

European Fiscal Board

**Assessment of the
fiscal stance appropriate for the euro area in 2022**

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

Massimo BORDIGNON

Member

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

Xavier DEBRUN

Member

Advisor in the Research Department of the National Bank of Belgium

Mateusz SZCZUREK

Member

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

More information about the European Fiscal Board is available at:

<https://ec.europa.eu/european-fiscal-board>

This report was written under the responsibility of the European Fiscal Board with the support of its secretariat. Comments on the report should be sent to:

Secretariat of the European Fiscal Board
European Commission
Rue de la Loi 200
Office BERL 2/353
B-1000 Brussels
Email: EFB-SECRETARIAT@ec.europa.eu

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FOREWORD



Prof. Niels Thygesen

Chair of the European Fiscal Board (EFB)

Advising on the appropriate fiscal stance for the euro area in 2022 is exceptionally challenging. The economic outlook is clouded by conflicting forces: the pace of Covid-19 vaccinations is accelerating, but epidemiological dynamics remain uncertain and economic performance across Member States is uneven.

The fiscal rules have been applied with extreme flexibility since the severe downturn clause (known as the general escape clause) was activated in early 2020. The pandemic clearly showed the need for a coordinated response, paving the way for two new features of a temporary central fiscal capacity: the SURE scheme and Next Generation EU recovery fund (NGEU). The EFB had already noted that activating the severe economic downturn clause should be subject to a sunset provision contingent on a clear criterion: the return of aggregate euro area income to its pre-pandemic level. As this criterion may only be met in 2022, we support the recent decision for the clause to remain active next year.

The EU's focus until now has been on finalising legislation to underpin the 2020 initiatives and getting the investment and reform plans drawn up by the Member States over the finishing line. Over the coming months, the Commission should relaunch the economic governance review. A revised framework should be more cognisant of the diversity of national public finances, notably that of the public debt, and focus more on 'gross policy errors' to replace the many improvisations of the past.

That said, neither the uncertain economic outlook nor the absence of specific fiscal guidance removes the responsibility for offering advice on the appropriate fiscal stance. The term

'stance' is of special significance in the current environment. Recent policy advice, notably from the IMF and the OECD, has been to not withdraw fiscal stimuli too early. This may have given the impression that current policies are less expansionary and hence that the need for such policies is greater than in reality.

In view of the rapid recovery from a deep downturn, an assessment of the fiscal stance must factor in the operation of automatic stabilisers and the unwinding of emergency measures. Considering that conventional indicators underestimate the strength of fiscal support, the euro area fiscal stance in 2022 implied by current policies appears appropriate.

However, the challenge of recovering from the pandemic requires more than aggregate budgetary support. The composition of expenditure is essential: the advice being to focus on increasing growth-enhancing spending and facilitating reallocations of labour and capital, while keeping in check the traditional drivers of public deficits, public consumption and transfers. This was underlined in the Commission's recommendations to avoid commitments to permanent expenditure and, hopefully, in elements of joint influence via the NGEU on national budgetary allocations.

In light of policy decisions elsewhere, notably in the US, the question is sometimes raised as to whether EU fiscal policy is becoming overly cautious. We do not think so. The EU should aim to strike a proper balance between a growth-friendly expenditure strategy and longer-term fiscal sustainability, currently stretched in a number of Member States, despite exceptional monetary accommodation and very low debt-servicing costs. Returning to a revised rules-based fiscal framework is a matter of urgency to cement credibility and mitigate uncertainty about future policies. This would allow for gradually regaining space for both monetary and fiscal policy.

KEY MESSAGES

- The euro area economy is rebounding, as a result of a forceful policy response and the rollout of vaccines. After contracting by almost 7% in 2020, forecasters expect annual real GDP in the euro area to exceed the pre-crisis level by next year.
- The rebound is predicated on an improving global economic outlook, the release of pent-up consumer spending, implementation of the EU's Recovery and Resilience Facility (RRF) and still sizeable fiscal and monetary support.
- The recovery has been strong across all euro area Member States. However, the combined effect of structural legacies, the severity of the health crisis and the sectoral composition of each economy have a bearing on the forecast for individual Member States in 2022.
- The specifics of the pandemic and the policy response complicate the assessment of the fiscal stance using conventional indicators:
 - Although declining on the previous year, the structural primary deficit of the euro area is projected to be close to the level recorded in 2020 and around 3% of GDP higher than in 2019, the last year before the pandemic. Hence, the budget will still provide considerable support to the economy.
 - Member States' fiscal response also includes substantial guarantee schemes, which help stabilise demand but are not recorded in government budgets unless called.
 - In national accounts, government expenditure backed by debt-financed EU grants from the RRF is recorded as deficit neutral, regardless of when the EU grants are paid out.
- Based on the current outlook, the EFB recommends a supportive fiscal stance for the euro area in 2022. Policies adopted or credibly announced by governments to date appear to achieve an appropriate degree of fiscal support. They should ensure the emergency measures are gradually phased out, while keeping expenditure above pre-crisis levels.
- For high debt countries the RRF offers the opportunity to support the recovery with additional investment and reforms without affecting sustainability of public finances in the medium term.
- To safeguard the support needed for the ongoing recovery of the euro area, monetary and fiscal policy will have to continue to complement each other. With policy rates at the effective lower bound, an accommodative monetary stance can only be effective if government budgets act as the main transmission channel.
- Agreeing on a revised economic governance framework before deactivating the severe economic downturn clause would contribute to a smooth normalisation of fiscal and monetary policies, offering space to both in the post-pandemic times beyond 2022 within a revised rules-based economic governance framework.
- Beyond the overall size of fiscal support, and as the health crisis ebbs, fiscal support should shift towards rolling out more targeted initiatives promoting a sustainable economic recovery and supporting the need to achieve the digital and green transitions.

1. Macroeconomic situation and outlook

The Covid-19 crisis has magnified the importance of the euro area fiscal stance. In normal times, the aggregation of national fiscal stances and related policy recommendations may provide reasonable guidance to achieve an appropriate overall fiscal stance. In a deeper crisis, however, this is unlikely to be the case, especially when monetary policy rates are at the effective lower bound. The provisions of the Stability and Growth Pact (SGP) for severe economic downturns (known in the public debate as the general escape clause) offers additional flexibility. However, to achieve an appropriate fiscal stance for the euro area, and in the absence of a genuine central fiscal capacity, policy guidance must address the right level of fiscal support and adequate fiscal coordination, subject to sustainability considerations.

More precise language is needed to describe the role of fiscal policy in macroeconomic stabilisation. The fiscal stance has often been used interchangeably to mean either the level of support to aggregate demand provided by the government budget or the additional impulse offered by new fiscal measures. In light of the forceful fiscal policy response to the Covid-19 pandemic, a clear distinction needs to be made between *fiscal stance* and *fiscal impulse* (see Box 1 for a detailed discussion). The fiscal stance is the overall level of support provided by the government budget and other relevant fiscal measures. The discretionary part is typically measured as the structural primary balance (SPB) relative to potential output. Conversely, the annual change in the SPB captures the discretionary fiscal impulse, that is, the change - positive or negative - to the fiscal stance. Confounding the two notions can lead to miscommunication. Making this distinction is particularly important during a crisis when a contractionary impulse can very well coincide with a supportive fiscal stance, thanks to sizeable measures taken during, and carried over from previous, crisis years.

The recovery of the global economy is expected to continue in 2022. Main international institutions expect global output to grow by more than 4% in 2022. The massive fiscal stimulus in the US launched by the Biden administration as well as a return to pre-crisis growth rates in East Asia, are the pillars supporting the positive global outlook. Trade volume is expected to recover to above its pre-crisis level in 2022, growing over 6%. The global investment rate remains above its pre-crisis level, also due to government programmes and improving investor confidence. Thanks to the strong expansion in China and the US, global demand will provide a boost to euro area exports, with the final impact depending on interest rate and exchange rate developments.

In the euro area, the economic rebound is projected to push real GDP above pre-crisis levels. Based on the latest round of economic forecasts, in 2022 the euro area will continue to recover from the economic slump in 2020, which saw a record drop in economic activity of close to 7%. As the confinement or lockdown measures are being lifted and Covid-19 vaccines are being administered, real GDP in the single currency area is expected to increase by well over 4% in 2022, which adds to a similar rate of growth expected in 2021. As a result, in 2022 the annual level of aggregate economic activity should exceed that of 2019 (see Graph 1.3).

The drivers of growth are expected to be broad-based. Bottled up savings and a return of consumer and business confidence are projected to spur private consumption. At the same time, private and public investment at constant prices is expected to exceed pre-pandemic rates of growth. However, the pre-crisis level of investment was historically low in many Member States, which means the recovery of investment will still be limited in some countries. Euro area exports are also expected to exceed pre-crisis levels on the back of the global recovery.

The economic recovery does not offset the difference in the depth of the recession. The crisis has affected Member States quite differently in terms of both the health crisis and the economic impact. The change in annual real GDP in 2020 ranged from a 10.8% contraction in Spain to 3.4% growth in Ireland. Although it is expected to be fairly strong in all countries, the economic rebound is not always proportional to the depth of the downturn (see Graph 1.9). However, in 2022 nearly all euro area Member States are forecast to return to or exceed their annual level of real GDP recorded in 2019.

The Covid-19 pandemic is likely to have lasting effects on the euro area economy. Most economic crises have had a lasting negative impact on output dynamics and dragged downward the output growth path (see Graph 1.12) ⁽¹⁾. There are emerging signs that the pandemic may have had a profound impact on both the growth path and on the composition of the economy. Contact-intensive sectors have taken the brunt, and although they can be expected to normalise to some extent over the coming years, they are unlikely to return to their pre-crisis levels of output. Many businesses are likely to go into insolvency once debt-servicing moratoria expire, triggering a rise in unemployment. At the same time, digitalisation has accelerated during the lockdown and some businesses have profited. Ultimately, the crisis has accelerated the ongoing technological transition and the rise of new business models. Support measures initially geared to protecting jobs and firms have stalled some of these transformative forces but other future-oriented programmes such as the Recovery and Resilience Facility (RRF) should accelerate the process over the course of the next years.

Unemployment only rose modestly during the crisis and is expected to fall back to pre-

⁽¹⁾ [ECB \(2020\) Economic Bulletin on the scarring effects of past crises on the global economy](#) and [IMF \(2020\) report 'The Long Economic Hangover of Pandemics'](#).

crisis levels in 2022. Given the depth of the crisis, the increase in the unemployment rate was fairly limited from 7.5% in 2019 to 8.4% in 2021. The limited increase mostly reflects the remarkable rebound of economic activity combined with the successful activation of job-retention schemes, which mask the underlying labour market conditions. Once restrictions on economic activity are lifted, the job-retention schemes are expected to be gradually withdrawn as regular employment recovers. This is likely to be the case in 2022, when the rate of unemployment is forecast to fall to 7.8%. There are indications that other labour market metrics, such as employment and total hours worked, will rebound in 2022, although a small gap to pre-crisis values is likely to remain.

Estimating economic slack is exceptionally challenging. As mentioned above, deep economic recessions can have a lasting negative impact on economic activity. Separating cyclical from structural change to real GDP is more difficult than usual and the final outcome is only revealed in time. In the immediate wake of the crisis, the Commission and the competent working group of the Council decided to apply ad hoc adjustments to the commonly agreed methodology of estimating potential output and the output gap ⁽²⁾. As a result, the impact of the crisis is mostly considered to be temporary. In its latest forecast, the Commission estimates a negative output gap of less than ½% of potential GDP in 2022 ⁽³⁾, up from 6.3% and 3.3% in 2020 and 2021 respectively.

The Recovery and Resilience Facility (RRF) can provide a sizable boost to economic growth in 2022. With an overall envelope of EUR 672.5 billion, the RRF constitutes the

⁽²⁾ Adjustments to (1) average hours worked, (2) capacity utilisation indicators and (3) structural unemployment.

⁽³⁾ Without the ad hoc adjustments to the commonly agreed method for estimating potential output and the output gap decided in early 2020, the estimated degree of slack would be smaller; the HP-filtered output gap for 2022 is positive.

lion's share of the Next Generation EU (NGEU) initiative. The RRF includes EUR 312.5 billion of grants (see Graph 1.11). The facility was adopted in 2021 and is expected to produce the first sizeable effects in 2022. Early simulations by the Commission suggest that, depending on how quickly the RRF is implemented by the Member States, in 2022, real GDP of the euro area could be up to 1.2% higher (see Graph 1.22) ⁽⁴⁾. IMF estimates of the possible impact of the RRF are in the same order of magnitude. According to the 2021 spring forecast, the Commission expects RRF grants to finance EUR 140 billion of government expenditures by 2022, which represents close to 1% of 2019 GDP.

The economic impact of the RRF depends on the degree of additionality in terms of government investment and on how efficiently funds are spent. Holding the size of the recovery impulse constant, Commission simulations suggest that, with a low degree of additionality – where additionality is to be understood with respect to policies known at the moment of the simulation - euro area real GDP would be half a percentage point lower in the medium term than if the degree of additionality is high (see Graph 1.22). Moreover, the IMF expects that if RRF funds are used inefficiently, their impact could be halved by 2023. It remains to be seen if and to what extent the RRF will create a crowding out effect of other investment or if Member States cut already planned government investment in response. Overall, the exact degree of additionality is difficult to assess in practice.

The severe economic downturn clause under the SGP will remain active in 2022. Since the severe economic downturn clause was activated in spring 2020, Member States have been given ample flexibility to respond to the crisis. In March 2021, the Commission clarified

⁽⁴⁾ The simulations are based on a non-linear relationship between the risk premia on government borrowing and the debt ratio, particularly for high debt countries.

that it would decide whether to extend or deactivate the clause by an overall assessment involving quantitative elements, notably a return of the EU or the euro area to its pre-crisis real GDP level ⁽⁵⁾. Considering its latest macroeconomic projections, on 2 June 2021 the Commission recommended a further extension of the severe economic downturn clause to 2022 and expects a deactivation in 2023. The EFB supports this recommendation as it accommodates a gradual withdrawal of budgetary support in the Member States.

2. Fiscal policy developments

The fiscal stance of the euro area is expected to remain supportive in 2022. Based on current policies, and against the backdrop of a robust economic rebound, the structural primary deficit of the euro area as a whole is forecast to reach 2.4% of GDP in 2022. Although declining from the previous year, it remains around the level recorded in 2020 and close to 3% of GDP higher than the level recorded in 2019, the last year before the crisis (see Graphs 1.15 and 1.16). Therefore, the projected fiscal stance is still expected to provide significant support to the euro area economy.

Assessing the fiscal stance is more challenging under the current circumstances. Aside from the uncertainty surrounding output gap estimates as mentioned, three factors further complicate the analysis in the current context: (1) government measures that are not captured in the budget deficit; (2) the way RRF expenditure backed by debt-financed EU grants is recorded in national accounts; and (3) distinguishing emergency measures from other support measures.

The government deficit is an imperfect measure of support to aggregate demand. Not all government measures captured in the deficit have the same impact on aggregate

⁽⁵⁾ [European Commission \(2021\) communication on updated approach to fiscal policy response.](#)

demand. By contrast, some government measures that do not alter the deficit can have a substantial impact on aggregate demand, such as government guarantees or capital injections in the private sector recorded as financial transactions. Guarantees have been heavily deployed during the pandemic to support businesses. They enable firms to implement investment plans, maintain payrolls and, in turn, create demand for input. The importance of government guarantees must not be understated under the current circumstances and needs to be kept in mind, even if they do not show up in the conventional measures of the fiscal stance. Only the guarantees that are called will eventually show up in a government's deficit and debt.

Government spending backed by RRF grants is recorded as deficit neutral. Based on current accounting practice, government expenditure financed by RRF grants will be counterbalanced by an equivalent amount of EU grants on the revenue side of the budget, regardless of when the country will receive them (see Box 2). However, from an economic perspective, the fiscal contribution generated by RRF grants supports aggregate demand in the Member States and must be taken into account when assessing the appropriateness of the euro area fiscal stance.

How the emergency measures are accounted for has a profound impact on the assessment of the euro area fiscal stance. During its 2020 autumn forecast, the Commission set out to isolate fiscal 'emergency measures', since they are of a temporary nature and are strictly related to the intensity of the pandemic ⁽⁶⁾. The Commission deems these measures as outside the conventional interpretation of discretionary fiscal decisions with a muted short-term impact on demand due to low multipliers ⁽⁷⁾. This raises the issue of

⁽⁶⁾ These are mainly measures providing direct support to the health sector as well as furlough and firm loss compensation schemes.

⁽⁷⁾ [Commission \(2020\) communication on the 2021 Draft Budgetary Plans: Overall Assessment.](#)

whether emergency measures should be accounted for differently or even excluded from the calculation of the fiscal stance. The stark difference of this approach to the conventional application is illustrated in Graph 1.20. With the conventional approach, overall support measures drop sharply in 2022 while excluding the emergency measures would indicate only a modest reduction on the back of a significant cyclical improvement.

Fiscal support is higher when taking a broader approach. If the previous three complicating factors are taken into account, the actual level of fiscal support is likely to be higher than suggested by the structural primary budget balance. The use of RRF grants is expected to increase somewhat in 2022 compared to 2021 to reach 0.5% of GDP. Likewise, how the emergency measures are unwound depends on the development of the health crisis, with very limited impact on the broader economic developments. Lastly, the support provided by government guarantees will still be active in 2021 and 2022.

Latest Commission guidance considers some of the complicating factors by introducing a new indicator but more information would be desirable. In its 2021 spring package, the European Commission has taken some of the factors complicating the assessment of the fiscal stance or impulse into account ⁽⁸⁾. The EFB approach to the assessment of the general orientation of fiscal policy is to make a clear distinction between fiscal stance and fiscal impulse (see Box 1). By contrast, the fiscal recommendations issued to Member States on 2 June are based on a new variant of the expenditure benchmark, which differs greatly from the conventional approach, implying an expansionary fiscal impulse in 2022. The new variant includes RRF spending financed by EU grants and excludes so-called temporary emergency measures, which in some countries are estimated to make a major difference in 2022. Although the Commission

explains the adjustment, more information and experience on its implementation would be desirable.

The current economic outlook still warrants a supportive fiscal stance in 2022. The projected extension of the economic recovery in the euro area in 2022 is not only predicated on an improving global environment and progress in vaccination rollout. It is also based on fiscal positions, which, although lower than in 2021, still provide support to aggregate demand. Hence, the appropriate fiscal stance in 2022 is compatible with a gradual withdrawal of the large-scale expansion adopted in response to the pandemic. The current policies pursued by national governments would seem sufficient to safeguard the necessary fiscal support for the euro area: emergency measures should be withdrawn in lockstep with the ebbing health crisis while total government expenditures still remain above pre-crisis levels. In this context, governments should refrain from using RRF funds to cut existing expenditure plans, especially investment.

Stabilisation objectives currently dominate the debate against the backdrop of persistent sustainability risks. Flexibility under the severe economic downturn clause comes with a general condition: Member States can be allowed temporarily to depart from the adjustment path towards their medium-term budgetary objective provided that this does not endanger fiscal sustainability in the medium term ⁽⁹⁾. The European Commission's 2020 Debt Sustainability Monitor highlights risks over different time horizons. The latest vintage of sustainability indicators highlights significant fiscal adjustment needs in most high debt countries (see Graph 1.25) ⁽¹⁰⁾. For instance, the

⁽⁸⁾ [European Commission spring package 2021](#)

⁽⁹⁾ Art. 5(1) Regulation (EC) 1466/97 on the strengthening of the surveillance of budgetary positions and the surveillance and coordination of economic policies.

⁽¹⁰⁾ The S1 indicator (see glossary) has been modified to start the adjustment period as of 2022. This modified S1 indicator derives a cumulative fiscal

average budgetary improvement needed over the coming five years to reduce the 2021 high debt levels by 10% by the mid-2030s in several countries markedly exceeds the average adjustment in the pre-crisis years (see Graph 1.26).

Government debt levels warrant a somewhat differentiated approach across countries.

One of the main objectives of the RRF is to provide Member States who entered the Covid-19 crisis with stretched public finances fiscal space to mitigate the economic and social impact of the pandemic. This goal is clearly reflected in the estimated distribution of net benefits across euro area countries. Keeping in mind the sustainability assessment mentioned above, countries with high debt should therefore use the RRF funds as an opportunity to secure budgetary support to the economic recovery by financing additional investment and supporting reform projects while starting to rebalance government expenditure towards growth-enhancing items.

Fiscal measures should become more targeted as the health crisis recedes.

The recovery phase will be characterised by strong growth and new business opportunities in some sectors but continued stress in others. Against this background, it is particularly important to recalibrate fiscal support to provide relief only to those firms that are viable – though identifying these is no easy feat. Blanket support measures should be phased out as the broader recovery commences. The overarching ambition should be to facilitate the transition of the economy and pursue optimal resource allocation. This ambition must be balanced with the need to take measures that reduce unemployment and other socioeconomic consequences during the transition. Useful instruments could be active labour market policies and investment in systems to match vacancies with jobseekers. The trade-off between creative destruction and

adjustment over five years of above 3% of GDP in five countries (Belgium, Spain, France, Italy and Portugal).

managing the repercussions on society is challenging and certainly sensitive.

Risks remain difficult to assess at the current juncture, but they have become evenly balanced. Upside risks have become more prominent in recent months thanks to progress in rolling out vaccinations and faster unwinding of pent-up demand. At the same time, the economic outlook could worsen significantly in the event of further virus mutations affecting the effectiveness of available vaccines. Another downside risk is associated with a stronger than anticipated increase in the number of insolvencies, which could spill over into the financial sector.

3. The euro area policy mix during and after the pandemic

A salient feature of the Covid-19 crisis has been the unprecedented and simultaneous response of monetary and fiscal policies. In the euro area, the ECB promptly augmented its policy toolkit over the course of the pandemic, including additional large-scale asset purchases and targeted liquidity injections at favourable conditions. National fiscal policies were given a break from the consequences of breaching the requirements under the SGP. Lastly, fiscal space was created centrally through the issuance of EU debt guaranteed by Member States to fund new mechanisms (SURE and NGEU).

At first sight, the very notion of the policy mix may seem at odds with the policy assignments wired in euro area governance. In the euro area, monetary and fiscal decisions are strictly separated ('Maastricht assignment'). The central bank responds to shocks to the euro area economy with the aim of stabilising prices, while the rules-based fiscal framework – backed by extensive surveillance and cooperation procedures – aims to ensure public debt sustainability in individual Member States without prejudice to public finances' contributions to economic efficiency (public goods, stable tax system) and social equity (including across generations). The

countercyclical effects of fiscal policy are deemed to be primarily produced by automatic stabilisers, with little scope for discretionary measures in normal times.

During the Covid-19 crisis, however, monetary and fiscal policies have mutually reinforced each other. When central banks have limited room for manoeuvre to decrease policy rates (effective lower bound), monetary and fiscal policies can usefully complement and empower each other, thus jointly help stabilise the economy. First, monetary and fiscal policy both influence aggregate demand, and by extension, output and prices. Second, money and public debt are two alternative means of financing state budgets, which is the chief reason why monetary and fiscal authorities are operationally distinct. Monetary policy is geared towards stabilising demand at levels consistent with price stability. This is supported by discretionary fiscal measures while at the same time government debt issuance must remain consistent with a sustainable debt-to-GDP ratio and the prohibition of monetary financing. This separation in the policy-making process precludes ex-ante coordination, leaving each authority free to pursue its mandate independently from the other.

In normal times, monetary and fiscal policies tend to be strategic substitutes. When there is policy space on both sides of the mix, when the shocks are moderate and fiscal and monetary policymakers follow different policy objectives, their policies can produce counteracting effects on aggregate demand. A central bank may respond with higher interest rates to a fiscal stance it sees as overly lax in view of the inflation outlook. It may respond to fiscal tightening by lowering rates if the inflation outlook is no longer compatible with the inflation objective.

Large-scale disturbances turn monetary and fiscal policy into strategic complements. When the pandemic struck in the euro area, conventional monetary policy instruments were already stretched, and public debts were uncomfortably high in many countries.

Nevertheless, governments and central banks had to pull strongly and in the same direction, given the severity of the economic shock caused by the pandemic. Both understood that space had to be created on both sides to stabilise the euro area economy. Fiscal policy can stimulate demand directly, helping the central bank avert entrenched deflation. Monetary policy keeps borrowing costs low, which also created space for fiscal policy. Moreover, solvent governments may be shielded in exceptional circumstances against self-fulfilling, belief-driven rollover crises, while correcting fundamental fiscal imbalances remains a government task.

Strategic complementarity shapes the answer to two important questions. The first is whether pulling in the same direction breached the perimeter of the EU policy framework. The short answer is no. Governments and central banks have acted within their respective mandates, using the built-in flexibility in the framework. The pressure to take unprecedented action came from exogenous events. Thus, the current policy mix is the outcome of independent action in a context of strategic complementarity, not the result of formal coordination by governments to push inflation closer to a target chosen by the central bank and by the latter trying to preserve public debt sustainability ⁽¹⁾.

The second key question is how to normalise policies in a timely and orderly manner as the emergency recedes. Though the transition to the current policy mix was quick and seamless, moving back to a more normal mix will be more challenging. The crisis response required swift and bold action. Successful normalisation is about finding the right pace to withdraw crisis measures. It is about getting the targeting, the timing, the sequencing, and the definition of the longer-term normal right.

⁽¹⁾ For further detail see [Geneva Report 23](#).

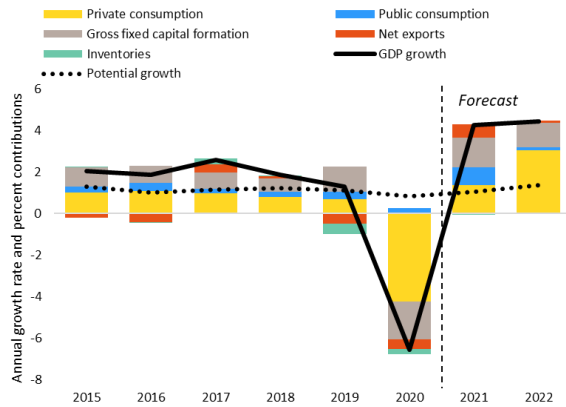
Gradual normalisation should eventually create scope to pursue different policy objectives. Monetary policy is expected to remain highly accommodative for some time, guided by the ECB's price stability mandate. Fiscal policy would in turn normalise, ideally in a gradual fashion (i.e. as a result of growth) without endangering the recovery, thus putting the economy back on a path that would minimise scarring effects and ultimately create scope for monetary policy to normalise. In many cases, legacy of high debt and structural deficits would require growth-friendly consolidations. Views on the appropriate normalisation pace are nevertheless likely to differ, complicating the conduct of monetary and fiscal policies.

If the transition to a new normal comes with risks and unknowns, preserving fiscal credibility is a must. How large will the permanent scars of the crisis be on the economy and public budgets? And how successful will NGEU-supported policies be in durably lifting the growth potential? These are just two of the major known unknowns as economies start emerging from the worst phase of the health crisis. There are two certainties, however. The first is that the credibility of longer-term policy commitments (to price stability and debt sustainability) remains as important as ever to rebuild fiscal space organically and to use it again if needed. The second is that to achieve this credibility, it is essential to have a clear definition of roles and mandates.

The EU fiscal framework should be reviewed as soon as possible, ideally before deactivating the severe economic downturn clause. On the fiscal side, completing the review of the fiscal framework to at least define its future contours should be treated as an urgent matter. Political stalemate that leaves the fiscal framework in the limbo would feed doubt about government's commitment to debt sustainability and complicate matters for macroeconomic policymakers in the euro area. It would also undermine the credibility of the current fiscal framework.

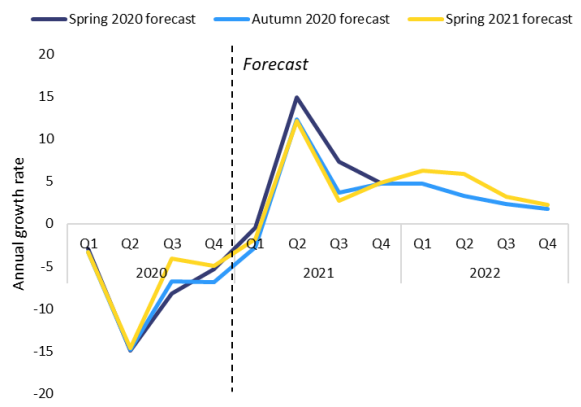
THE MACROECONOMIC OUTLOOK

Graph 1.1: GDP growth and contributions, euro area



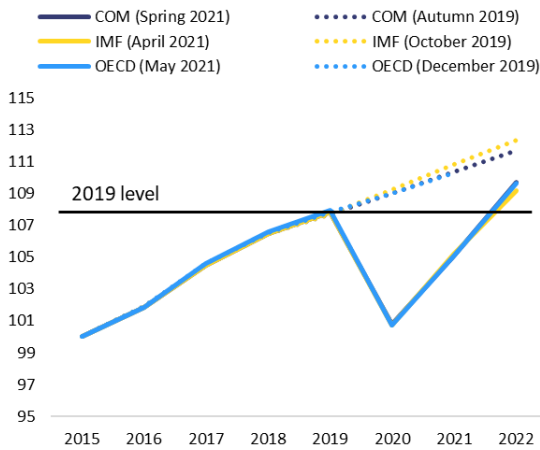
Source: European Commission.

Graph 1.2: Euro area quarterly real GDP growth



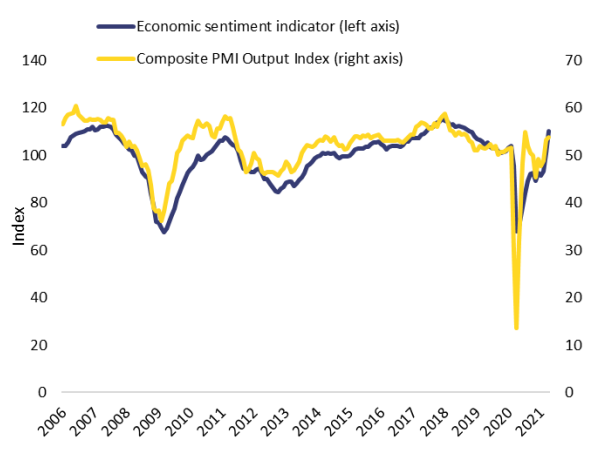
Source: European Commission.

Graph 1.3: Euro area real GDP forecasts



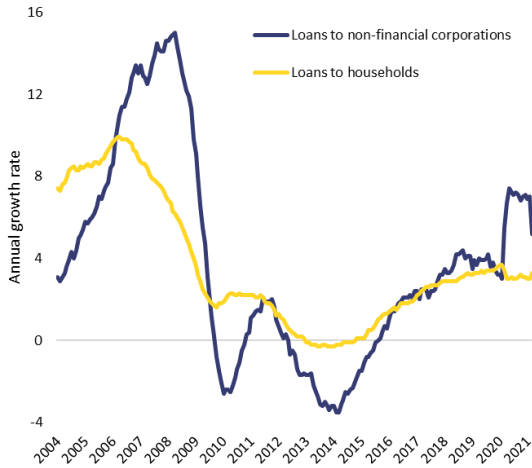
Source: European Commission, OECD, IMF.
Note: 2015 real GDP = 100.

Graph 1.4: Economic survey indicators, euro area



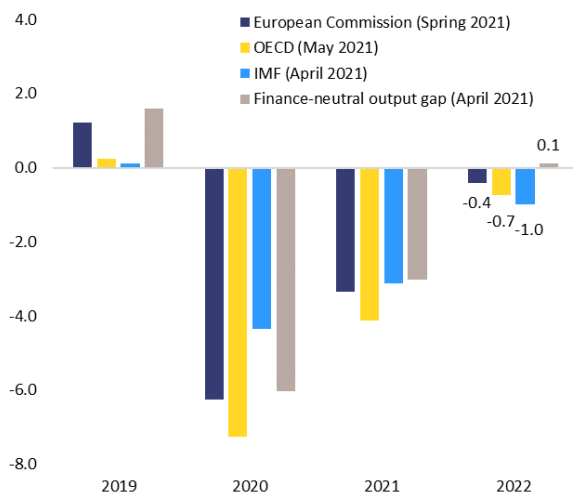
Source: European Commission, Macrobond.

Graph 1.5: Lending growth, euro area



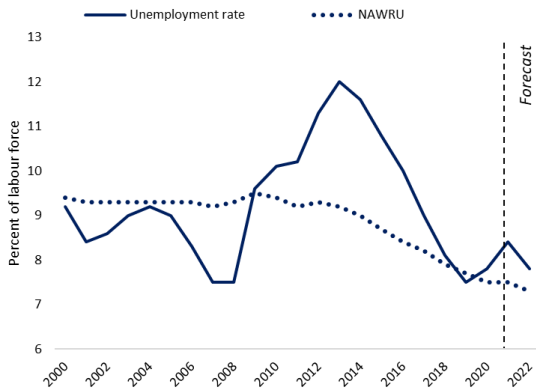
Source: European Central Bank.

Graph 1.6: Output gap, euro area



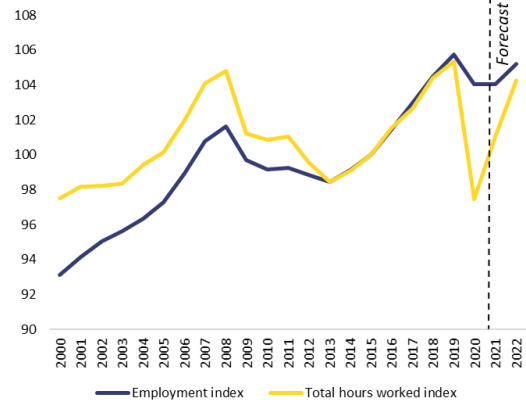
Source: European Commission, OECD, IMF.
Note: (1) OECD data only includes OECD members, thus 17 euro area Member States (excl. Malta and Cyprus); (2) publication dates OECD (31 May 2021), COM (21 April, 2020), IMF (6 April 2021); (3) IMF estimates do not yet reflect the expected impact of the RRF; (4) The finance-neutral output gap is derived from an extended HP filter that takes into account short-term real interest rates, credit growth and house price inflation.

Graph 1.7: Unemployment rate, euro area



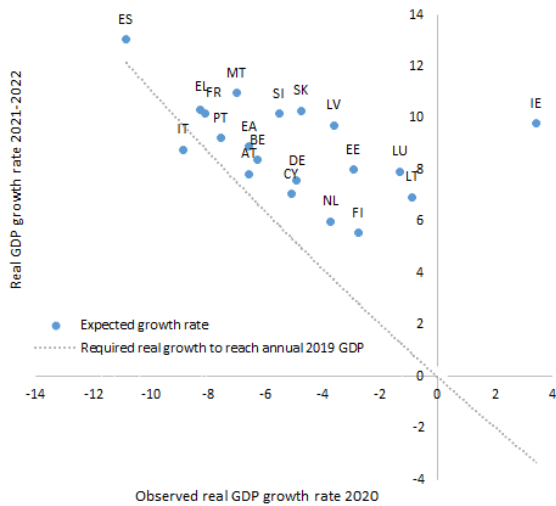
Source: European Commission.
 Note: NAWRU refers to the non-accelerating wage rate of unemployment.

Graph 1.8: Employment and total hours worked



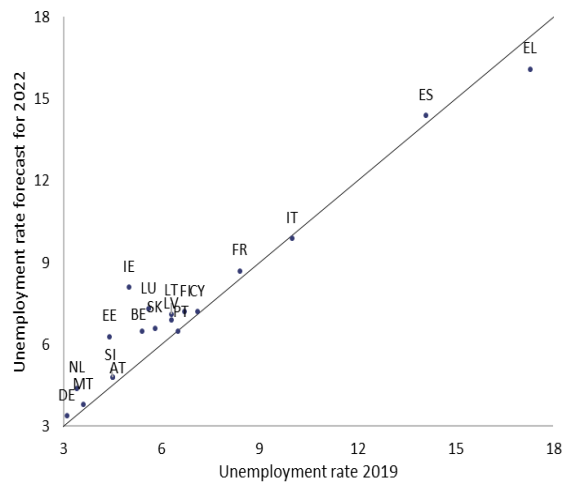
Source: European Commission.

Graph 1.9: Heterogeneity in recession and recovery



Source: European Commission.

Graph 1.10: Unemployment across Member States



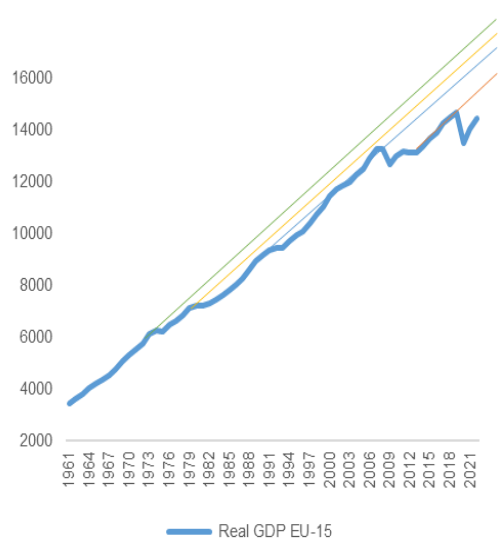
Source: European Commission.

Graph 1.11: RRF maximum grant allocation

	For 70% of the amount available	For 30% of the amount available	Total
Belgium	3.6	2.3	5.9
Bulgaria	4.6	1.5	6.3
Czechia	3.5	3.5	7.1
Denmark	1.3	0.2	1.6
Germany	15.3	9.3	25.6
Estonia	0.8	0.2	1.0
Ireland	0.9	0.1	1.0
Greece	13.5	4.3	17.8
Spain	45.6	22.9	69.5
France	24.3	15.0	39.4
Croatia	4.5	1.7	6.3
Italy	47.9	21.0	68.9
Cyprus	0.8	0.2	1.0
Latvia	1.6	0.3	2.0
Lithuania	2.1	0.1	2.2
Luxembourg	0.1	0.0	0.1
Hungary	4.5	2.5	7.2
Malta	0.2	0.1	0.3
Netherlands	3.9	2.0	6.0
Austria	2.2	1.2	3.5
Poland	20.3	3.6	23.9
Portugal	9.8	4.1	13.9
Romania	10.2	4.0	14.2
Slovenia	1.3	0.5	1.8
Slovakia	4.5	1.7	6.3
Finland	1.7	0.4	2.1
Sweden	2.9	0.4	3.3
EU 27	234.5	103.5	338.0

Source: European Commission (2020).
 Notes: (1) Indicative numbers based on the autumn forecast 2020 for growth in 2020 and 2021. The allocation of 30% of grants in 2022 will be based on outturn data established in June 2022. (2) Figures given in current prices, which explains the discrepancy to the agreed total allocations of EUR312.5bn, which are in 2018 prices.

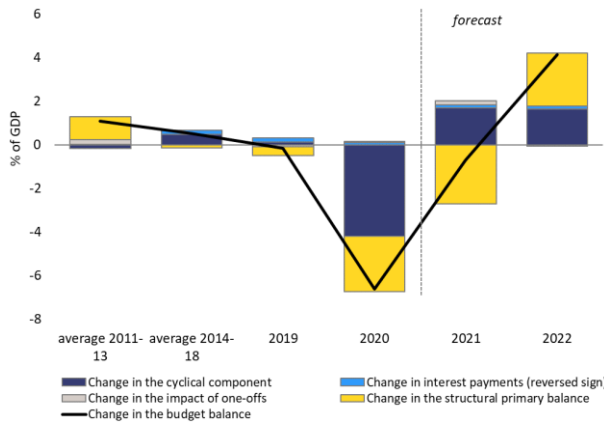
Graph 1.12: Parallel shift in real GDP growth after crises



Source: European Commission.
 Note: Straight lines represent an extrapolation of the pre-crisis growth trend.

FISCAL POLICY DEVELOPMENTS

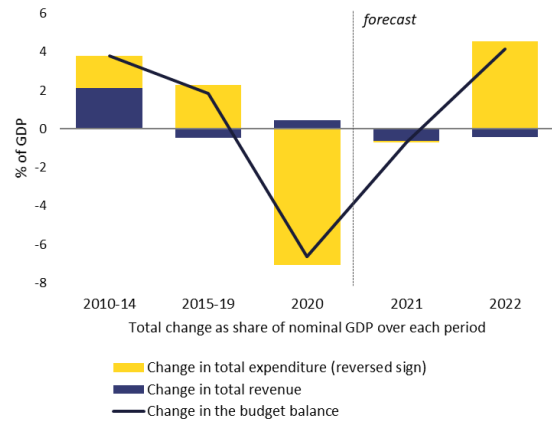
Graph 1.13: Drivers of the change in the general government budget balance; euro area aggregate



Source: European Commission.

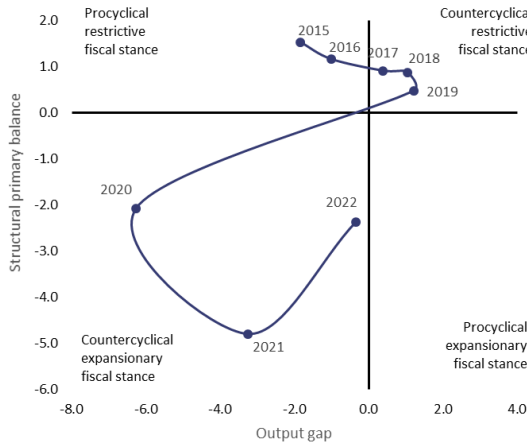
Note: A decrease in interest payments is shown as an improvement in the headline balance.

Graph 1.14: Government revenue and expenditure; euro area aggregate



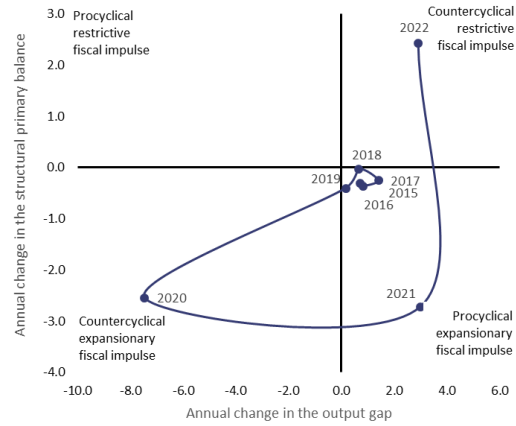
Source: European Commission.

Graph 1.15: Fiscal stance, the structural primary balance; euro area aggregate



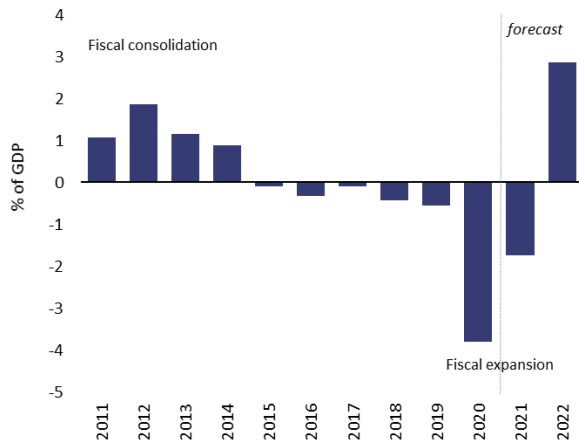
Source: European Commission.

Graph 1.16: Fiscal impulse, change of the structural primary balance, euro area aggregate



Source: European Commission.

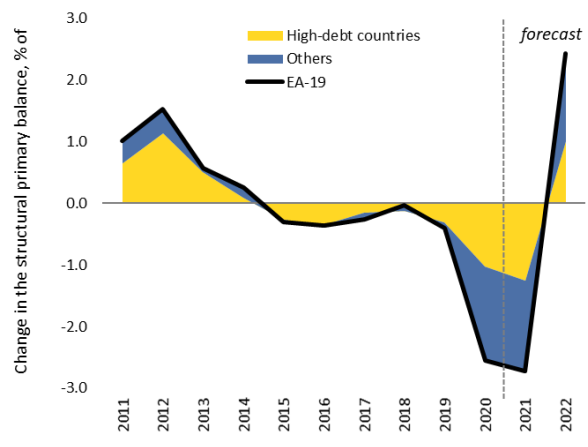
Graph 1.17: Fiscal impulse as measured by net government expenditure growth relative to medium-term potential growth; euro area aggregate



Source: European Commission, own calculations.

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

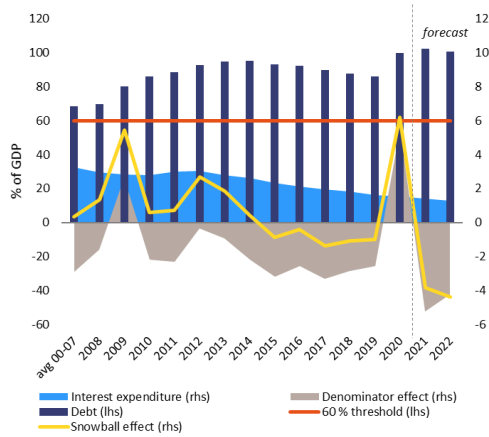
Graph 1.18: Contributions of countries to the aggregate fiscal impulse



Source: European Commission.

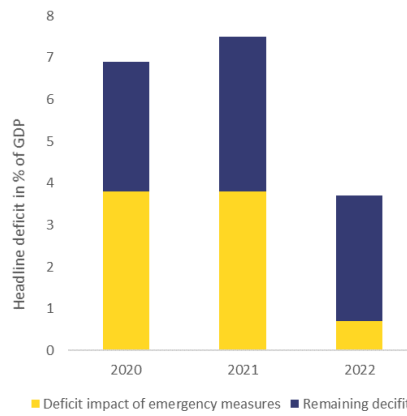
Notes: (1) The group of high-debt countries includes the euro area countries with a debt-to-GDP ratio above 90% in 2020: Belgium, Greece, Spain, France, Italy, Cyprus and Portugal. Others: the remaining countries of the euro area.

Graph 1.19: Government debt developments; euro area aggregate



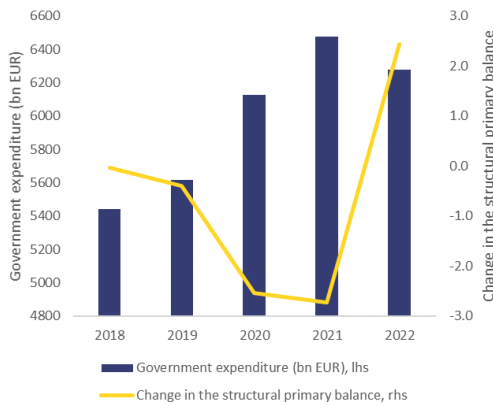
Source: European Commission.
Notes: (1) The snowball effect combines the impact of interest expenditure (blue area) and of nominal GDP growth (denominator effect, grey area) on the debt-to-GDP ratio: if GDP does not grow sufficiently fast to offset the cost of servicing debt, the debt ratio increases.

Graph 1.20: Direct budgetary impact of emergency measures on the EU headline deficit



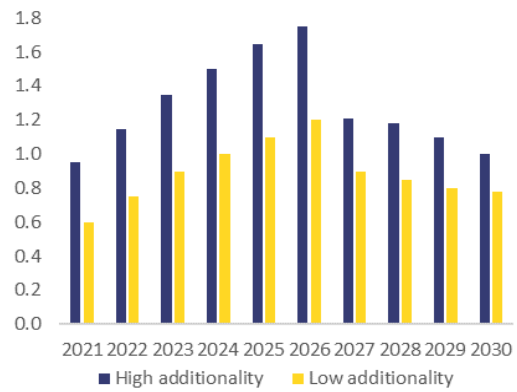
Source: European Commission, European Fiscal Board calculations.

Graph 1.21: Euro area government expenditures and change in the structural primary budget balance (SPB)



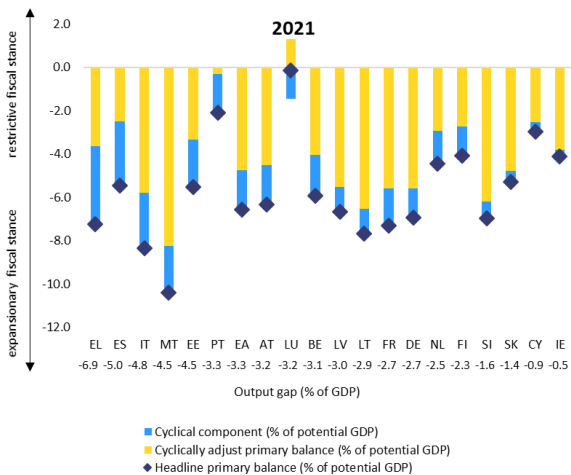
Source: European Commission.

Graph 1.22: NGEU impact on real GDP above no-policy change baseline



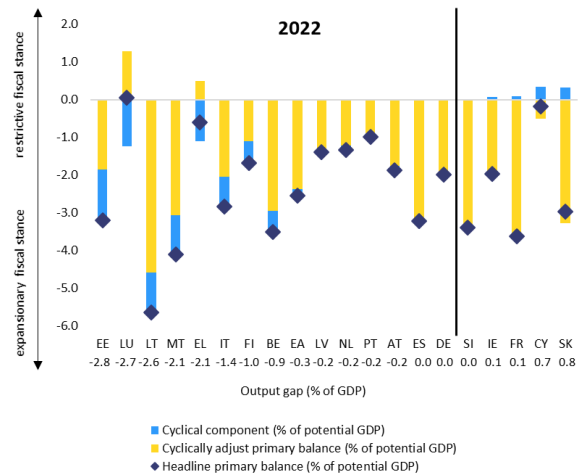
Source: European Commission (2020 autumn forecast).
Notes: (1) Based on European Commission QUEST model. (2) Six-year horizon and equal distribution of payments. The original Commission proposal foresaw a peak in payments in 2023/2024. (3) The high additionality scenario assumes 100% of grants and 50% of loans are used for productive public investment. The low additionality scenario assumes both at 50%.

Graph 1.23: Fiscal stance across euro area Member States in 2021



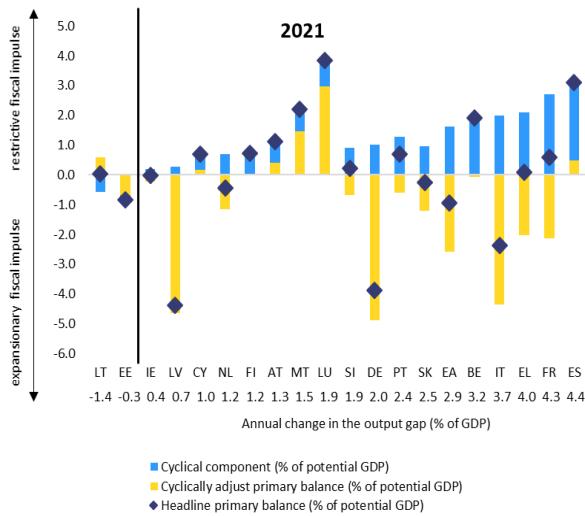
Source: European Commission.

Graph 1.24: Fiscal stance across euro area Member States in 2022



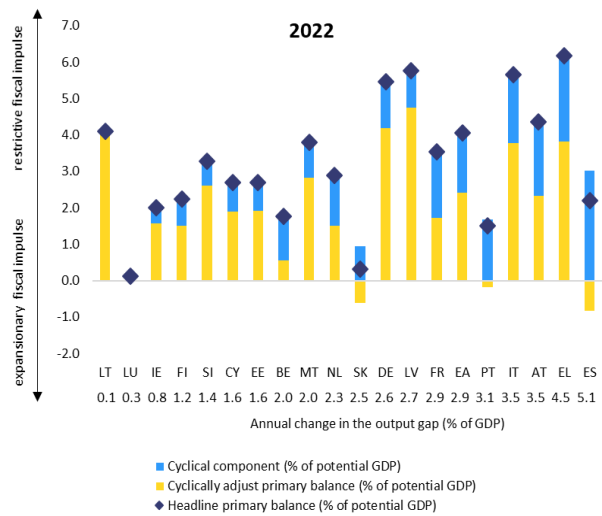
Source: European Commission.

Graph 1.23: Fiscal impulse, cyclical conditions and sustainability in euro area Member States in 2021



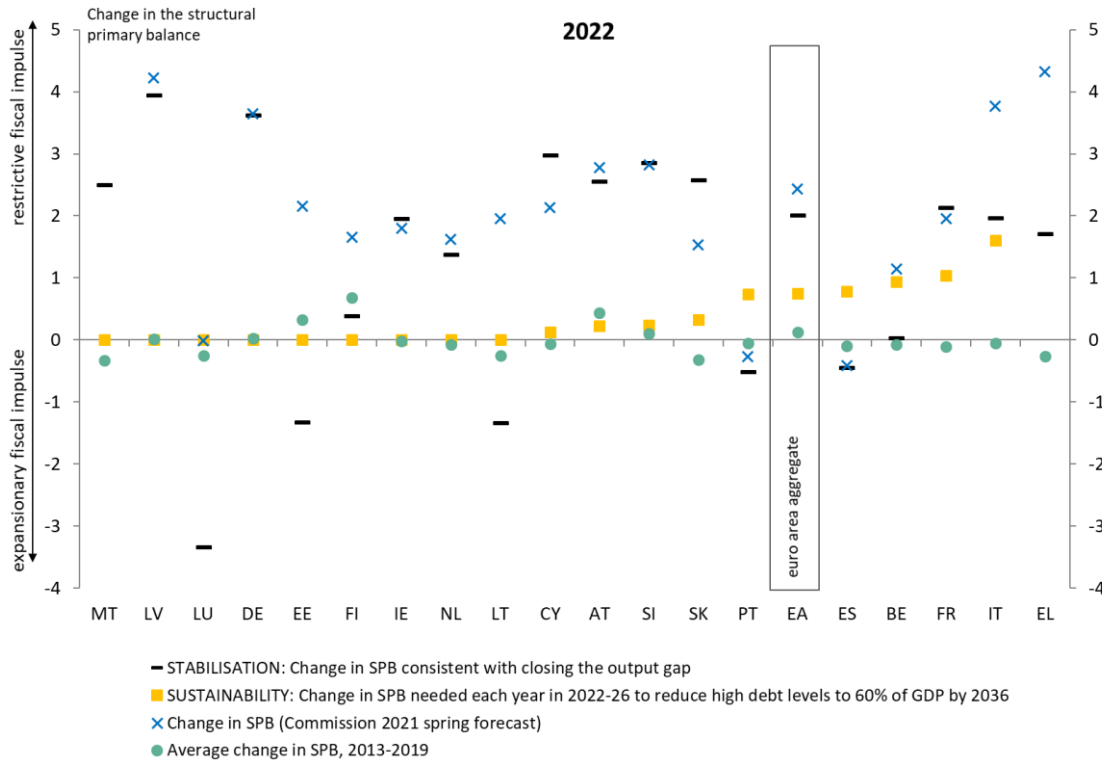
Source: European Commission.

Graph 1.24: Fiscal impulse, cyclical conditions and sustainability across euro area Member States in 2022



Source: European Commission.

Graph 1.25: Overview: Expected national and aggregate fiscal impulse, stabilisation and sustainability

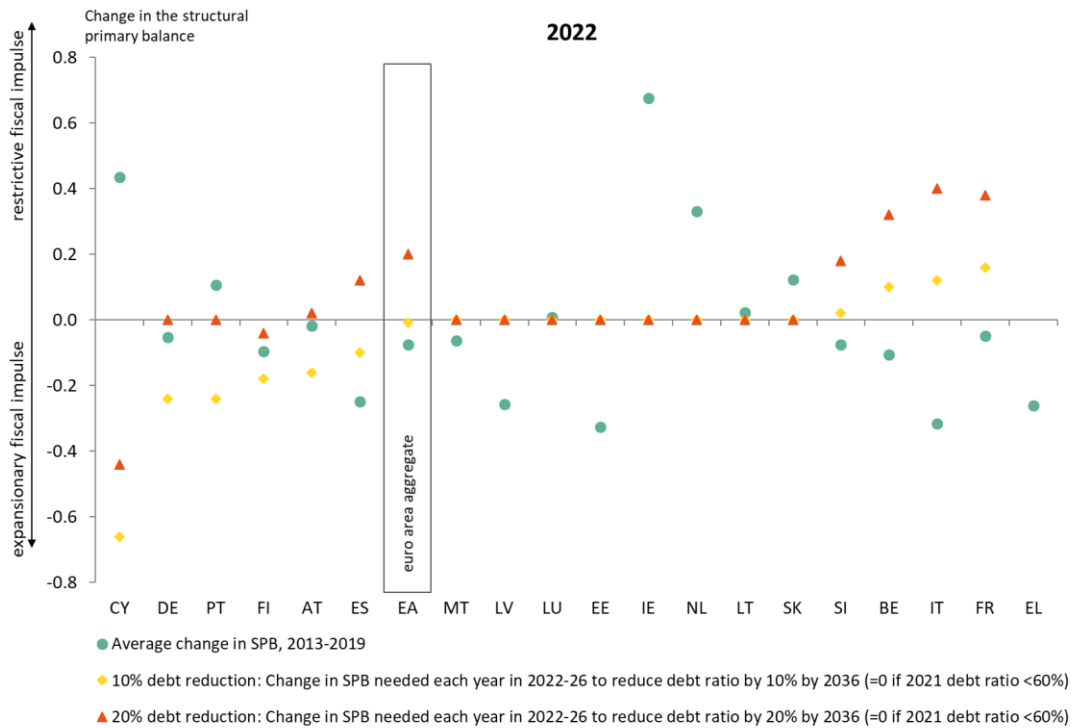


Source: European Commission, own calculations.

Notes:

- (1) Countries are ordered by increasing sustainability needs.
- (2) Stabilisation: a neutral fiscal impulse (i.e. letting automatic fiscal stabilisers operate without any additional discretionary measures) is appropriate when the output gap recently changed signs or is expected to narrow at a sufficient pace. If not, the stabilisation point shows the fiscal impulse consistent with a reduction of the output gap by 100% compared to its 2021 level, using a uniform fiscal multiplier of 0.8.
- (3) Sustainability needs are assessed using the Commission's S1 indicator. S1 measures the total cumulative adjustment needed in 2022-2026, with the last SPB being maintained for another ten years, to bring the debt-to-GDP ratio to 60% by 2036. For countries where S1 is positive, we assume that sustainability needs are addressed by implementing S1 in a uniform manner over five years, i.e. one fifth of S1 is implemented in 2022.
- (4) In countries where S1 is negative, debt is already below 60% of GDP or expected to fall below it by 2036, therefore no additional consolidation is needed.
- (5) The Commission has not published S1 for Greece in the Debt Sustainability Monitor (DSM) 2020.
- (6) The Commission's own S1 analysis has been recently amended, so that adjustment towards the necessary SPB only starts after a Member State has reached its pre-crisis forecast SPB.
- (7) The sustainability estimate for the euro area is approximated by weighing countries by debt levels (in euro).
- (8) The forecast for 2022 does not yet include the draft budgetary plans of euro area Member States.
- (9) While under the adjustment programme, Greece achieved a very high structural primary surplus but since the high surplus was already established in 2012 the figure indicates an average expansion for the depicted period.
- (10) Data for the stabilisation and sustainability indicator is based on DSM 2020 and the Commission's autumn forecast 2020.

Graph 1.26: Annual fiscal effort needed to achieve debt reduction by 2036



Source: European Commission, own calculations.

Notes:

- (1) Countries are ordered by increasing level of fiscal effort needed to achieve a 10% debt reduction.
- (2) For countries with a debt ratio below 60% of GDP in 2021, zero change in the SPB is indicated.
- (3) The change in the SPB consistent with a debt reduction of 10% or 20% is derived in a way analogous to the derivation of the European Commission's S1 indicator (see glossary). The country must conduct the SPB adjustment in the first five years (2022-2026), with the last SPB maintained for another ten years, to reduce the debt-to-GDP of 2021 by 10% or 20% by 2036. The graph shows the annual adjustment effort of the first five years (uniformly spread over five years, i.e. one fifth is implemented in 2022).
- (4) The debt reduction estimate for the euro area is approximated by weighing countries by debt levels (in euro).
- (5) While under the adjustment programme, Greece achieved a very high structural primary surplus but since the high surplus was already established in 2012, the figure indicates an average expansion for the depicted period.
- (6) Data for the debt reduction simulation is based on DSM 2020 and the Commission's autumn forecast 2020.

Key indicators for the euro area

Output		LTA ⁽¹⁾	2016	2017	2018	2019	2020	20Q1	20Q2	20Q3	20Q4	21Q1
Economic sentiment	<i>Indicator</i>	100.0	104.0	110.4	111.8	103.7	88.2	100.8	72	88.5	91.4	95.3
Gross domestic product	<i>% ch. on prev. period</i>							-3.8	-11.5	12.6	-0.6	-0.3
	<i>% ch. on prev. year</i>	1.2	1.9	2.5	1.9	1.3	-6.7	-3.3	-14.6	-4.1	-4.7	-1.3
Labour productivity	<i>% ch. on prev. period</i>							-5.7	-8.5	11.1	1.8	-2.9
	<i>% ch. on prev. year</i>	0.5	0.6	0.9	0.3	0.1	-5	-3.4	-12.2	-2.1	-2.4	0.5
Private consumption		LTA ⁽¹⁾	2016	2017	2018	2019	2020	20Q1	20Q2	20Q3	20Q4	21Q1
Consumer confidence	<i>Balance⁽²⁾</i>	-10.7	-8.1	-5.4	-4.9	-7	-14.3	-8.6	-18.5	-14.4	-15.6	-13.7
Retail confidence	<i>Balance⁽²⁾</i>	-8.6	0.6	2.3	1.3	-0.5	-12.9	-3.0	-26.4	-11.3	-10.9	-16.6
Private consumption	<i>% ch. on prev. period</i>							-4.4	-12.7	14.2	-2.9	-2.3
	<i>% ch. on prev. year</i>	1.1	2.0	1.8	1.5	1.3	-7.9	-3.9	-16.2	-4.6	-7.4	-5.4
Retail sales	<i>% ch. on prev. period</i>							-2.7	-4.7	10.2	-1.0	-1.8
	<i>% ch. on prev. year</i>	0.8	1.6	2.5	1.6	2.3	-1	-1.3	-6.5	2.5	1.5	2.1
Investment		LTA ⁽¹⁾	2016	2017	2018	2019	2020	20Q1	20Q2	20Q3	20Q4	21Q1
Capacity utilisation	<i>Level (%)</i>	80.7	81.5	82.9	83.8	82.3	74.4	80.9	68.4	72.1	76.3	77.5
Production expectations (manufacturing)	<i>Balance⁽²⁾</i>	7.1	9.8	17.0	16.5	4.4	-3	0.0	-23	7	4	11
Gross fixed capital formation (3)	<i>% ch. on prev. period</i>							-5.8	-16.1	13.7	2.5	0.2
	<i>% ch. on prev. year</i>	1.3	2.6	3.9	3.6	3.0	-8.2	0.8	-20.9	-4.7	-7.9	-2.0
- equipment investment	<i>% ch. on prev. period</i>							-9.6	-18.7	26	1.5	1.2
	<i>% ch. on prev. year</i>	2.4	5.8	4.1	3.8	2.2	-13	-10.5	-27.3	-8.2	-5.9	5.3
- construction investment	<i>% ch. on prev. period</i>							-2.4	-12.4	13.2	1.7	0.9
	<i>% ch. on prev. year</i>	0.3	2.7	3.6	3.8	3.4	-5.7	-2.5	-14.5	-4	-1.6	1.7
Change in stocks	<i>Contrib. to GDP (pp)</i>	0.0	0.0	0.2	0.1	-0.5	-0.1	0.5	-0.1	-1.4	0.4	0.7
Labour market		LTA ⁽¹⁾	2016	2017	2018	2019	2020	20Q1	20Q2	20Q3	20Q4	21Q1
Employment expectations (manufacturing)	<i>Balance⁽²⁾</i>	-7.0	0.0	7.7	9.4	-1.4	-14	-8	-24	-14	-10	-5
Employment expectations (services)	<i>Balance⁽²⁾</i>	5.7	8.5	11.1	13.0	9.4	-6.1	5.4	-19.5	-3.5	-6.7	-3.8
Employment	<i>% ch. on prev. period</i>							-0.2	-3.0	1.0	0.4	-0.3
	<i>% ch. on prev. year</i>	0.8	1.3	1.6	1.6	1.2	-7	0.4	-2.9	-2.1	-1.8	-1.9
Employment (000)	<i>ch. on prev. period</i>		2003	2450	2423	1909	-2925	-328	-4752	1529	626	-437
Compensation of employees (per head, nominal)	<i>% ch. on prev. period</i>							-0.6	-4.9	6.2	0.3	
	<i>% ch. on prev. year</i>	1.9	1.3	1.7	2.2	1.9	-0.6	0.8	-4.6	0.6	0.7	
Unemployment rate	<i>% of lab. force</i>		10.0	9.0	8.1	7.5	7.8	7.4	7.5	7.3	8.4	8.0
Unemployment (000)	<i>ch. on prev. period</i>		-1139	-1587	-1385	-951	369	151	-632	2086	-679	1342
International transactions		LTA ⁽¹⁾	2016	2017	2018	2019	2020	20Q1	20Q2	20Q3	20Q4	21Q1
World trade	<i>% ch. on prev. period</i>							-2.7	-11.3	11.8	3.9	3.5
	<i>% ch. on prev. year</i>		1.4	4.9	3.5	-0.4	-5.4	-3.4	-14.1	-4.2	0.2	6.7
Export order books	<i>Balance⁽²⁾</i>	-18.3	-10.9	-1.4	1.2	-13.4	-34	-19	-47	-41	-29	-21
Trade balance (merchandise)	<i>Billion EUR</i>		263.7	236.3	191.4	223.2	235.2	71.5	25.5	62	76.2	64.1
Exports of goods and services	<i>% ch. on prev. period</i>							-3.9	-18.6	16.8	3.8	1.0
	<i>% ch. on prev. year</i>	4.3	2.9	5.5	3.6	2.5	-9.6	-3.2	-21.4	-8.7	-5.1	-0.3
Imports of goods and services (3)	<i>% ch. on prev. period</i>							-2.6	-18.5	11.9	4.5	0.9
	<i>% ch. on prev. year</i>	0.3	3.3	5.2	3.7	2.0	-9.1	0.6	-20.6	-9.1	-7.1	-3.8
Prices		LTA ⁽¹⁾	2016	2017	2018	2019	2020	20Q1	20Q2	20Q3	20Q4	21Q1
Headline inflation (HICP)	<i>% ch. on prev. year</i>		0.2	1.5	1.8	1.2	0.3	1.1	0.2	0.0	-0.3	1.0
Core inflation	<i>% ch. on prev. year</i>		0.8	1.1	1.2	1.2	0.9	1.3	1.1	0.7	0.4	1.2
Monetary and financial indicators		LTA ⁽¹⁾	2016	2017	2018	2019	2020	20Q1	20Q2	20Q3	20Q4	21Q1
Nominal interest rates (3-month)	<i>Level</i>		-0.26	-0.33	-0.32	-0.36	-0.38	-0.41	-0.30	-0.47	-0.52	-0.54
Nominal interest rates (10-year)	<i>Level</i>		0.18	0.32	0.47	-0.21	-0.48	-0.41	-0.45	-0.48	-0.58	-0.41
ECB repo rate	<i>Level</i>		0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Bilateral exchange rate USD/EUR	<i>Level</i>		1.11	1.12	1.18	1.12	1.14	1.10	1.10	1.17	1.19	1.20
	<i>% ch. on prev. period</i>							-0.5	-0.1	6.1	2.0	1.0
	<i>% ch. on prev. year</i>		1.6	5.1	4.6	-5.1	1.8	-3.0	-2.0	5.1	7.7	9.3
Nominal effective exchange rate	<i>% ch. on prev. period</i>							-0.2	1.4	2.5	0.1	
	<i>% ch. on prev. year</i>		2.9	2.4	2.5	-1.8	1.5	-1.0	0.6	2.8	3.8	

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

Notes: Data in the table have been taken from different sources available until 8 June 2021 and at different moments in time. (1) LTA = Long-term average (since 1990 or earlier if available). (2) Balance: the difference between positive and negative answers, in percentage points of total answers. (3) Data on gross fixed capital formation and on imports of goods and services do not include Ireland.

Box 1: Assessing the fiscal stance and fiscal impulse

The fiscal stance for the euro area as a whole has become an important concept within the EU fiscal framework. However, how to measure the fiscal stance and what terminology to apply can pose communication challenges. In the Five Presidents' report and subsequent publications ⁽¹²⁾, the Commission has at times interpreted the euro area fiscal stance as the change in the structural primary balance relative to the previous year ⁽¹³⁾. Depending on the sign of the change in the structural primary balance, it is referred to as expansionary, contractionary or neutral. The intention is to assess whether the orientation of discretionary fiscal policies is appropriate in view of the cyclical conditions of the economy, which the Commission usually approximates with the level of the output gap (as percent of potential GDP) or the change in the output gap ⁽¹⁴⁾. The ECB followed a similar approach ⁽¹⁵⁾.

The IMF has adopted different terminology ⁽¹⁶⁾. It defines the (discretionary) fiscal stance as the headline (structural primary) deficit relative to potential GDP in a given year. The annual change in the headline (structural primary) budget is instead referred to as the (discretionary) fiscal impulse. The term fiscal impulse has at times also been used by the Commission and ECB but interchangeably with fiscal stance ⁽¹⁷⁾.

In this report, the EFB defines the discretionary fiscal stance as the structural primary budget balance as a percent of potential GDP and the discretionary fiscal impulse as the year-on-year change of the same balance. It is important to separate the two perspectives of fiscal stance and fiscal impulse. The approach followed by central banks in describing monetary policy can be considered best practice. In particular, a contractionary measure such as an increase in the main refinancing rate can still be consistent with an accommodative or very accommodative monetary policy depending on the starting point.

The right terminology is of particular importance in 2021 and 2022. The years 2020 and 2021 have seen an extraordinary fiscal stimulus, also thanks to automatic stabilisers, with government expenditure rising to EUR 6.1 trillion (see Graph 1.21), up by close to 9% of euro area GDP. The structural budget balance rose from being broadly balanced in 2019 to a deficit of close to 5% of GDP (see Graph 1.15). A neutral or negative fiscal impulse in 2022 would still constitute a supportive fiscal stance given the extraordinarily high level of fiscal support put in place the previous year. Expenditure is expected to remain far higher than in the pre-crisis years against the backdrop of a strong economic recovery.

⁽¹²⁾ See e.g. [European Commission \(2016\) communication Towards a Positive Fiscal Stance for the Euro Area](#) and [European Commission \(2019\) communication on the 2020 Draft Budgetary Plans: Overall Assessment](#)

⁽¹³⁾ The SPB is a metric of the discretionary fiscal measures, which also exclude interest expenditures. For the euro area the SPB is derived by aggregating national fiscal stances.

⁽¹⁴⁾ The balance is often assessed by the S1 indicator for sustainability and a closing of the output gap by 25% of 50% during the relevant year. Both indicators are expressed as changes.

⁽¹⁵⁾ [ECB \(2017\) report on Euro area fiscal stance](#).

⁽¹⁶⁾ See for example, the [IMF \(1991\) report on Fiscal Impulse](#).

⁽¹⁷⁾ See [European Commission \(2016\) report on Public Finances in EMU 2016](#) (footnote 136) and [ECB \(2016\) Economic Bulletin on The euro area fiscal stance](#).

Box 2: The Recovery and Resilience Facility (RRF) and fiscal statistics

The RRF is a significant EU initiative that allows EU Member States with limited or no fiscal space to address the impact of the Covid-19 pandemic. This box highlights a number of implications of the RRF for conventional fiscal statistics, notably general government gross debt in national accounts and in measuring the fiscal impulse.

National accounts

Before adoption of the RRF, national accounts data provided a complete picture of government transactions, assets and liabilities in the EU. First, expenditure from and revenues to the EU budget had a direct correspondence in national budgets in the same fiscal year. Second, loans by the Commission or by the European Stability Mechanism (ESM) to Member States for financial assistance purposes was comparatively limited and are recorded as debt for the receiving countries.

Implementation of the RRF will change this. Under the RRF, the EU undertook to issue debt of close EUR 672.5 billion, of which EUR 360 billion is earmarked for loans and EUR 312.5 billion for grants. When passed on to Member States in the form of loans, these funds will continue to show up in national accounts as an equivalent increase in the gross government debt of that country. When spent, they will also increase the deficit. By contrast, when passed on in the form of grants, they will only start weighing on national public finances when the governments start increasing contributions to the EU budget to repay their share of loans raised at the EU level⁽¹⁸⁾. At the same time, under current arrangements, there is no dedicated sector in the ESA showing the deficit accrued or the debt accumulated at EU level. As a result, the national accounts of EU Member States will no longer depict the full extent of government deficit and debt. The budget deficit of the EU in national account terms and the ensuing debt incurred at EU level to finance grants to Member States will not be identifiable. This can be an issue, as EU citizens and financial markets should have a complete picture of how much debt governments have accumulated and will eventually have to service via taxes or other government revenues.

In theory, statisticians would be perfectly able to produce a full set of accounts for the EU government sector. However, there is no statistical office in charge of compiling such accounts. Eurostat is tasked to verify data submitted by national statistical offices; it does not produce national accounts of the EU. National statistical offices record transactions with the EU in a residual and not-further-detailed sector called ‘rest of the world’. Consequently, aggregating national debt and deficits of all Member States will no longer reflect total government debt and deficits in the EU.

As part of its accountability initiative, the European Commission publishes annually the Consolidated Annual Accounts of the European Union for the preceding year⁽¹⁹⁾. These accounts include a detailed overview of the EU’s finances as well as implementation of the EU budget. They are based on accrual-based accounting rules in line with the International Public Sector Accounting Standards (IPSAS). The EU consolidated annual accounts include a complete record of assets and liabilities, with the latter encompassing debt issued by the EU for various programmes such as balance of payment assistance to non-euro area Member States or neighbouring countries, financial assistance to euro area Member States or the recent SURE initiative. The difference between total liabilities and total assets is called *amounts to be called from Member States*, i.e. future claims on national governments to finance any excess of expenditure over revenue. Over the coming years, these claims will increase significantly on the back of debt-financed RRF grants. The assets and liabilities of entities not included in the scope of consolidation, such as the ESM, are not included in the EU consolidated annual accounts.

Some observers argue that, for analytical purposes, all EU debt should be viewed as government debt of receiving Member States, regardless of whether it is in the form of loans or grants⁽²⁰⁾. The argument is underpinned by the view that EU debt is issued on behalf of Member States backed by several, as opposed to joint commitments, to repay it with future contributions to the EU budget in line with their respective GNI shares⁽²¹⁾. Short of reclassifying EU debt, an upgrade of ESA implementation to show detailed accounts for the EU, including a budget balance and gross debt, would improve transparency.

⁽¹⁸⁾ If allocated to Member State accounts, and using 2021 GDP as a reference, the gross debt to GDP ratio of, e.g. Greece would be close to 10 percentage points higher, 6 ½ percentage points in Portugal, close to 6 percentage points in Spain, 4 percentage points in Italy, around 1 ½ percentage points in France.

⁽¹⁹⁾ [Consolidated Annual Accounts of the European Union](#).

⁽²⁰⁾ [Bundesbank \(2020\) Monthly Bulletin on the informative value of national fiscal indicators in respect of debt at the European level](#).

⁽²¹⁾ Article 125 TFEU states that the EU cannot be liable for or assume the commitments of governments.

Fiscal impulse

Apart from having an impact on national accounts, implementing the RRF will also affect the way we interpret the fiscal impulse of Member States. The assessment of the fiscal impulse looks at the observed change in the budget balance: a deterioration is interpreted as offering support to aggregate demand, a decline is seen as a restrictive move. To gauge the contribution of discretionary policy decisions, as opposed to the effect of automatic stabilisers, analysts look at the change in the structural primary budget balance.

However, with grants from the EU issued to national budgets financed by debt raised at EU level, the conventional approach no longer works. If used to increase spending, EU grants will stimulate Member State economies, but the balance of both the headline and the structural budget will a priori remain unchanged. In a similar vein, when the EU grants funded by EU debt expire, a possible deterioration in the budget balance will not imply an expansion if the government decides not to immediately cut spending accordingly. By contrast, if the government decided to immediately adjust spending, an unchanged budget balance would misleadingly signal a neutral fiscal impulse. The underlying issue is that national budget balances capture the impulse generated at national level; the contribution generated by the EU is to be accounted for separately.

Illustration of how the RRF impacts national and EU debt levels

New debt raised at EU level in year t ΔD_t^{EU} can be passed on as loans l or grants g . α_i and β_i are the shares of country i of new EU debt passed on as loans and grants respectively:

$$\Delta D_t^{EU} = \sum_i (\alpha_i \Delta D_t^{EU,l} + \beta_i \Delta D_t^{EU,g}) = \Delta D_t^{EU,l} + \Delta D_t^{EU,g}$$

The change in government debt in year t of country i , $\Delta D_{i,t}$, is composed of new debt raised by the national government itself, $\Delta D_{i,t}^N$, and the share of new debt raised at EU level and passed on as loan, $\alpha_i \Delta D_t^{EU,l}$:

$$\Delta D_{i,t} = \Delta D_{i,t}^N + \alpha_i \Delta D_t^{EU,l} = r_{i,t} D_{i,t-1} + E_{i,t}^N + E_{i,t}^{EU} - R_{i,t}^N - R_{i,t}^{EU}$$

In turn, the total change of government debt of country i in year t is equal to interest payments on the existing stock of debt $r_{i,t} D_{i,t-1}$ and the primary budget balance, the difference between primary expenditure and revenues, which may include expenditure financed by grants from the EU, $E_{i,t}^{EU}$. Under current practice, government expenditure in country i in year t backed by EU grants are recorded as budget neutral:

$$E_{i,t}^{EU} = R_{i,t}^{EU} = \beta_i \Delta D_t^{EU,g}$$

By contrast, the same government spending increases national debt and the deficit if financed by EU loans.

If $\Delta D_t^{EU,g} = 0$, i.e. if new EU debt is passed on exclusively in the form of loans, then $\sum_i \Delta D_{i,t} = \sum_i \Delta D_{i,t}^N + \Delta D_t^{EU,l}$: the aggregate increase in government debt across all countries equals total new government debt in the EU.

If $\Delta D_t^{EU,g} \neq 0$, i.e. if new EU debt is also passed on in the form of grants, then $\sum_i \Delta D_{i,t} = \sum_i (\Delta D_{i,t}^N + \Delta D_t^{EU,l}) < \sum_i (\Delta D_{i,t}^N + \Delta D_t^{EU,l} + \Delta D_t^{EU,g})$: The aggregate increase in government debt across all EU countries is smaller than total new government debt in the EU, because the portion passed on as grants $\Delta D_t^{EU,g}$ only counts debt of the EU. Under current practice, the latter part is not visible in the system of national accounts.

GLOSSARY

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

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

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

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

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

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

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

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

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

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

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

Output gap: the difference between actual output and estimated potential output at a particular point in time. A business cycle typically includes a period of positive output gaps and a period of negative output gaps. When the output gap is closed, the economy is in line with its potential level (see ‘potential GDP’). Observations indicate that a standard business cycle usually lasts up to 8 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 ‘output gap’).

S1 indicator: medium-term sustainability indicator published by the European Commission. It indicates the additional adjustment, in terms of change in the

structural primary balance, required over five years to bring the general government debt-to-GDP ratio to 60% in 15 years' time, including financing for any future additional expenditure arising from an ageing population.

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

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

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

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

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

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

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