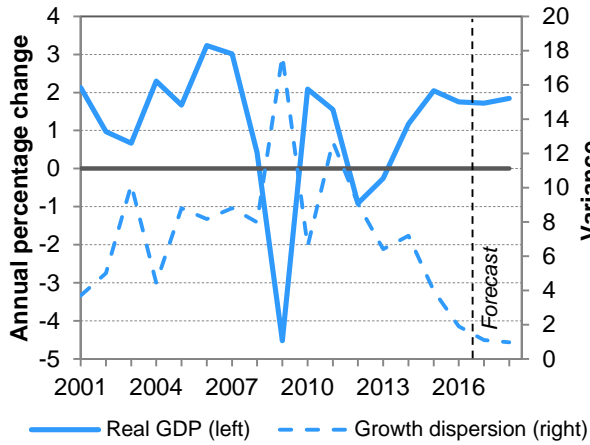
Source: Commission 2017 spring forecast
Note: OECD aggregate excludes Israel and Chile.

Graph 1.4: Gross fixed capital formation (index)



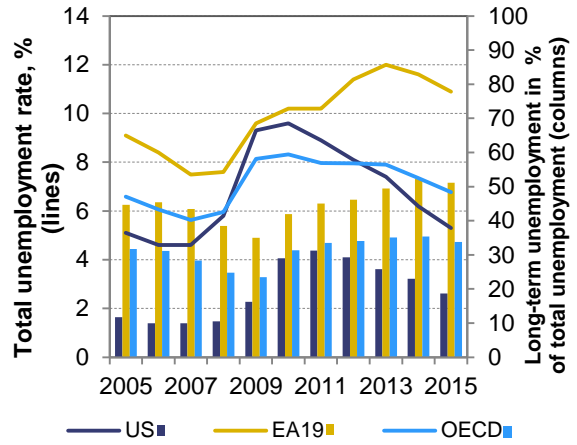
Source: Commission 2017 spring forecast
Note: OECD aggregate excludes Israel and Chile.

Graph 1.5: Real GDP growth in the euro area and dispersion across Member States



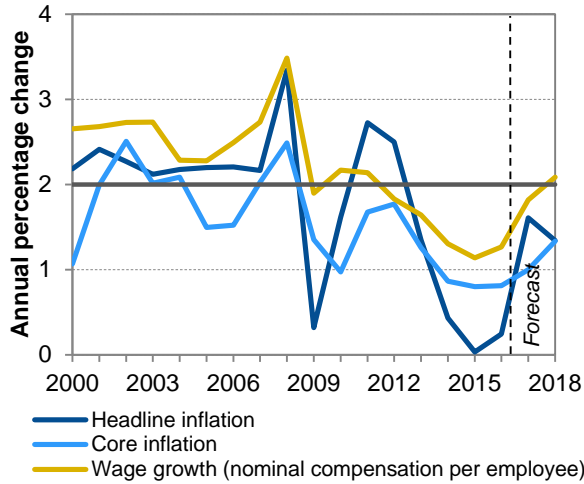
Source: Commission 2017 spring forecast
 Note: Unweighted variance, corrected for GDP revision in Ireland in 2015.

Graph 1.6: Total and long-term unemployment



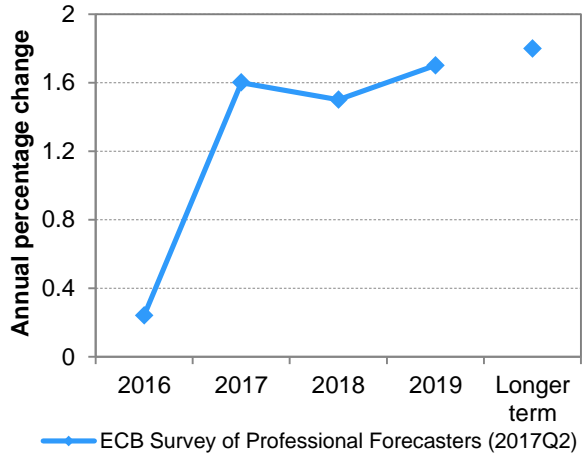
Source: Commission

Graph 1.7: Inflation and wage growth in the euro area



Source: Commission 2017 spring forecast

Graph 1.8: Inflation expectations



2. CYCLICAL CONDITIONS

The amount of economic slack in the euro area is shrinking. As the effects of the 2007 financial crisis and the 2011 sovereign debt crisis gradually unwind, in 2017 the euro area economy is still below its potential level for the ninth consecutive year. According to the Commission 2017 spring forecast, the output gap is projected to narrow from -1.1 % in 2016 to -0.6 % in 2017 before fully closing in 2018⁽⁴⁾. This profile is broadly in line with earlier Commission forecasts. Based on the conventional ‘rule of thumb’ linking contemporaneous changes in output and unemployment, an output gap of -1 % amounts to between 5 and 7 million of additional unemployed people in the euro area as a whole⁽⁵⁾.

Current output gap estimates are subject to a high degree of uncertainty. The prolonged economic downturn is likely to have led to lasting effects on the labour market and the capital stock which weigh on the euro area’s economic ‘speed limit’. At the same time, and in line with past financial crises, the recovery is likely to be more drawn out than in normal cycles. Such effects add to the inherent difficulty of quantifying the extent to which the current lacklustre economic performance is indicative of a persistent degree of slack or of lower growth potential. In particular, the IMF estimates the euro area output gap at -0.7 % in 2017, essentially in line with the Commission’s latest estimate, but still expects some residual slack of -0.3 % in 2018. Currently available projections

by the OECD indicate an output gap of -0.9 % in 2017 and closing in 2018⁽⁶⁾.

The current account surplus in the euro area remains at a record-high level. The current account surplus is projected to decline to 3.0 % of GDP in 2017, from 3.3 % in 2016, but this is still substantially higher than the pre-crisis level of a broadly balanced current account between 2000 and 2007. While the government sector has recorded steadily increasing savings since 2010, as a result of the prolonged period of fiscal consolidation in 2010-2014 and the recovery, these developments have not been offset by the reduction in household savings and the recent increase in corporate investments.

The financial cycle is recovering too, but remains muted. A number of studies underline the importance of financial variables in assessing the degree of economic slack⁽⁷⁾. In the euro area, lending to households and non-financial corporations has recovered substantially since 2014, partly because of the record-low interest rate environment and a steady improvement in loan supply, on the back of progress in banking sector repair. However, growth in credit to the private sector remains below any rates recorded between 1999 and 2007, signalling lacklustre demand, especially for investment, and still high levels of non-performing loans in the banks.

Prices and wage developments do not indicate imminent pressures. According to the Commission 2017 spring forecast, annual average consumer price inflation is projected to

⁴ The Commission forecast is based on the so-called no-policy change assumption. For any given year, it factors in the estimated effect of all policy measures that have been made public in a credible manner and with a sufficient degree of detail by the cut-off date of the forecast.

⁵ The reported numbers assume an Okun coefficient, which captures the nexus between the output gap and cyclical unemployment, of 0.3 to 0.4.

⁶ The IMF estimates are taken from the April 2017 *World Economic Outlook*. The latest available OECD output gap estimates for the euro area are from the June 2017 *Economic Outlook*. Differences in output gap estimates across institutions reflect a series of factors such as the timing of the forecast, different forecasts for headline variables such as real GDP growth, different assessments of the impact of policy measures and different methodologies for estimating the output gap.

⁷ For a comprehensive review, see: Borio, C. (2012), ‘The financial cycle and macroeconomics: What have we learnt?’, *BIS Working Papers* No 395.

increase from 0.2 % in 2016 to 1.6 % in 2017, mostly driven by a rebound in energy prices, and to decline again in 2018 to 1.3 %. The ECB's survey of professional forecasters for the second quarter of 2017 shows average inflation expectations of 1.6 %, 1.5 % and 1.7 % for the years 2017, 2018 and 2019 respectively, still below the ECB's target. Nominal compensation per employee is expected to accelerate in 2017 and 2018. While this is consistent with the ongoing recovery in jobs, the growth rates of nominal wages are expected to be lower than at any point between 1999 and 2008.

Heterogeneity across euro area countries is decreasing, but remains pronounced.

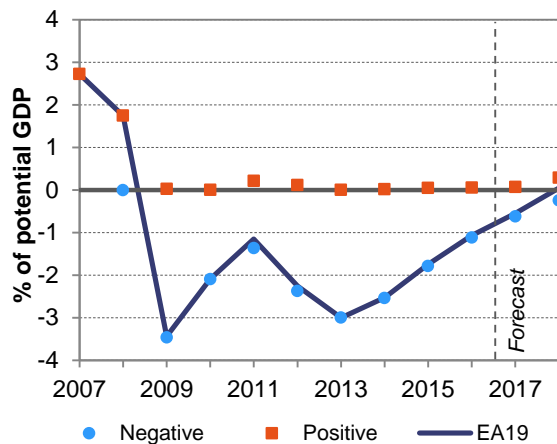
Divergence of economic growth has markedly declined in the euro area from 2014 onwards, as Member States most affected by financial stress have seen a steady recovery. But the distribution of output gaps remains wide. Based on the Commission 2017 spring forecast, eight Member States accounting for about 75 % of the euro

area economy are expected to show negative output gaps in 2017. The situation is expected to improve in 2018, when only five Member States, accounting for about 30 % of euro area GDP, are projected to show a negative output gap.

Overall, while there is still a measurable degree of slack in 2017, the picture for 2018 is less clear.

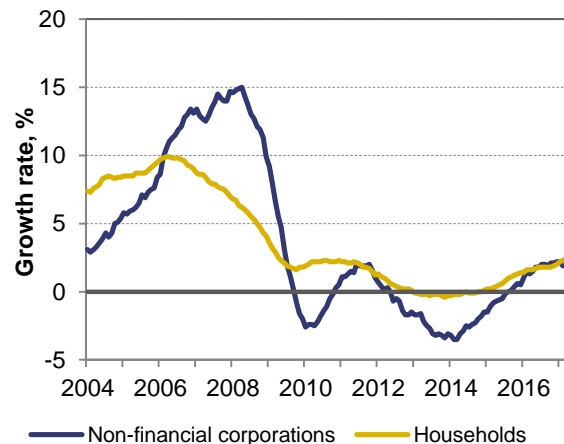
In 2017, both conventional output gap estimates and other indicators of prevailing cyclical conditions suggest that the euro area economy is still operating below its potential. Leaving aside minor differences, major international economic institutions share this view. For 2018, conventional output gap estimates suggest that the euro area is at or near its potential. However, the slow recovery in prices and wages, the unusually slow revival of investment, subdued developments in the financial sector and the large external surplus raise some unresolved questions about whether the post-crisis recovery remains incomplete.

Graph 2.1: Euro area output gap



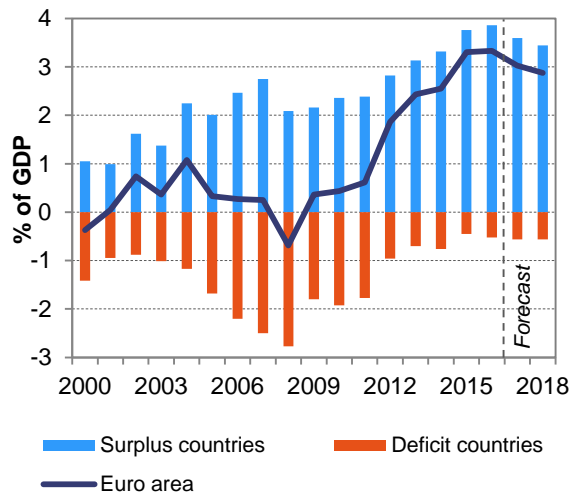
Source: Commission 2017 spring forecast
 Note: 'Negative' ('Positive') shows the total output gap, weighted by GDP, of Member States with a negative (positive) output gap.

Graph 2.2: Loans to non-financial private sector



Source: ECB
 Note: Loans adjusted for sales and securitisation.

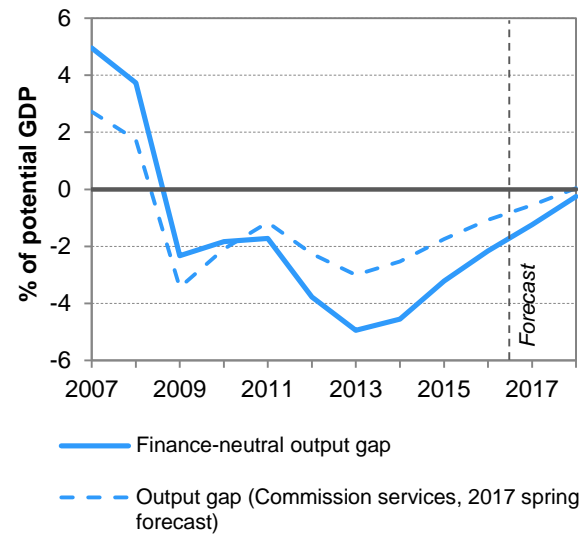
Graph 2.3: Current account in the euro area



Source: Commission

Note: The composition of surplus countries and deficit countries changes over time.

Graph 2.4: 'Standard' and 'finance-neutral' output gaps



Source: Commission

Note: The finance-neutral output gap is an extended HP filter which takes into account financial variables, and is derived from the following model:

$$\begin{aligned} (1) \quad y_t &= p_t + c_t \\ (2) \quad p_t &= 2p_{t-1} - p_{t-2} + \varepsilon_t^p \\ (3) \quad c_t &= \Phi c_{t-1} + \gamma z_t + \varepsilon_t^c \end{aligned}$$

where y_t is output in t , p_t is potential output, c_t is the output gap, ε_t^p and ε_t^c are white noise processes with zero mean and constant but different variances, and z_t is a vector of explanatory financial variables which includes credit growth, house price inflation and the real interest rate. For more details on finance-neutral output gaps, see Borio, C., P. Disyatat and M. Juselius (2013), 'Rethinking Potential Output: Embedding Information about the Financial Cycle', *BIS Working Papers*, No 404, February 2013.

3. FISCAL POLICY DEVELOPMENTS

Following a protracted period of consolidation, fiscal policy turned broadly neutral in 2015. The aggregate budget deficit of the euro area steadily declined from 6.3 % of GDP in 2009 to 1.5 % of GDP in 2016. Most of the fiscal correction occurred between 2010 and 2014, at a time when the euro area economy was still weak, including a new recession in 2012 and 2013. This extended period of fiscal retrenchment, implemented against the backdrop of the sovereign debt crisis, gave way to a marginal fiscal expansion in 2015 and 2016 — as measured by the change in the structural primary budget balance reported in the latest Commission forecast — while the aggregate level of economic activity was still estimated to be significantly below its potential.

Under current policies, the euro area fiscal stance is expected to be mildly expansionary in 2017 and 2018. Based on the latest Commission forecast, the structural primary surplus is estimated to decline from 1.2 % of GDP in 2016 to 0.9 % in 2017 and 0.6 % in 2018. This forecast incorporates the effects of all policy measures that had been publicly announced with a sufficient degree of detail by the cut-off date of the forecast (25 April 2017), irrespective of whether they are consistent with the SGP provisions or not. The latest OECD projections also point to a slightly expansionary fiscal stance in both 2017 and 2018. By contrast, the latest IMF projections suggest a mild fiscal expansion in 2017 followed by a broadly neutral fiscal stance in 2018⁽⁸⁾.

The share of growth-enhancing expenditure in government budgets remains low. The fiscal adjustment after the crisis had a significant impact on the composition of government expenditure. Most importantly, investment expenditure as a share of GDP has been

significantly reduced in many Member States. At the aggregate level, it has dropped from 3.1 % of GDP on average before the crisis to 2.7 % of GDP in recent years, while government consumption and transfers have increased as a share of GDP (see Graph 3.6).

The very high aggregate debt ratio in the euro area has been edging downward since 2015. The debt ratio is projected to decline from 91.3 % of GDP in 2016 to 90.3 % in 2017 and 89.0 % in 2018. Debt developments in the euro area have greatly benefitted from an exceptionally low interest rate environment. Compared to pre-crisis years, interest expenditure dropped by close to 1 % of GDP in the euro area aggregate, and the ‘snow-ball effect’ — the differential between interest rates and nominal GDP growth — has been negative, that is, has been reducing the debt ratio since 2015⁽⁹⁾. The obvious flipside of the favourable borrowing costs is the risk of faster than expected normalisation of nominal interest rates.

Current policies are expected to keep the debt ratio on a declining path in the near term but ageing costs are set to exert new upward pressure in the longer run. In the baseline scenario of the Commission’s latest debt sustainability analysis, the aggregate debt ratio of the euro area is projected to be on a slightly declining trend until the mid-2020s, dropping just under 85 % of GDP. A new increase is projected in the second half of the 2020s as a result of the budgetary costs of ageing⁽¹⁰⁾. Hence, the aggregate debt ratio is expected to remain far above the 60 % of GDP reference value for the foreseeable future. The assessment also indicates significant sensitivity to interest rate shocks: a permanent increase in interest rates by one percentage point over and above the assumed normalisation of nominal interest rates would largely offset the projected

⁸ The difference compared to Commission and OECD forecasts is also due to the fact that the IMF’s fiscal projections include all fiscal policy measures that are judged likely to be implemented.

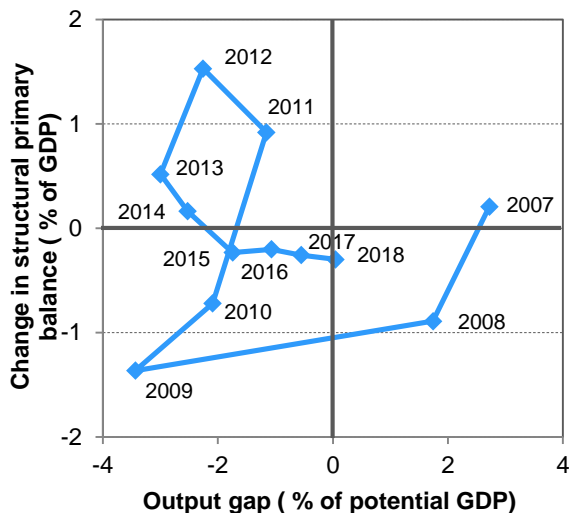
⁹ This effect has, however, been debt-increasing in some Member States.

¹⁰ This scenario already assumes that long-term market interest rates converge to 3 % in real terms and annual average inflation to 2 % by 2026.

decline in the baseline scenario, with aggregate debt staying well above 85 % of GDP and embarking on a stronger upward trend in the mid-2020s⁽¹¹⁾.

Government debt levels and dynamics differ significantly across countries. In the current framework, fiscal policy is implemented at national level and sustainability is first and foremost a country-specific issue. Only 7 out of the current 19 euro area Member States, typically the small ones, are expected to have government debt levels below 60 % of GDP in 2017 and 2018; these Member States account for less than 10 % of euro area GDP. Among the Member States with a debt ratio in excess of 60 % of GDP in 2017 and 2018, there are nine where, based on available Commission projections, the ratio is expected to decline in both years. This group represents about half of euro area GDP.

Graph 3.1: Fiscal stance in the euro area



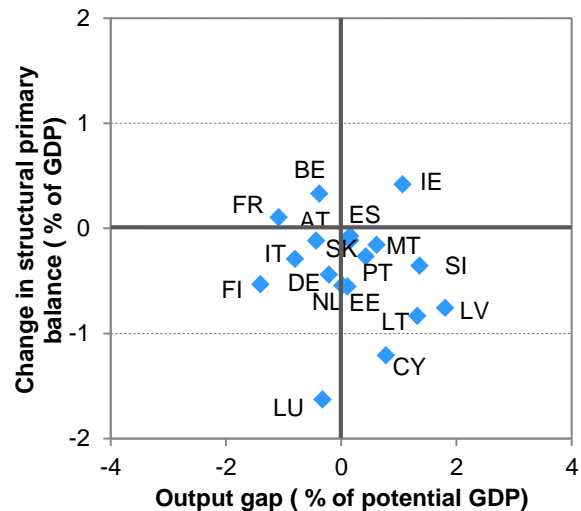
Source: Commission 2017 spring forecast
 Note: The cyclically adjusted primary balance is used before 2010, which is not corrected for one-off measures. The figure for 2018 does not yet include the draft budgetary plans of euro area Member States.

¹¹ Conversely, if interest rates were permanently one percentage point lower than in the baseline, the aggregate debt ratio would decline to 80 % of GDP by the late 2020s. For more details see the European Commission Debt Sustainability Monitor, 2016 at: https://ec.europa.eu/info/publications/economy-finance/debt-sustainability-monitor-2016_en.

Finally, despite the favourable interest rate environment, the debt ratios of two euro area Member States which already exceed 60 % of GDP are projected to increase further in both 2017 and 2018.

Some Member States still face sustainability challenges in the medium term. Notable challenges pertain to the capacity of some Member States to reduce their debt level towards the 60 % of GDP reference value in line with the SGP debt rule over the medium term. Nevertheless, overall the latest Commission sustainability assessment suggests that sustainability challenges in the long term are largely contained. That assessment leaves aside country-specific political risks. The latest assessments by the IMF indicate significant vulnerabilities in countries with a high debt level, especially to shifts in market sentiment⁽¹²⁾.

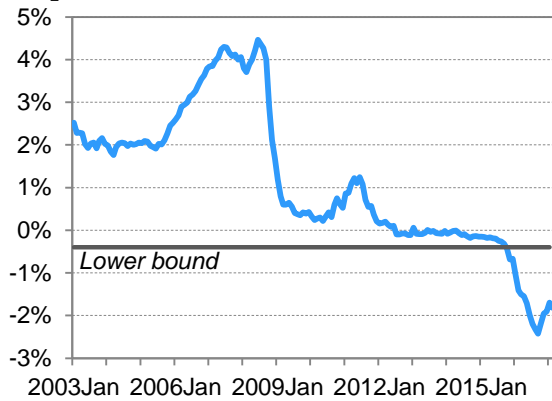
Graph 3.2: Fiscal stance across euro area Member States in 2017



Source: Commission 2017 spring forecast
 Note: Greece: output gap: -7.6, change in structural primary balance: -3.0.

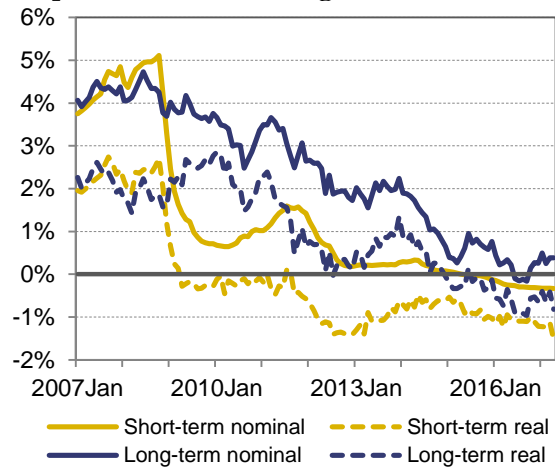
¹² The IMF's assessment for non-programme countries covers a shorter period (five years) than the Commission's debt sustainability analysis, which covers a 10-year horizon, and it uses different thresholds for assessing risks.

Graph 3.3: Shadow short rate



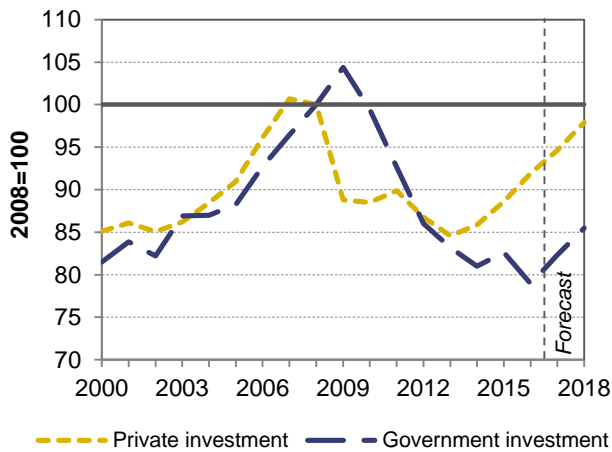
Source: Commission
 Note: Lower bound at -0.40 %, recorded in March 2016 for the ECB deposit facility rate. The shadow short rate represents the interest rate that would prevail in a hypothetical world where economic agents cannot turn to cash at the zero lower bound, thereby enabling interest rates to fall arbitrarily deep into negative territory. It is computed by estimating the price of this 'cash option' and subtracting it from the observable short-term rate, which is truncated at the zero lower bound. See Krippner, L. (2012), 'Modifying Gaussian term structure models when interest rates are near the zero lower bound', *Reserve Bank of New Zealand Discussion Paper*, No 2012/2.

Graph 3.4: Short- and long-term interest rates



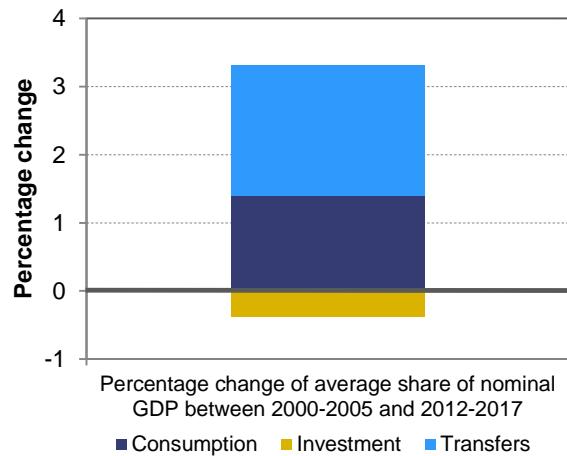
Source: ECB
 Note: Real rates computed by subtracting core inflation from the nominal rates.

Graph 3.5: Private and government investment, euro area aggregate, volume



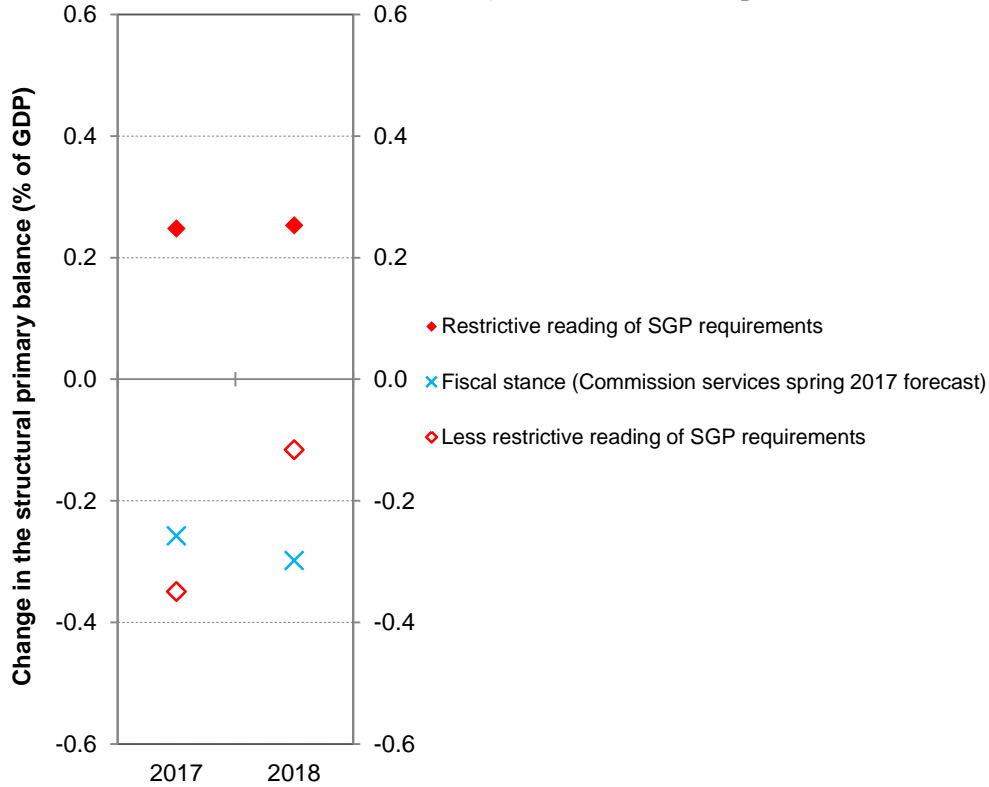
Source: Commission 2017 spring forecast

Graph 3.6: Composition of government expenditure; euro area aggregate



Source: Commission 2017 spring forecast

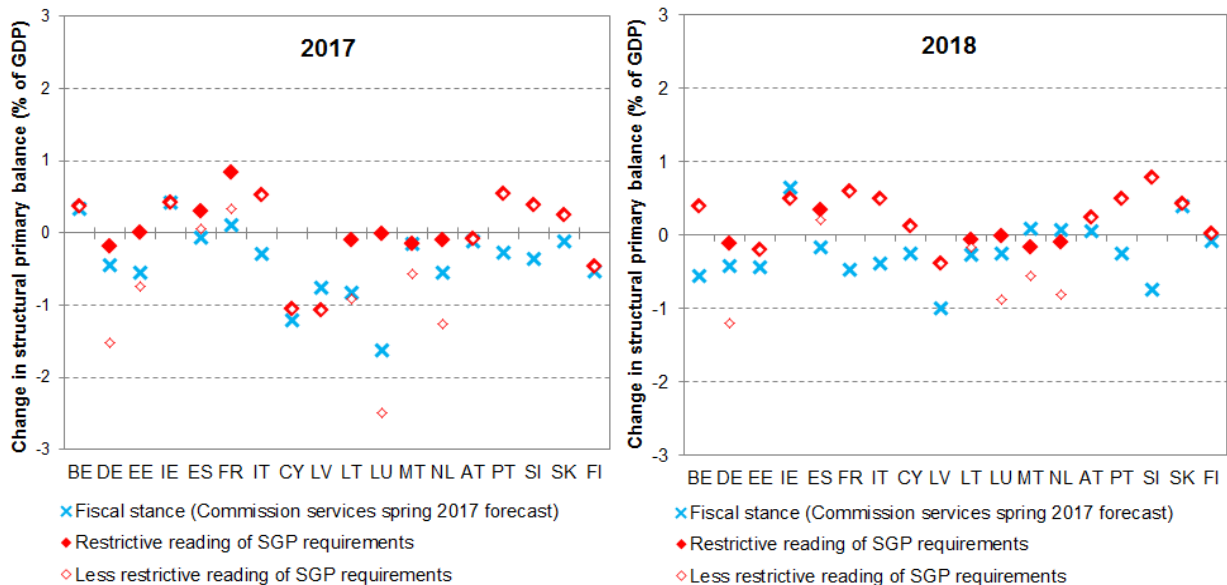
Graph 3.7: Euro area fiscal stance – current projections and SGP requirements



Source: EFB calculations and Commission 2017 spring forecast.

Note: *Restrictive reading of SGP*: Member States implement the structural adjustment required under the SGP, including the leeway granted under the flexibility clauses in the preventive arm. Member States that have over-achieved their MTO keep their structural balance unchanged. *Less restrictive reading of SGP*: Same as above for Member States in the preventive arm which are not at their MTO, while Member States with fiscal space entirely use it and countries in the corrective arm adopt a 'nominal strategy', i.e. they comply with nominal targets set by the Council, which in an economic upturn is less demanding than complying with the structural requirement.

Graph 3.8: Expected national fiscal stances and SGP requirements



Source: EFB calculations and Commission 2017 spring forecast.

Note: *Restrictive reading of SGP*: Member States implement the structural adjustment required under the SGP, including the leeway granted under the flexibility clauses in the preventive arm. Member States that have over-achieved their MTO keep their structural balance unchanged. *Less restrictive reading of SGP*: Same as above for Member States in the preventive arm which are not at their MTO (as a result, the red and white diamonds overlap), while Member States with fiscal space entirely use it and countries in the corrective arm adopt a 'nominal strategy', i.e. they comply with nominal targets set by the Council, which in an economic upturn is less demanding than complying with the structural requirement.

4. OVERALL ASSESSMENT

This section first focuses on the prospective fiscal stance appropriate for the euro area in 2018. The assessment is meant to inform preparations for the forthcoming draft budgetary plans for next year. For completeness, it also includes a brief examination of the euro area fiscal stance emerging from budget execution in 2017 and compares it with advice issued last year.

In 2018, a neutral fiscal stance for the euro area as a whole seems appropriate. Current projections of a closing output gap do not support a case for discretionary fiscal expansion, i.e. on top of the effect of automatic stabilisers, at the aggregate level, keeping in mind the continuation of a very accommodative monetary policy. At the same time, we have observed increasing and large external imbalances of the euro area. Moreover, there is a danger of long-lasting effects of low levels of economic activity on the labour market and the capital stock. Therefore, a significant euro-area wide fiscal contraction to accelerate debt reduction over and above the projected decline could weigh on the steady but fairly measured pace of the economic recovery. If economic conditions improve substantially, windfalls should be allocated to debt reduction, especially in the countries with high government debt-to-GDP ratios.

A neutral aggregate fiscal stance in 2018 requires corrections of budgetary trends. Current budget projections by the Commission, which incorporate only policy plans made available with a sufficient degree of detail by the end of April, point to a deterioration in the structural primary balance by 0.3 % of GDP in 2018, that is, a mild fiscal expansion. Therefore, in order to achieve a neutral fiscal stance for the euro area as a whole in 2018, adjustments to current trends are required⁽¹³⁾.

¹³ The aggregation of government plans presented in the 2017 stability programmes is expected to lead to a marginal improvement in the structural

A broadly neutral fiscal stance for the euro area in 2018 could be implemented through differentiated national policies within the parameters of the SGP. Some Member States, whose structural budget balance exceeds the medium-term budgetary objective (MTO), are not making full use of the available fiscal space. If these Member States were to fully use their fiscal space in 2018, while others consolidated as required under the SGP — consolidation is particularly warranted in countries with a high debt ratio — a neutral fiscal stance for the euro area as a whole could be achieved. Making or not making use of available fiscal space — both options are compatible with the SGP. This freedom of choice follows from the asymmetry of the fiscal rules, which do not include provisions for countries over-achieving the MTO⁽¹⁴⁾. Therefore, achieving the appropriate fiscal stance in 2018, while at the same time respecting the SGP at national level, presupposes coordinated agreement between participating Member States. Implementing the SGP without the use of available fiscal space would lead to a slightly contractionary fiscal stance.

A country-by-country assessment of the fiscal stance highlights tensions with the euro area perspective. While a neutral fiscal stance would be appropriate for the euro area as a whole in 2018, implementation at country level faces a formidable dilemma. From a purely national perspective, cyclical conditions in some Member States with fiscal space are not perceived to warrant fiscal expansion, while fiscal expansion is seen to be justified in

primary balance of the euro area by 0.1 % of GDP. This differs from the Commission 2017 spring forecast partly because some stability programmes were not available at the cut-off date of the forecast and partly because the programmes did not provide a sufficient degree of detail on some planned measures.

¹⁴ Countries that have over-achieved their MTO do not receive a fiscal country-specific recommendation in the context of the European Semester.

Member States with no fiscal space, where SGP rules require consolidation. This dilemma results from the current euro area governance framework, which combines centralised monetary policy with decentralised, rules-based fiscal policy. Individual countries do not factor in spill-overs of national fiscal policies and, more generally, do not plan policies explicitly aimed at the smooth functioning of the euro area more broadly. This also includes the reduction of macroeconomic imbalances. Tensions between the euro area and the national perspective are bound to arise in the current governance framework. Such tensions can only be overcome through enhanced forms of cross-country coordination or further fiscal integration⁽¹⁵⁾.

Fiscal policy should be rebalanced towards a more growth-friendly composition. While the available evidence does not give grounds for a fiscal expansion from a euro area perspective in 2018, fiscal policy can still contribute to addressing persisting vulnerabilities in the ongoing economic recovery in a budgetary neutral manner, especially by improving the composition of national budgets. Specifically, public expenditure should be refocused towards investment, which has borne the brunt of fiscal adjustment in the aftermath of the 2009 crisis; the low interest rate environment offers a unique opportunity. In 2016, public investment as a share of GDP was still about one quarter below the level of 2008 (see Graph 3.5). The importance of public investment in supporting the recovery is compounded by the potential complementarity with private investment spending, which also remains fairly weak by pre-crisis standards⁽¹⁶⁾.

¹⁵ The Commission's Reflection paper on the deepening of the Economic and Monetary Union published on 31 May 2017 includes a number of proposals to strengthen coordination and fiscal integration. The EFB will provide an assessment of these proposals in its next Annual Report.

¹⁶ See Dreger, C. and Reimers, H.-E. (2016), 'Does public investment stimulate private investment?

In 2017, the fiscal stance for the euro area as a whole is expected to be mildly expansionary. The implementation of Member States' budgetary plans for 2017 is currently projected to deliver a mild fiscal expansion of 0.3 % of GDP, as measured by the change in the structural primary balance. At the aggregate level, such an outcome would be close to the indications provided by the European Commission in November last year⁽¹⁷⁾. A mild fiscal expansion provides support for the steady but slow pace of economic recovery in the euro area, which in 2017 still shows some signs of economic slack. It comes at a moment when monetary policy is still highly accommodative and when the growth impact of fiscal impulses is higher than in normal times. Also, it takes effect against the backdrop of an aggregate government debt level that has stabilised and, under current policies, is projected to decline slowly in the coming years. However, in some countries, debt developments remain vulnerable to changes in the macroeconomic outlook and in particular interest rate shocks.

Current projections indicate possible deviations from SGP requirements at country level. The Commission 2017 spring forecast suggests that several Member States, under both the preventive and corrective arms, are at risk of deviating from the recommended adjustment path in 2017. A restrictive application of EU fiscal rules, combined with no use of fiscal space where available, would actually be contractionary. In such a scenario, the structural primary budget surplus is estimated to increase by 0.3 % of GDP. A mild fiscal expansion could be compatible with the SGP rules if some Member States made more use of available fiscal space than currently projected.

Evidence for the euro area', *Economic Modelling*, 58, 154-158.

¹⁷ https://ec.europa.eu/info/publications/2017-european-semester-communication-fiscal-stance_en

KEY INDICATORS FOR THE EURO AREA

Output		LTA⁽¹⁾	2013	2014	2015	2016	16Q1	16Q2	16Q3	16Q4	17Q1
Economic sentiment	<i>Indicator</i>	100.0	93.3	101.4	104.2	104.8	103.9	104.2	104.2	106.9	108.0
Gross domestic product (real)	<i>% ch. on prev. period</i>						0.5	0.3	0.4	0.5	0.6
	<i>% ch. on prev. year</i>	1.5	-0.3	1.2	2.0	1.8	1.7	1.6	1.8	1.8	1.9
Labour productivity	<i>% ch. on prev. period</i>						0.2	-0.1	0.1	0.1	0.2
	<i>% ch. on prev. year</i>	0.7	0.3	0.6	1.0	0.4	0.3	0.2	0.5	0.4	0.4
Private consumption		LTA⁽¹⁾	2013	2014	2015	2016	16Q1	16Q2	16Q3	16Q4	17Q1
Consumer confidence	<i>Balance</i>	-12.6	-18.8	-10.2	-6.3	-7.8	-8.4	-7.9	-8.3	-6.5	-5.5
Retail confidence	<i>Balance</i>	-8.0	-12.2	-3.1	1.6	1.5	1.9	1.8	0.4	1.8	2.0
Private consumption	<i>% ch. on prev. period</i>						0.7	0.4	0.4	0.4	0.3
	<i>% ch. on prev. year</i>	1.3	-0.6	0.8	1.8	2.1	2.0	2.0	1.9	2.0	1.6
Retail sales	<i>% ch. on prev. period</i>						0.8	0.3	0.5	1.0	0.2
	<i>% ch. on prev. year</i>	0.8	-0.6	1.5	3.1	2.2	2.7	2.0	1.5	2.6	1.9
Investment		LTA⁽¹⁾	2013	2014	2015	2016	16Q1	16Q2	16Q3	16Q4	17Q1
Capacity utilisation	<i>Level (%)</i>	80.8	78.3	80.4	81.3	81.8	81.9	81.5	81.6	82.3	82.5
Production expectations (manufacturing)	<i>Balance</i>	6.2	3.4	7.9	8.0	8.3	6.8	7.3	8.0	11.1	13.2
Gross fixed capital formation	<i>% ch. on prev. period</i>						0.5	1.2	0.0	3.4	1.3
	<i>% ch. on prev. year</i>	1.4	-2.5	1.6	3.2	3.7	2.5	3.7	2.5	5.1	6.0
- Equipment investment	<i>% ch. on prev. period</i>						-0.1	0.7	0.8	-0.3	1.8
	<i>% ch. on prev. year</i>		-2.7	4.6	4.7	3.8	4.3	5.0	4.1	1.0	3.0
- Construction investment	<i>% ch. on prev. period</i>						0.5	-0.4	1.6	0.1	1.3
	<i>% ch. on prev. year</i>		-3.5	-0.9	1.4	2.4	1.9	2.0	2.5	1.8	2.5
Change in stocks	<i>Contribution to GDP (pp)</i>	0.0	0.2	0.4	-0.1	-0.1	-0.3	-0.1	0.1	0.4	0.0
Labour market		LTA⁽¹⁾	2013	2014	2015	2016	16Q1	16Q2	16Q3	16Q4	17Q1
Employment expectations (manufacturing)	<i>Balance</i>	-9.6	-9.3	-4.8	-2.3	-1.2	-3.6	-2.6	-0.9	2.2	3.6
Employment expectations (services)	<i>Balance</i>	5.0	-4.2	1.1	6.3	8.4	7.8	7.1	8.0	10.7	10.2
Employment	<i>% ch. on prev. period</i>						0.3	0.4	0.3	0.4	0.4
	<i>% ch. on prev. year</i>	0.7	-0.6	0.6	1.0	1.4	1.4	1.4	1.3	1.4	1.5
Employment (000)	<i>ch. on prev. period</i>		-895.8	818.7	1,471	2,057.4	505.6	555.7	466.4	554.7	660.4
Compensation of employees (per head, nominal)	<i>% ch. on prev. period</i>						0.4	0.1	0.4	0.5	0.2
	<i>% ch. on prev. year</i>	1.8	1.5	1.4	1.2	1.3	1.2	1.1	1.3	1.5	1.3
Unemployment rate	<i>% of lab. force</i>		12.0	11.6	10.9	10.0	10.3	10.2	9.9	9.7	9.4
Unemployment (000)	<i>ch. on prev. period</i>		1,022	-589	-1,194	-1,219	-275	-144	-379	-336	-373
International transactions		LTA⁽¹⁾	2013	2014	2015	2016	16Q1	16Q2	16Q3	16Q4	17Q1
World trade	<i>% ch. on prev. period</i>						-0.5	0.0	0.8	1.7	1.4
	<i>% ch. on prev. year</i>		2.3	2.7	2.0	1.4	0.8	1.6	1.2	2.0	3.9
Trade balance	<i>Billion EUR</i>		155.4	184.4	238.2	266.5	65.1	71.4	65.6	64.4	55.8
Exports of goods and services	<i>% ch. on prev. period</i>						0.4	1.2	0.4	1.7	1.2
	<i>% ch. on prev. year</i>	4.9	2.1	4.4	6.2	3.0	2.5	2.7	2.8	3.8	4.6
Imports of goods and services	<i>% ch. on prev. period</i>						0.0	1.6	0.3	3.8	1.3
	<i>% ch. on prev. year</i>	4.7	1.4	4.9	6.3	4.1	3.4	4.2	3.2	5.7	7.1
Prices		LTA⁽¹⁾	2013	2014	2015	2016	16Q1	16Q2	16Q3	16Q4	17Q1
Headline inflation (HICP)	<i>% ch. on prev. year</i>		1.3	0.4	0.0	0.2	0.0	-0.1	0.3	0.7	1.8
Core inflation	<i>% ch. on prev. year</i>		1.2	0.9	0.8	0.8	0.9	0.8	0.8	0.8	0.8
Monetary and financial indicators		LTA⁽¹⁾	2013	2014	2015	2016	16Q1	16Q2	16Q3	16Q4	17Q1
Nominal interest rates (3-month)	<i>Level</i>		0.2	0.2	0.0	-0.3	-0.2	-0.3	-0.3	-0.3	-0.3
Nominal interest rates (10-year)	<i>Level</i>		2.0	1.4	0.6	0.1	0.3	0.1	-0.1	0.2	0.3
ECB repo rate	<i>Level</i>		0.6	0.2	0.1	0.0	0.0	0.0	0.0	0.0	0.0
Bilateral exchange rate EUR/USD	<i>Level</i>		1.33	1.33	1.11	1.11	1.10	1.13	1.12	1.08	1.06
	<i>% ch. on prev. period</i>						0.6	2.5	-1.1	-3.4	-1.3
	<i>% ch. on prev. year</i>		3.4	0.0	-16.5	-0.2	-2.1	2.2	0.4	-1.5	-3.4
Nominal effective exchange rate	<i>% ch. on prev. period</i>						1.8	0.8	0.3	-0.3	-0.7
	<i>% ch. on prev. year</i>		3.6	0.6	-9.3	2.6	1.2	4.0	2.7	2.7	0.1

Source: Commission, ECB, Central Planning Bureau.

(1) LTA = Long-term average

GLOSSARY

Automatic fiscal stabilisers: Features of the tax and spending regime which react automatically to the economic cycle and reduce its fluctuations. As a result, the budget balance in per cent of GDP tends to improve in years of high growth, and deteriorate during economic slowdowns.

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 have been excluded (see also fiscal stance).

Fiscal stance: 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. When the change is positive (negative) the fiscal stance is said to be restrictive (expansive).

Medium-term budgetary objective (MTO): According to 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 as well as of fiscal risks to the sustainability of public finances, and is defined in structural terms (see structural balance).

Output gap: The difference between actual output and estimated potential output at any 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 normally expected to close roughly every four years.

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 production function approach and output gap).

Production function approach: A method to estimate the sustainable level of output of an economy compatible with stable inflation based on available labour inputs, the capital stock and their level of efficiency. Potential output is used to estimate the output gap, a key input in the estimation of the structural balance.

S0 indicator: A composite indicator published by the European Commission to evaluate the extent to which there might be a fiscal stress risk in the short term, stemming from the fiscal, the macro-financial and competitiveness sides of the economy. A set of 25 fiscal

and financial-competitiveness variables proven to perform well in detecting fiscal stress in the past is used to construct the indicator.

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.

S2 indicator: The long-term sustainability indicator of the European Commission. It shows the upfront adjustment to the current structural primary balance required to stabilise the debt-to-GDP ratio over the infinite horizon, including financing for any additional expenditure arising from an ageing population.

Stabilisation: Economic policy intervention to bring actual output closer to potential output. In economic and monetary union (EMU), 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.

Structural balance: The actual 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 is using three indicators of sustainability with different time horizons (S0, S1 and S2) which are complemented by a debt sustainability analysis including sensitivity tests on government debt projections and alternative scenarios.

Zero 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, e.g. 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.