››› Fiscal policy in the euro area – greater focus on the economic cycle and closer coordination between member states

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Author: Dr Philipp Ehmer, phone +49 69 7431-6197, research@kfw.de

Fiscal policy leeway in the euro area was severely constrained during the debt crisis. Some countries had to pay high interest premiums on refinanced debt and were forced to consolidate their budgets. Therefore, euro area fiscal policy had a pro-cyclical effect during the debt crisis, putting pressure on already flagging economies.

Only in 2015 did fiscal policy again deliver a slight expansionary stimulus. The conditions for fiscal stimuli are currently favourable: Debt levels have largely stabilised, the ECB's low interest rate policy creates favourable conditions for borrowers and growth is cautiously returning. However, expansionary measures must be used in moderation and in the right places. There is neither the need nor the necessary leeway for extensive stimulus packages.

National fiscal policy measures generate effects travelling across national borders, particularly in a common currency area such as the euro area. However, these measures are only decided in the member countries themselves. The result is a wide divergence in the fiscal policy stance of the different economies. Harmonisation of national plans would increase the punch of European fiscal policy.

How expansionary is fiscal policy in the euro area?

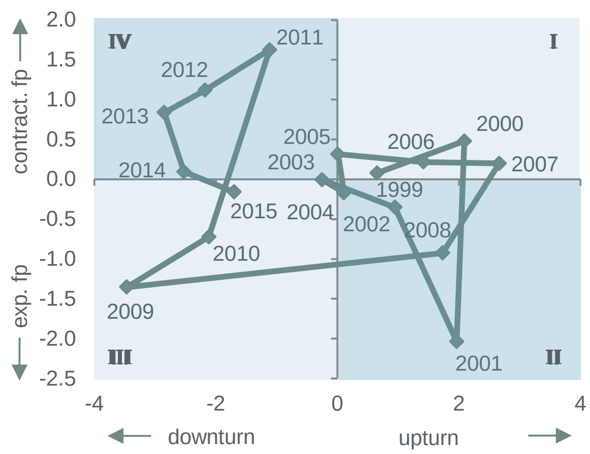
Calls for an expansionary fiscal policy in the euro area are growing louder. Mario Draghi has repeatedly stressed that fiscal policy should now follow expansionary monetary policy to support the recovery. Others agree with the tenor of his arguments. Are these calls justified? How expansionary is fiscal policy in the euro area, if at all?

One way of judging this is to take a country's budget balance and adjust it for cyclical influences and interest payments. Figure 1 traces the euro area's "fiscal stance" – in other words, the impact of its fiscal policy on its economy – since the start of monetary union. It shows years of fiscal consolidation in quadrants I and IV (positive change in adjusted budget balance) and expansionary fiscal policy in quadrants II and III. The fiscal stance is compared with the economic situation as measured by the "output gap" – the extent to which actual economic growth deviates from potential growth.

Quadrants I and III identify years of countercyclical fiscal policy. In these cases, an economic upturn coincided with fiscal consolidation (quadrant I), and a downturn with fiscal expansion (quadrant III). A countercyclical fiscal policy is desirable in order to stabilise the economy in times of crisis, and to use tax revenues to limit debt levels during boom phases.

Comparing the two indicators, it appears that fiscal policy helped stabilise the economy in the financial crisis of 2008/2009. In the debt crisis after 2010, however, the tables were turned. Although the economic situation remained poor and deteriorated further still from 2012 onwards, countries reduced their spending or increased their revenue base – adjusted for cyclical influences and interest payments. Hence, they followed a pro-cyclical fiscal policy and increased the burden on the private sector.

Figure 1: Pro-cyclical fiscal policy during the debt crisis



X-axis: euro area output gap, percent of potential GDP
Y-axis: change in euro area's cyclically adjusted primary balance, percentage points year on year

Sources: AMECO, own calculations

Last year, fiscal policy was slightly expansionary for the first time since 2010. In 2016 last year's trend is likely to be continued, based on the EU Commission's forecasts, so that fiscal policy will remain countercyclical.

Additional stimuli possible in the current environment

It is too soon, though, to draw conclusions merely from the fiscal stance as to the quality of fiscal policy. After all, managing the business cycle is not the primary purpose of fiscal policy – it performs a whole range of tasks, such as providing public goods, social equality etc. Furthermore, investors who lend money to governments in the euro area continuously question the solvency of their debtors. During the debt crisis, high and massively increased public debt drove up the risk premiums that countries such as Portugal or Italy had to pay on the bonds they issued. Temporarily, some economies even lost their access to the capital markets altogether. Therefore, during the crisis austerity was forced on some governments by the doubtful debt sustainability of their public finances.

However, times have changed since then. First, debt levels have now stabilised in most countries. Second, the ECB is keeping interest rates at a record low and, with its monetary policy, has created a very favourable environment for borrowers. Third, the economic recovery in the euro area is slowly getting underway – governments can again afford more vigorous fiscal stimuli. At the same time, the recovery has not yet reached the stage of a self-sustaining upswing and remains dependent on a supportive fiscal policy.

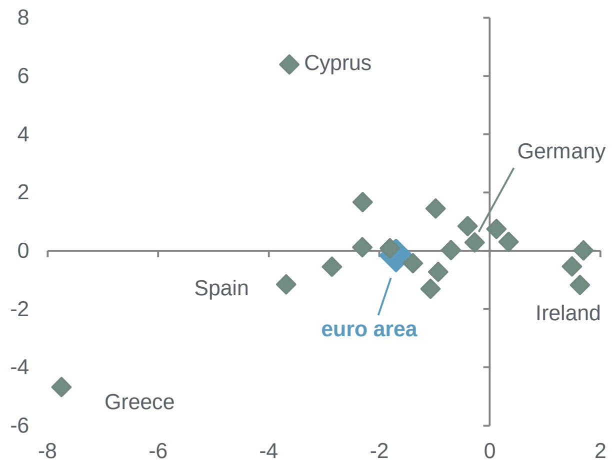
Importance of a common fiscal stance in the euro area

Looking beyond what nations require from fiscal policy, it is important for the euro area as a whole to have a common fiscal stance. Figure 2 shows the divergences in fiscal stance between member states. While Cyprus and Spain, for example, were at a similar stage of the cycle as measured by the output gap in 2015, Cyprus pursued a vigorous consolidation policy while Spain's fiscal policy had an expansionary impact. In other years, the divergences between euro area countries have been even greater.

Fiscal policy is a national matter, but in common currency areas its effects travel across national borders. For example, fiscal policy measures in one country can have a moderate impact on other countries' economies due to trade links. Similarly, the financing environment changes for other countries too when one government borrows substantial funds on the capital market for a stimulus programme, for instance. Furthermore, demand for goods in one country affects the inflation rate in the common currency area.

When deciding national fiscal policy, an external effect comes into play: Governments usually only consider the effect of a measure on their own economy when taking fiscal policy decisions. Wider effects are neglected. As a result, fiscal policy in the euro area becomes less efficient. After all, the effect of a stimulus package in one country will be diminished if, at the same time, other countries are cutting their spending.

Figure 2: Large differences in fiscal stance



X-axis: output gap in 2015, percent of potential GDP
Y-axis: change in cyclically adjusted primary balance in 2015, percentage points year on year

Sources: AMECO, own calculations

Not all countries are free from restrictions and able to manage their fiscal policy so that it is countercyclical at any given time. Due to spill-over effects in the euro area, it makes sense for less restricted economies to counter this and ensure that the fiscal stance remains generally countercyclical. This means that individual countries should both use their leeway to make additional investments when the euro area's economy needs to be stabilised, as well as adopt contractionary fiscal policies in boom periods. Greater coordination of European fiscal policy is therefore desirable.

Against this background, the forthcoming establishment of the European Fiscal Board and the recent adjustment of the European Semester are to be welcomed. Since the end of last year, the phase in which the Commission makes country-specific recommendations and member states draw up their budget plans is preceded by a phase in which the Commission sets targets for the euro area as a whole. At this point in time, there should be even more focus on harmonising fiscal stimuli and adopting a common fiscal stance for the euro area.[1] This would increase the punch of European fiscal policy. ■

[1] See: Ministère des Finances et des Comptes Publics and Ministère de l'Économie de l'Industrie et du Numérique (2016), Towards a better management of the fiscal stance in the euro area?, Direction Générale du Trésor, Trésor-Economics No. 163.