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

TOWARDS A POSITIVE FISCAL STANCE FOR THE EURO AREA

1. INTRODUCTION

In the Letter of Intent accompanying the 2016 State of the Union address, President Juncker and First Vice-President Timmermans announced the intention of the Commission to promote "in the next Recommendation on the economic policy of the euro area, a positive fiscal stance for the euro area, in support of the monetary policy of the European Central Bank".

This Communication is adopted together with the Recommendation on the economic policy of the euro area for 2017-2018[1] and sets out the rationale behind its fiscal aspects. Their publication at the start of the annual cycle of the European Semester of economic policy coordination, together with the Annual Growth Survey 2017[2] and related documents, allows for a timely debate on economic and social priorities at the EU, euro area and the national levels. The outcome of this debate should be reflected in Member States' policies and in particular in their economic and fiscal programmes in spring of next year.

The focus on the need for a positive fiscal stance for the euro area stems from a broader background of a resilient but modest economic growth, as illustrated by the recent Commission Autumn 2016 Economic Forecast.[3] There has been significant progress in recent years: euro area GDP has recovered its pre-crisis level in real terms since 2015, unemployment has declined to its lowest level since 2010-11 and investment has started to pick up. However, the euro area recovery remains slow, unused capacity in labour and capital is still significant and the overall level of uncertainty is high. Moreover, the subdued and uncertain growth prospects outside the EU suggest little support from exports, if any. The continuation of the expansion in the euro area would thus need to rely increasingly on domestic demand.

Monetary policy has been supportive of growth in recent years, but this is less the case for fiscal policy. Over 2011-2013, the aggregate fiscal stance was contractionary as many Member States engaged in fiscal consolidation to preserve their access to the markets at the height of the sovereign debt crisis. While this dampened growth, it was seen as necessary to safeguard financial stability in unprecedented circumstances and to respond to the risk of contagion across the euro area, which could have resulted in even worse scenarios. In 2014-2015, the aggregate fiscal stance turned broadly neutral and then slightly expansionary in 2016, but it is expected to be broadly neutral again in 2017.

This situation partly highlights the limits of the EU's fiscal framework.[4] First, the EU's current fiscal framework contains no rules or instruments to directly manage the aggregate fiscal stance of the euro area, which is a key difference when compared to unified currency areas across the world. The Recommendation on the economic policy of the euro area is becoming a source of reference to guide efforts, but its effectiveness ultimately depends on the individual and collective willingness of the Member States to follow through.

[1] See COM(2016)726 of 16 November 2016.

[2] See COM(2016)725 of 16 November 2016.

[3] The Forecast is available at: http://ec.europa.eu/economy_finance/eu/forecasts/2016_autumn_forecast_en.htm

[4] See also the chapter on the "euro area fiscal stance" of the European Central Bank's Economic Bulletin of June 2016.

Second, the rules of the Stability and Growth Pact are essentially designed to prevent excessive levels of deficit and government debt.[5] They foresee more stringent and binding mechanisms for the Member States which are away from their medium-term budgetary objective, also as a way to help them regain room for macroeconomic stabilisation. However, for those Member States which have achieved their fiscal goals and/or have more fiscal space to act, the tools of the European Semester can only recommend, not enforce, more expansionary fiscal policies. This reflects what is sometimes described as an asymmetry of the EU fiscal framework: the rules can proscribe high deficits (also to avoid high debt) but they can only prescribe the reduction of budgetary surpluses, without imposing it.

Given the need to support the ongoing recovery, and to overcome the risk of a "low growth, low inflation" trap, this Communication sets out the case for a significantly more positive fiscal stance for the euro area at this point in time. A positive fiscal stance refers both to the supportive, i.e. expansionary, direction that fiscal policy should take overall, and to the quality of the composition of the adjustment, in terms of repartition of efforts across countries and of the types of expenditure and/or taxes behind it.

The current situation is sub-optimal in at least two respects. First, in light of the latest economic and budgetary data, a full delivery of the fiscal requirements contained in the country-specific recommendations of the Council would lead, on aggregate, to a moderately restrictive fiscal stance for the euro area as a whole in 2017 and 2018, while the economic situation would seem to call for an expansionary fiscal stance in the present circumstances.

Second, the current fiscal aggregate conceals a very uneven fiscal distribution across Member States, which does not make good economic sense from the point of view of the euro area. This situation has been summarised in the form of a telling paradox: those who do not have fiscal space want to use it; those who have fiscal space do not want to use it. A more collective approach is needed to overcome the risk of a "lose-lose" scenario for the euro area as a whole.

In moving towards such a positive fiscal stance, there are a number of economic and legal limitations to take into account, and possible trade-offs to be acknowledged. Moreover, this Communication stresses the crucial need to improve the quality of public finances with a view to maximising their impact on jobs and growth, as well as social fairness, not just at national level, but also by looking at the euro area as an aggregate.

A number of conclusions are drawn here and the more immediate policy implications are presented in the proposed Recommendation on the economic policy of the euro area for 2017-2018, which is published alongside this Communication.

[5] These rules were significantly strengthened over 2011-2013 as a response to the financial and sovereign debt crises.

Box 1. The euro area fiscal stance

While there is no universally accepted definition, the "fiscal stance" is usually understood as the orientation given to fiscal policy by governments' discretionary decisions on tax and expenditure. Traditionally, the fiscal stance is captured by the change in the structural primary balance (i.e. the budget balance corrected for the impact of the economic cycle, non-permanent measures and interest payments), although other indicators can also be used to characterise it (such as indicators based on expenditure growth net of new revenue measures). Depending on whether the government decides to support, reduce or leave unchanged the impact of public finances on the real economy – via the increase/reduction of spending, net of new tax measures – the fiscal stance is considered "expansionary", "contractionary" or "neutral", respectively.

Together with monetary policy, fiscal policy plays a role in the stabilisation of the macroeconomic environment, while also serving broader goals in terms of fiscal sustainability and redistribution functions. The orientation of the fiscal stance determines the role that fiscal policy plays in the economic cycle, which can be more or less pro- or counter-cyclical depending on the circumstances.

When looking at the euro area as a whole, it should be noted that while monetary policy is conceived and designed as a single instrument, the overall fiscal policy is the result of the aggregation of 19 individual fiscal policies. The tools of the European Semester and the rules of the Stability and Growth Pact have long provided direction for action at national level but, apart from the recent role assumed by the Recommendation on the economic policy of the euro area, coordination of action has been limited so far, and the situation and challenges of the euro area have not been easily factored in. In particular, whether the aggregation of national fiscal policies results in a euro area fiscal stance which is appropriate and consistent with monetary policy, is still largely random. This issue is particularly relevant when monetary policy interest rates reach a "zero lower bound" (see annex 2).

The discussion on the appropriate fiscal stance for the euro area is a key aspect of the Commission's efforts to reinforce the debate on the general interest of and collective responsibility for the euro area, as part of Stage 1 of the follow-up to the Five Presidents' Report on Completing Europe's Economic and Monetary Union ("deepening by doing").[6]

2. THE MIXED ECONOMIC ENVIRONMENT CALLS FOR A POSITIVE FISCAL STANCE

Compared to the pre-crisis period, the medium-term growth potential of the euro area has virtually halved. This is in part linked to demographic and broader developments but it also reflects what are known as the "hysteresis effects" resulting from a crisis: the economy's weak performance over a prolonged period of time can degrade physical capital and the productivity and participation of the workforce, to such an extent that it permanently reduces the growth potential.[7] As highlighted in the Annual Growth Survey 2017 and in the Recommendation on the economic policy of the euro area, lifting the EU's growth potential requires first and foremost structural policies to boost employment and productivity, but responsible growth-friendly fiscal policy also has a role to play, notably at this point in time.

[6] See Report at: https://ec.europa.eu/priorities/sites/beta-political/files/5-presidents-report_en.pdf

[7] Typical examples include the loss of skills resulting from high and prolonged levels of unemployment and the build-up of large investment gaps, as experienced in Europe.

The current economic outlook is mixed, with the recovery proceeding steadily since 2013, but failing to accelerate. The GDP of the euro area is now beyond its pre-crisis level but the recovery remains slow, with continued uncertainty surrounding its strength and evidence suggesting that there is still significant untapped potential in the economy. Inflation also remains persistently low despite unprecedented monetary policy measures. In addition, downside risks abound. The euro area's very large external surplus still hides broader imbalances. Unemployment is falling but remains at very high levels in some Member States. Productivity growth and wage growth remain subdued. New sources of uncertainty have emerged with the result of the UK's referendum on EU membership and other geopolitical developments. The above emphasises the need to strengthen domestic sources of growth.

As the European Central Bank (ECB) is using its monetary policy tools extensively, there is widespread acceptance that monetary policy cannot take the full burden of macroeconomic stabilisation, and that responsible growth-friendly fiscal policy needs to play a bigger role in supporting the recovery of the euro area. This is a concern shared by the global community: at its recent meetings, the G20 re-iterated its members' commitment to a three-pronged growth strategy, with the September 2016 statement saying "we are determined to use all policy tools – monetary, fiscal and structural – individually and collectively to achieve our goal of strong, sustainable, balanced and inclusive growth".[8]

There is both a need and a window of opportunity to act on the fiscal front at this precise juncture, also to rebalance the overall policy mix of the euro area. Actual and expected inflation expectations continue to fall short of the definition of price stability set by the ECB (understood as inflation below but close to 2% over the medium term). Together with the pursuit of structural reforms and a strong focus on investment, fiscal policy has to contribute more directly to domestic demand, supporting the recovery and moving out of the low inflation territory. Such a pick-up in inflation can also contribute to the normalisation of interest rates, with a beneficial impact on the remuneration of savings and more generally on the functioning of the financial sector, which still has to deal with the debt legacy inherited from the crisis.

Given the particular circumstances, the macroeconomic impact of fiscal policy is likely to be stronger than in normal times. The effectiveness of fiscal policy as a stabilisation tool depends on the overall economic environment in which it is used. Given the fact that monetary policy is at the "zero interest floor" (or "zero lower bound"), the impact of fiscal policy measures both on the real economy (the "multiplier" effect) and on other countries' economies (the "spillover" effect) are larger than would otherwise be the case,[9] for instance if interest rates were high or at risk of rising fast, and that public stimulus would risk to crowd out private investment (see annex 2). Moreover, the current context of low interest rates results in significantly reduced costs of financing or refinancing of public budgets.

[8] G20 Leaders' Communiqué Hangzhou Summit, 4-5 September 2016.

[9] The spillover effect of fiscal stimulus in 'core' EU Member States is generally found to be weak in normal times. However, this may not hold true at the current juncture with persistently very low inflation and interest rates. In particular, public investment in surplus countries could have significant positive GDP spillovers to the rest of the euro area (see annex 2).

If well designed, notably in combination with reforms and support to investment, a more active fiscal policy today can contribute to a faster reduction in unemployment in the short run, but also to lift the medium-term (potential) growth in the euro area. There is still considerable slack in the economy at this point in time and a key challenge is to avoid a situation of "low growth, low inflation" from becoming entrenched. There is also significant "reform fatigue" after years of crisis: the capacity to initiate and carry out major structural reforms may entail some costs for public finances in the short-term but if successful, such reforms can have direct long-term positive budgetary effects, including by raising potential growth. In addition to supporting recovery at home, a more supportive fiscal policy would also generate positive spillovers to the global economy, by contributing to lower the euro area's current account surplus, thereby also helping to tackle global imbalances.

Recent initiatives at EU level contribute to maximising the impact of public finances on the real economy. With its focus on leveraging private funds in economically viable and sustainable investment projects, the Investment Plan for Europe contributes to tackling the investment gap accumulated during the crisis years.[10] The combination of the European Structural and Investment Funds and of the European Fund for Strategic Investments is particularly promising in providing new innovative financial instruments which maximise the economic impact of every public euro invested. Progress with the completion of the Banking Union and of the Capital Markets Union[11] are also essential to diversify sources of financing to the real economy and thus to relieve pressure on public finances. The focus, as part of the European Semester of economic policy coordination, on pursuing structural reforms in support of investment (the so-called "third pillar" of the Investment Plan for Europe) is also essential to maximise the effectiveness of fiscal policy.

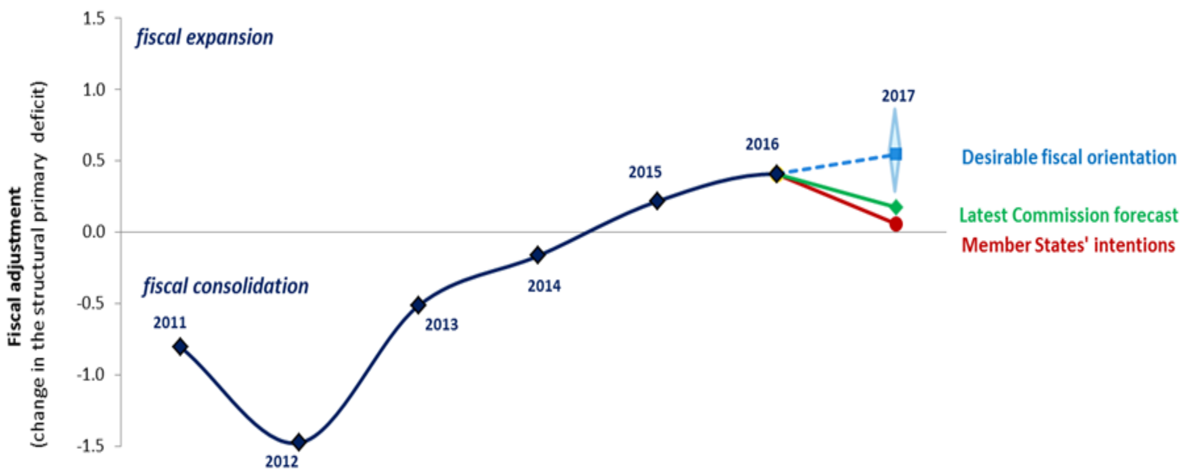
3. THE FISCAL STANCE OF THE EURO AREA TODAY

To assess the current situation, it is important to consider the euro area as a single entity, as if there were a Finance Minister for the euro area as a whole and to look at its fiscal policy in aggregate terms. This is the approach taken in this section.

Overall, following the significant fiscal consolidation in 2011-2013, the euro area fiscal stance is estimated to be broadly neutral over 2014-2017 (see graph below). The euro area fiscal stance was contractionary in the period 2011-2013, at a time when the economy was deteriorating. The fiscal stance became broadly neutral in 2014-2015 and slightly expansionary 2016, against the background of a recovery. For 2017, both the aggregation of the draft budgetary plans (referred to in the graph as "Member States' intentions") and the Commission Autumn 2016 Economic Forecast point to a broadly neutral fiscal stance again.

[10] The Commission proposed on 14 September 2016 to extend the duration of the European Fund for Strategic Investments (EFSI) and to raise its investment target to at least EUR 500 billion until end-2020, and EUR 630 billion by 2022.
[11] See COM (2016)601 of 14 September 2016.

Euro area fiscal stance over 2011-2017



Note: This graph illustrates the fiscal stance of the euro area, i.e. the orientation of fiscal policy at an aggregate level. This is measured by the change in the structural primary balance (see also Box 1). A positive value corresponds to a fiscal deficit which is widening (which contributes to a "fiscal expansion"), while a negative value corresponds to a fiscal deficit which is narrowing ("fiscal consolidation"). The aggregate does not include Greece, which is in a stability support programme.

In light of the slow recovery and risks in the macroeconomic environment, there is a case for a moderately expansionary fiscal stance for the euro area at this point in time. Based on estimates from the Commission services, a fiscal expansion of up to 0.5% of GDP at the level of the euro area as a whole is considered desirable for 2017 in the present circumstances.[12] This figure results from an assessment of the situation of the levels of economic activity, spare capacity, unemployment and inflation. It is a pragmatic and prudent target in a wider range of estimates: such an expansionary fiscal stance would reduce the share of unused productive capacity in the euro area, while supporting monetary policy[13] and avoiding unnecessary overheating of the economy.

While the direction is clear, the exact target can be considered within a range and requires judgement. A fiscal expansion of 0.3% would be the lower bound of the range: this would contribute to ensuring that the euro area halves its output gap in 2017,[14] while being broadly compatible with the objective of fiscal sustainability. However, such a stance may not be ambitious enough, especially since the estimates of the output gap are surrounded by uncertainty, which may result in underestimating the need for stabilisation in the euro area. By contrast, a fiscal expansion of 0.8% would represent an upper bound: it would allow for the closure of the output gap already in 2017. However, such a stance may be overly expansionary, since it may fuel undesirable overheating in some Member States and would be at odds with the goal of preserving the sustainability of public finances.

[12] Such a fiscal expansion would correspond to an additional fiscal "stimulus" of around 50 billion euros for the euro area as a whole in 2017, compared to the "business-as-usual" scenario estimated in the latest Commission Forecast. This amount corresponds to the increase in the structural deficit (including interest payments) to reach the desirable fiscal stance.

[13] An expansionary fiscal stance of 0.5% would also contribute to close a fourth of the gap between the forecast core inflation in the euro area and the objective of 2% inflation in 2017.

[14] The output gap is the difference between the level of actual economic output and its potential.

The issue today is that even if economists can point at a desirable fiscal stance for the euro area in order to combine macroeconomic with fiscal sustainability concerns, such a fiscal stance will not be the spontaneous result of the application of the rules to each Member State. In light of the latest economic and budgetary data, a full delivery of the fiscal requirements contained in the country-specific recommendations adopted by the Council in July 2016 would imply, on aggregate, a moderately restrictive fiscal stance for the euro area as a whole in 2017 and similar trends can be estimated for 2018[15] (see Graph 4 in annex 1). This is without factoring in the flexibility which exists within the rules to take account of changing economic circumstances.[16]

In discussing the appropriate fiscal stance for the euro area today, it is also important to stress that the current fiscal situation conceals a clearly sub-optimal repartition of the fiscal adjustment across countries at this point in time. Member States are in very different situations in terms of fiscal space or consolidation needs (see Graph 3 in annex 1). Looking at 2017, Member States with further consolidation needs would seem to expand further, which could fuel concerns about the sustainability of their public finances (see Graph 5 in annex 1). Conversely, Member States which enjoy fiscal space do not necessarily use it. This may create concerns about the need to increase investment and strengthen their growth fundamentals, but also about the capacity to support the recovery of the euro area as a whole.

4. ECONOMIC AND LEGAL LIMITATIONS TO ACHIEVE A POSITIVE FISCAL STANCE

Pursuing a positive fiscal stance at the aggregate euro area level comes with both economic and legal constraints. The former relate essentially to the need to balance macroeconomic stabilisation needs in the short term with the preservation of the sustainability of public finances in the medium run, as part of a broader economic agenda. The latter refer to the operation of the EU fiscal surveillance framework in certain circumstances. Both sets of constraints reveal possible trade-offs, which ultimately require political judgement.

The tension between the need to support the recovery over the short term and to ensure sustainable public finances over the medium term is particularly strong in Member States with very high levels of government debt (see Graph 3 and Graph 8 in annex 1). In those Member States, a too active fiscal policy may exacerbate confidence problems in the sustainability of public finances and in the sustainability of the recovery, rather than address them. This would notably be the case if the strategy were not accompanied by reforms and policies ensuring that the impact is indeed passed on to the real economy, if it proved unable to reduce significantly debt levels and/or if it led interest rates to increase.

[15] The fiscal requirements and resulting fiscal stance for the euro area in 2018 are expected to be broadly similar to those for 2017 since they depend on how far a country is from its medium-term fiscal objective, the economic situation and the level of debt, which are not forecast to change significantly.
[16] See COM(2015)12 of 13 January 2015.

Fiscal sustainability remains a priority, notably for specific Member States, but challenges have receded significantly since the peak of the crisis, and it may not be a major source of risks for the euro area as a whole in the short term. The situation of public finances had deteriorated sharply over 2008-2012, with levels of government debt rising on average from 60% of GDP to more than 90% in the euro area. In most cases, the large increase in debt in the recent past is the result of bank recapitalisation and low growth in nominal GDP, not of fiscal profligacy. Public debt is now receding slightly from its peak of 92% in 2015 but levels remain very high, for instance in the seven Member States above the euro area average: Greece (182% of GDP in 2016), Italy (133%), Portugal (130%), Cyprus (107%), Belgium (107%), Spain (99%) and France (96%). In parallel, the aggregate public deficit for the euro area has come down from above 6% of GDP in 2010 to less than 2% in 2016, and it is projected to fall further.

As seen above, a more positive fiscal stance would seem appropriate given the state of the recovery but it cannot be assumed for 2017-2018. The current EU fiscal framework focuses essentially on defining Member States' specific requirements, without capturing fully the euro area implications. Under the rules of the Stability and Growth Pact, the logic is that the Member States are best able to let automatic stabilisers play their role fully once the budget has reached its medium-term objective (MTO), and that some fiscal consolidation is expected until this is the case. Having done the necessary fiscal adjustments, those Member States that achieve their MTOs and have fiscal space are assumed to choose to support domestic demand, in their own interest and more generally, but they are only invited to do it: the EU's annual country-specific recommendations contain clear policy guidance about this, but no quantified fiscal requirements are addressed to those Member States. For 2017, the recommendations made under the Stability and Growth Pact request many Member States to continue consolidating their budgets, either to correct excessive deficits (in the corrective arm of the Pact) or to achieve their medium-term objectives (in the preventive arm).

Reaching the right policy mix for the euro area is less straightforward in the absence of a centralised budget which could play a more active role. Even if the European Structural and Investment Funds can play an important role in supporting domestic demand,[17] the current EU budget is comparatively small, at about 1% of EU GDP, and not specifically targeted to the needs of the euro area, with limited possibilities to adjust it from one year to the next. That element was also highlighted by the Five Presidents' Report on Completing Europe's Economic and Monetary Union.

[17] These Funds represent a very significant share of total public investment in many Member States, and more than 1% of GDP in seven euro area Member States in a given year. Moreover, the fact that they provide a regular stream of financial support means that they can also play a stabilisation function, especially for small economies more exposed to shocks.

5. THE COMPOSITION AND QUALITY OF THE FISCAL STANCE MATTER

Promoting a positive fiscal stance is not just a question of the direction and size of the budget balance, but also very much of the composition of the public finances behind it. In addition to the issue of the repartition of the adjustment across Member States mentioned above, it is thus important to stress the issue of the quality of public expenditure and taxation.

The EU's country-specific recommendations stress ways to design responsible, growth-friendly fiscal policy and identify some of the priority areas that would benefit from increased/better spending or a shift in taxation at national level. This is particularly important for the countries which need to address growth weaknesses and/or long-term fiscal sustainability risks. However, in spite of guidance given, there is evidence that the composition of the fiscal consolidation in the aftermath of the crisis has been sub-optimal in many Member States. In particular, notably in Member States which already had high revenue-to-GDP ratios, fiscal consolidation has relied excessively on tax increases, which have depressed growth (see Graph 6 in annex 1). At the same time, government investment spending, which was severely cut amidst the consolidation efforts in the post-crisis years, remains compressed (see Graph 7 in annex 1).

Reforming pension and health-care systems can further enhance the quality of public finances. Pension and health care constitute the bulk of public finances in most Member States and the further modernisation of welfare systems is a shared priority in the light of the new challenges - but also opportunities - brought about by changes in family structures, increased life expectancy and the digitisation of the economy. The Eurogroup has recently agreed on a number of principles that aim to increase the sustainability of pension systems. It has also invited the Commission to take them into account in its surveillance processes and to explore the development of appropriate benchmarks on that basis.[18]

Improvements in national fiscal frameworks can also foster the growth-friendliness of public spending, not least through the setting up of efficient spending reviews and stronger public finance management at all levels of government. Such tools and practices are very helpful in bolstering the credibility of fiscal policy, by internalising the EU framework in national policy settings and, thereby, enhancing the sense of ownership. The principles for the conduct of spending reviews recently endorsed by the Eurogroup provide a very useful starting point.[19]

Another important priority for most Member States is to make certain parts of their public finances more responsive to smoothen cyclical developments, and thus increase their macroeconomic stabilisation function. There are many aspects of public finances which have shock-absorbing and counter-cyclical properties, such as unemployment insurance and social assistance systems, or the progressive nature of income tax systems.

[18] The Eurogroup statement on common principles for strengthening pension sustainability can be found at: http://www.consilium.europa.eu/en/press/press-releases/2016/06/16-eurogroup-pension-sustainability/

[19] See: http://www.consilium.europa.eu/en/meetings/eurogroup/2016/09/spending-reviews_commission_note_pdf

Several instruments of the Investment Plan for Europe offer ways for Member States to magnify the financial firepower of their public interventions into the real economy, with benefits at home and across borders. This is for instance the case if Member States choose to make better use of innovative financial instruments under the European Structural and Investment Funds. This is also the case where Member States decide to contribute to the deployment of the European Fund for Strategic Investments (EFSI). For instance, guarantees to the EFSI are a particularly effective way for Member States with fiscal space to make good on their commitments to do their part to support the recovery in the euro area.[20]

The success of any stimulus aimed at boosting investment will depend on the availability of quality projects. At European level, a new European Investment Project Portal provides examples of European investment projects of interest. At national level, it is important to progress towards national infrastructure plans agreed and coordinated among all levels of administration, in order to ensure a stable pipeline of high-quality projects.

6. CONCLUSION

This Commission has put jobs, growth and social fairness at the core of its agenda. It has focused its action on a "virtuous triangle" of economic policy combining the re-launch of investment, the pursuit of structural reforms and responsible fiscal policies. It has clarified and made use of the flexibility which exists within the rules of the Stability and Growth Pact, to take better account of the economic cycle and to provide incentives for structural reforms and investment. It has provided concise guidance in its country-specific recommendations.

At a stage where the recovery remains fragile and uncertainty is high, a significantly more positive fiscal stance is warranted for the euro area. This is important to fuel the real economy, but also to support the monetary policy of the European Central Bank. At the same time, such an orientation should build on the legal framework set by the Stability and Growth Pact and take account of broader fiscal sustainability concerns, which is particularly relevant for certain Member States. This new orientation should be part of an overall rebalancing of the priorities and policy mix of the euro area, including a greater focus on the quality of public finances and the implementation of structural reforms.

In the absence of a fiscal stabilisation function, there is no in-built mechanism at EU level to deliver a fiscal stance which is appropriate for the euro area as a whole while being well balanced at Member States' level. Applying the rules of the Stability and Growth Pact blindly, by disregarding the elements of flexibility they contain, would also not result in a satisfactory outcome, especially not in the current circumstances. The design of a positive fiscal stance is thus essentially a matter for the collective responsibility of the euro area Member States.

[20] Contributions to the EFSI can take the form of cash or guarantee. While cash contributions, unlike guarantees, are deficit- and debt-increasing in statistical terms, they are neutralised for the purpose of assessment of compliance with the Stability and Growth Pact.

Given the need to act at the present juncture, the Commission confirms its intention:

- To support the Eurogroup, the Council and the European Council in their discussion on the Recommendation on the economic policy of the euro area for 2017-2018. The Recommendation should set out an overall direction for the euro area fiscal stance and specify the repartition of efforts expected by the different categories of Member States, not only in the light of their own economic and fiscal situation, but also of the euro area aggregate. Member States in the Excessive Deficit Procedure and others still needing to progress towards their medium-term budgetary objective should continue to do so, as recommended to them. Member States with fiscal space should be encouraged to carry out a more expansionary fiscal policy, including by making full use of the tools of the Investment Plan for Europe in order to maximise the impact on the real economy, such as guarantees to the European Fund for Strategic Investments.
- To continue to apply the Stability and Growth Pact with the economic reading which the rules foresee, including to take account of the challenges and priorities of the euro area as a whole. This approach is also reflected in the opinions on the 2017 Draft Budgetary Plans of euro area Member States adopted today.[21]
- To engage with each euro area Member State, in the context of European Semester of economic policy coordination, to better reflect euro area challenges and priorities into national policies. This will notably be the case for the Member States subject to in-depth reviews as part of the Macroeconomic Imbalances Procedure. The country reports next February will be used to track progress for each Member State.
- To continue to use all EU-level instruments, such as those of the Investment Plan for Europe, to maximise the impact of public spending at all levels of government, including cross-border, and to reinforce synergies between EU and national strategies.
- To re-assess the situation regularly in the context of the European Semester 2017 and of its future economic forecasts. The Commission stands ready to use all the available options under the EU fiscal framework in case the recovery of the euro area remains subdued or downside risks materialise. Conversely, risks of overheating and pro-cyclical policy should be averted, if the recovery becomes stronger than expected.

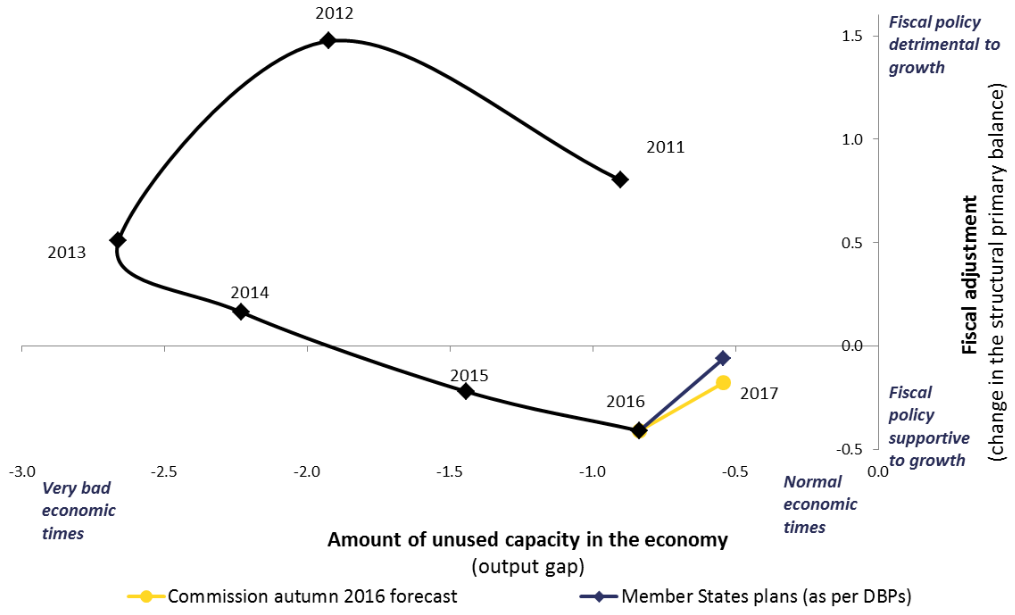
This Communication focuses essentially on the specific situation of 2017-2018, but it is part of the broader effort of the Commission to promote the collective interest of the euro area and of its Member States, and to deepen Europe's Economic and Monetary Union. Since the Five Presidents' Report and the follow-up Communication from the Commission,[22] there has been some progress in "deepening by doing". In particular, a European Fiscal Board was recently set up, which will regularly advise the Commission in the future on the fiscal stance appropriate for the euro area and on the application of the EU fiscal framework.

The Commission will come up with further orientations on the future of the Economic and Monetary Union as part of its White Paper on the future of Europe in March 2017.

[21] See COM(2016)730 of 16 November 2016.
[22] See COM(2015)600 of 21 October 2015.

Annex 1. Graphical evidence on the euro area fiscal stance

Graph 1. Euro area fiscal stance over 2011-2017

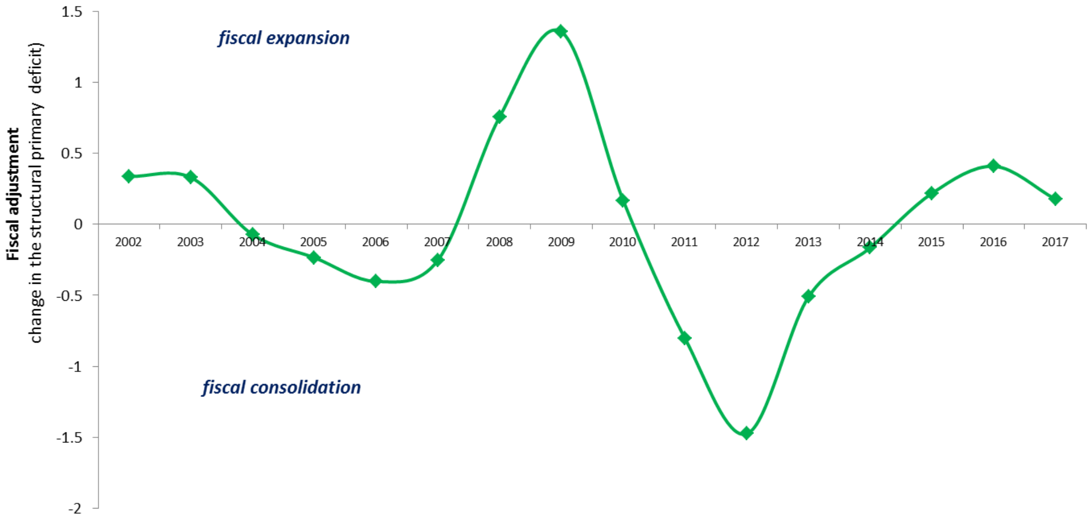


Graph 1 shows the orientation of the euro area's fiscal policy on the vertical axis as measured by the change in the structural primary balance (as in the graph in the main text of the Communication) and the amount of unused capacity in the economy on the horizontal axis. The euro area aggregate displayed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

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

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

Graph 2. Fiscal stance of the euro area since 2002

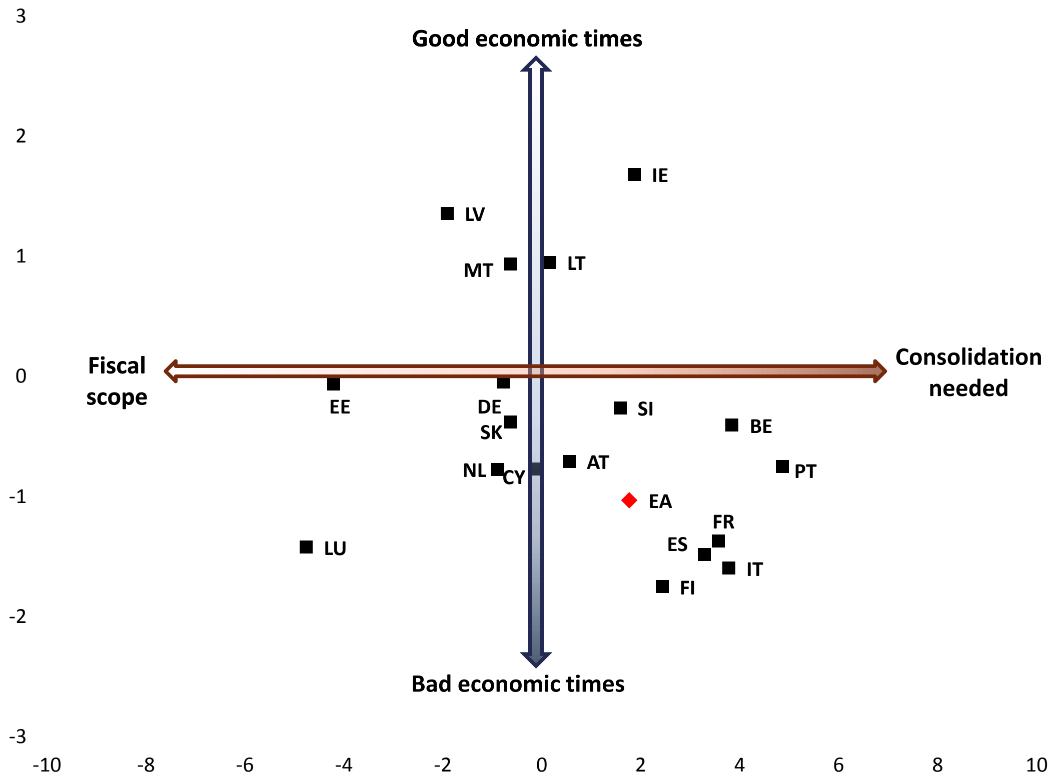


Graph 2 illustrates the fiscal stance of the euro area, i.e. the orientation of fiscal policy at an aggregate level, from an historical perspective.

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

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

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



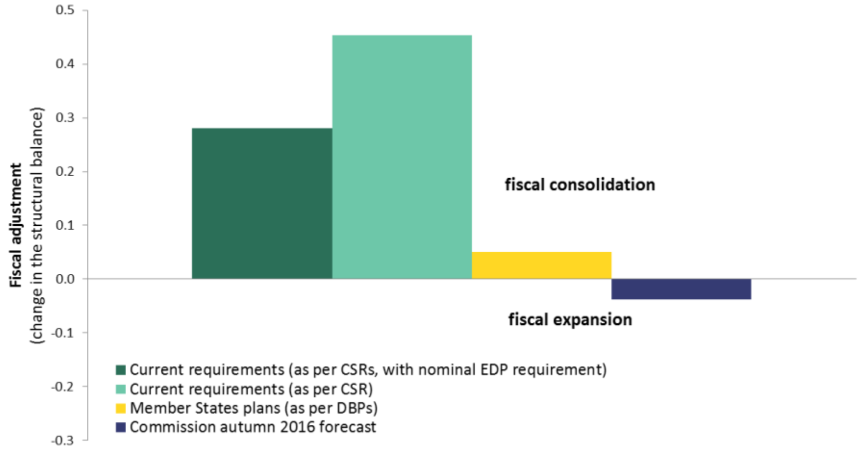
Graph 3 shows both the stabilisation needs (vertical axis, measured by the output gap in 2016) and sustainability needs in euro area Member States (horizontal axis, measured by the standard indicator of sustainability "S1", based on the Autumn 2016 Forecast and using 2016 as the base year).

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

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

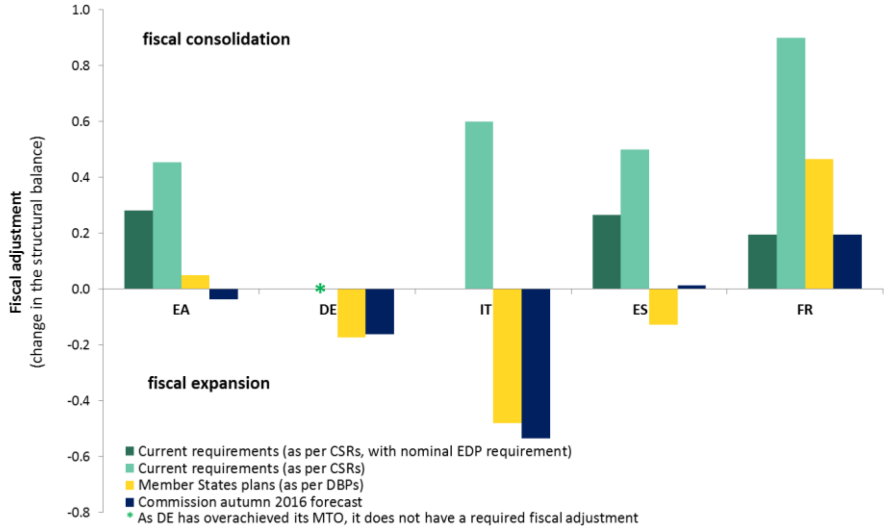
It should be noted that this graph points in opposite directions for a few countries that would benefit from a more supportive fiscal stance in the short term, while being confronted with sizeable fiscal sustainability issues in the longer run. This concerns for instance ES, FR and IT, among others.

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



Graph 4 shows what the fiscal stance for the euro area is likely to be in 2017 as measured by the change in the structural balance, including the change in interest payments.[23] *Current requirements are the ones reflected in the country-specific recommendations (CSRs) adopted by the Council in July 2016. Since recommendations under the Excessive Deficit Procedure (EDP, i.e. the corrective arm of the Stability and Growth Pact) include both nominal targets and the structural adjustments necessary to achieve them (for instance for countries like France or Spain), the fiscal adjustment required is shown both in terms of the structural requirements specified under the EDP recommendations (pale green) and the structural adjustment that would be necessary to achieve the nominal target in the EDP recommendations (dark green). This graph shows that a full delivery of the fiscal requirements of the CSRs would imply, on aggregate, a restrictive fiscal stance for the euro area in 2017. Similar trends can be assumed for 2018 based on existing fiscal requirements.*

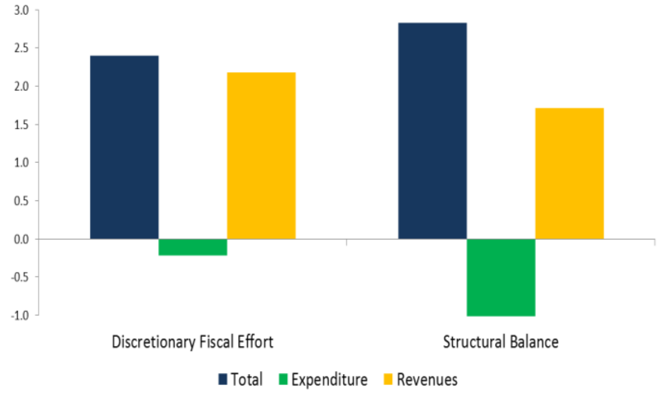
Graph 5. Euro area fiscal stance in 2017: repartition across main economies



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

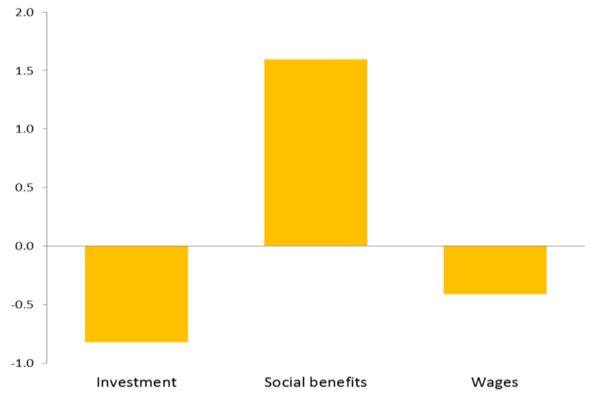
[23] This is a different measure than the one used in the graph of the main text. It is presented here as it is the one used in the EU fiscal surveillance to express fiscal requirements, but it differs slightly from the concept of "primary structural balance", which is a better measure of the fiscal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

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



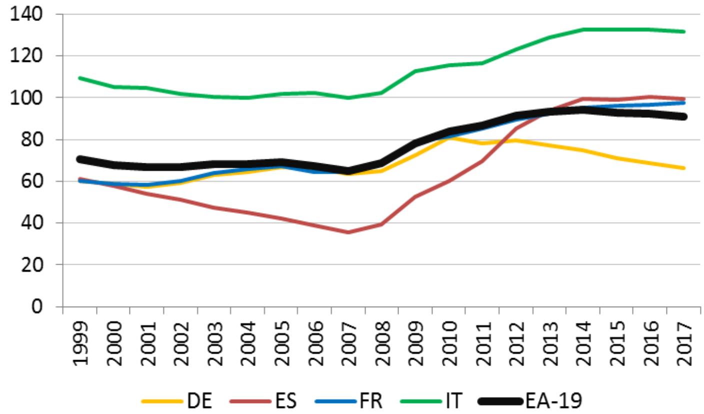
Graph 6 shows the Discretionary Fiscal Effort (DFE), which is another way of estimating the tone of fiscal policy. This is a complementary indicator to the change in the structural (primary) balance. Both the DFE and the change in the structural balance signal that the bulk of the fiscal adjustment undertaken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

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



Graph 7 shows that the compression of government investment was particularly large and played a significant role in the fiscal consolidation.

Graph 8. Government debt-to-GDP ratio since the euro: average and selected Member States (%)



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

Annex 2. Output and spillover effects of fiscal policy[24]

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

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

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

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

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

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