

European Fiscal Board

Implementation of the EU fiscal governance framework:

Assessment of the fiscal stance appropriate for the euro area

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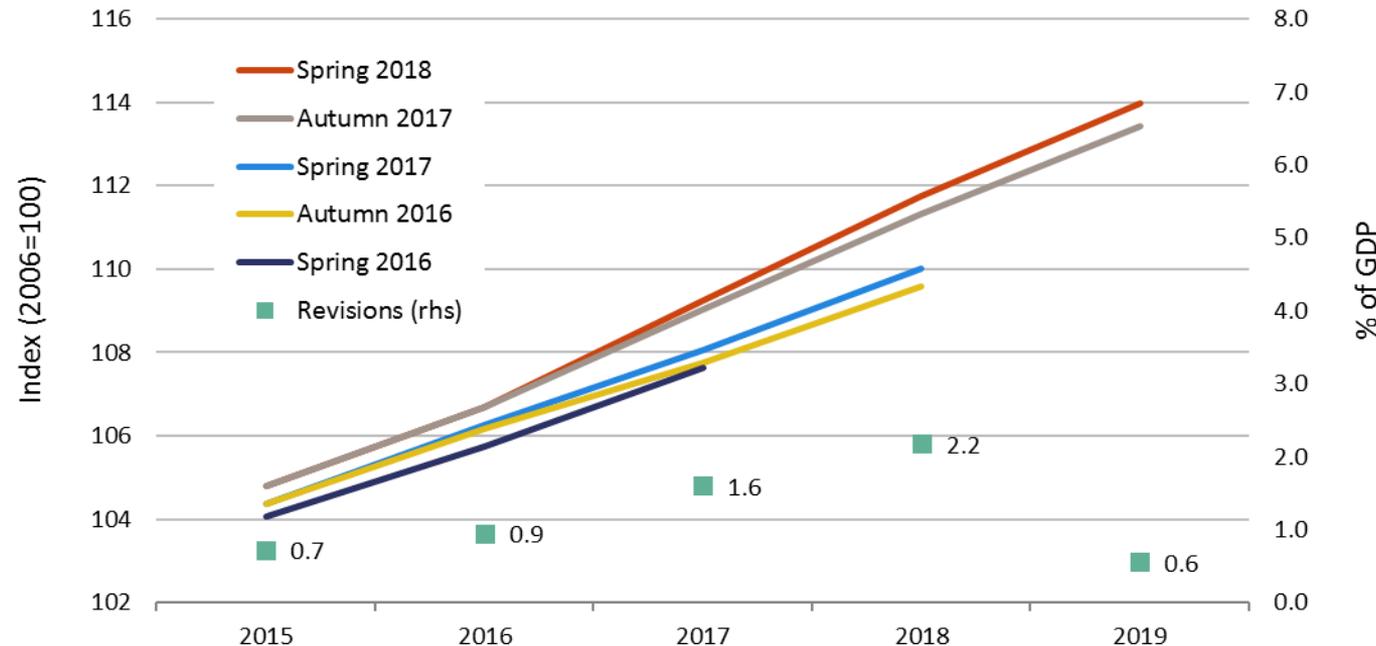
Main messages

- Euro area is enjoying a broad-based economic expansion. Current economic conditions offer a prime opportunity to create fiscal buffers.
- Need to avoid past mistakes when good times were wasted. If opportunity is missed, euro area will be more vulnerable when next shock hits.
- No radical shift of fiscal stance, but move from neutral to restrictive fiscal stance is appropriate. Especially high-debt countries need to improve their structural positions.
- Implementation of SGP would yield appropriate fiscal stance in 2019.
- In parallel, EU fiscal framework needs to be strengthened: An effective stabilisation function to be combined with simpler and stronger fiscal rules.

Euro area enjoying a broad-based economic expansion

Euro area real GDP has expanded faster than expected

(real GDP across COM forecast vintages)



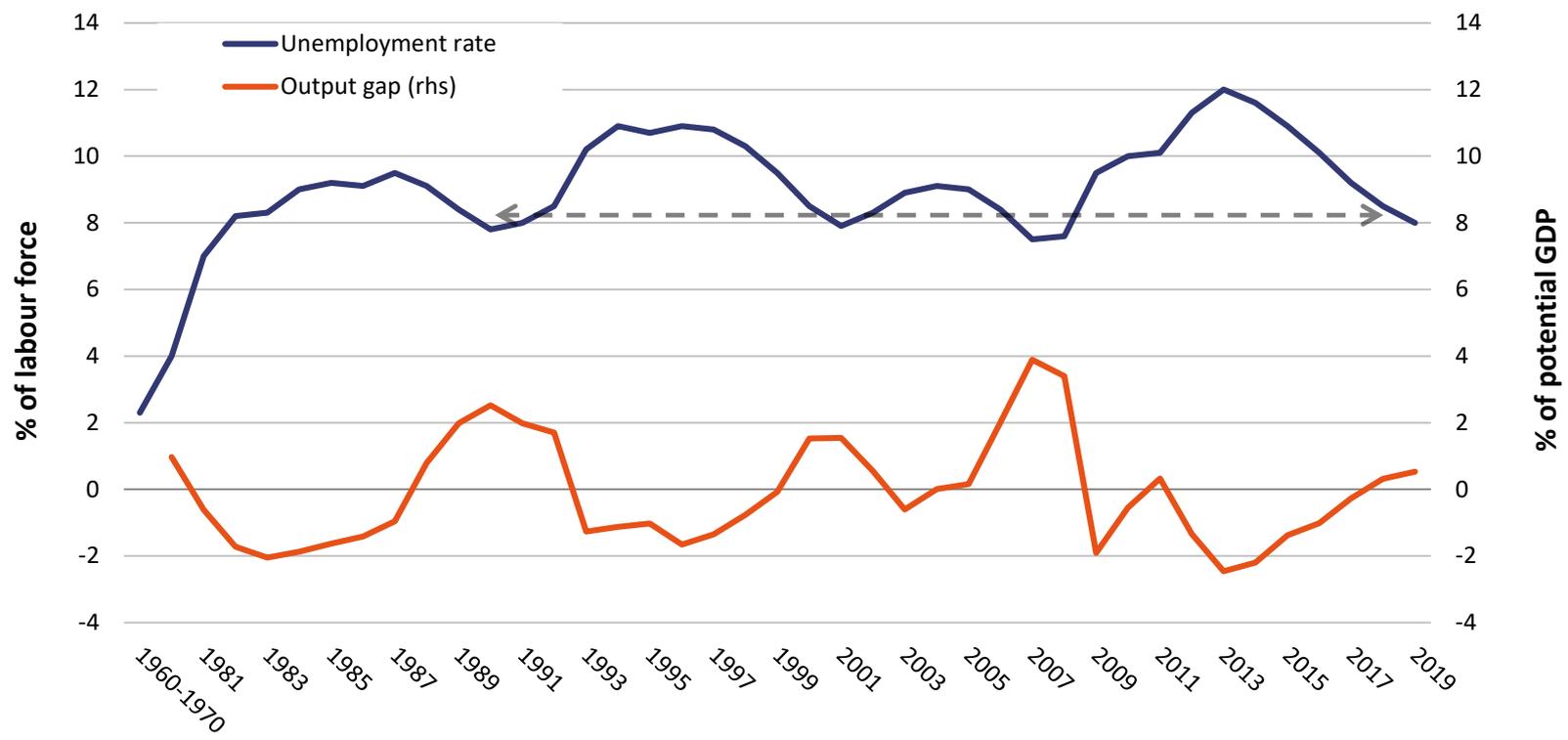
Source: European Commission

The ongoing recovery is broad-based and surprised on the upside. In spring 2018, euro area GDP (at constant prices) in 2018 was expected to be more than 2% higher than it was at the end of 2016. The outlook for 2019 was revised up too. Despite some softening in the first half of 2018, the growth outlook for 2019 remains comparatively strong.

Euro area enjoying a broad-based economic expansion

Unemployment is back to levels observed during previous booms

(EA-12 unemployment and output gap)



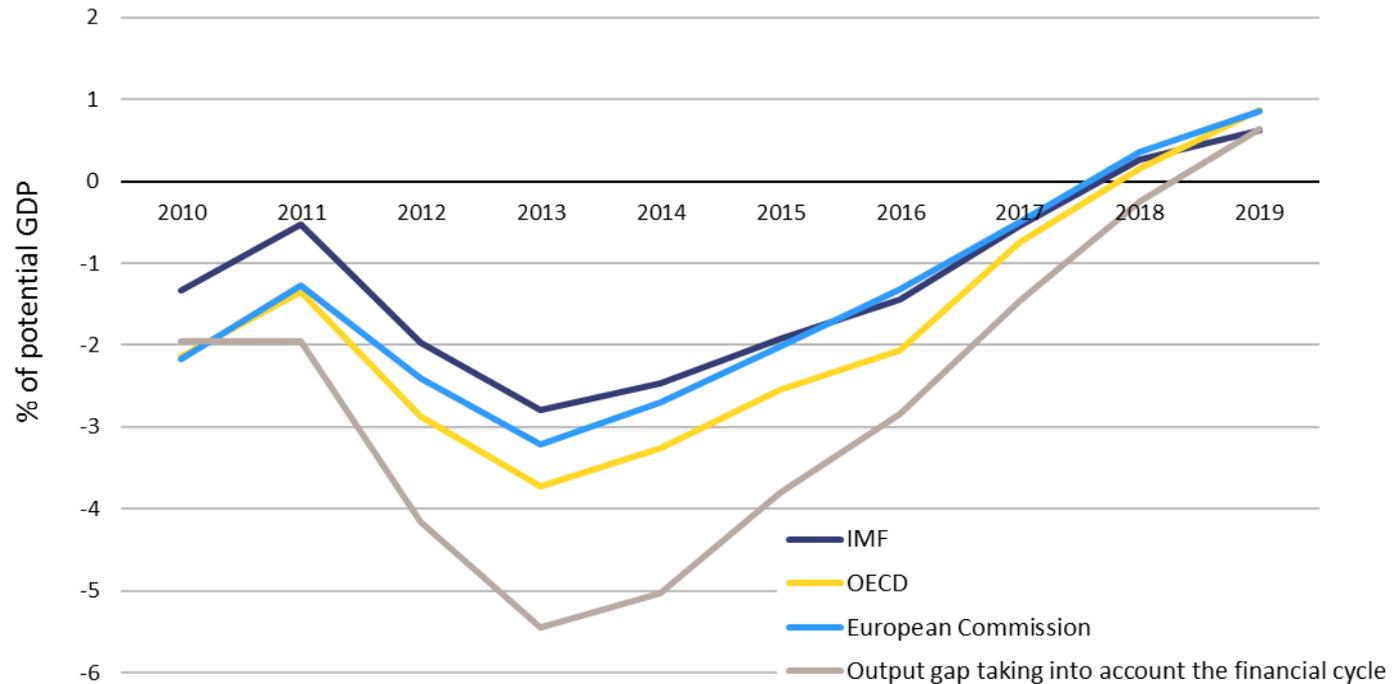
Source: European Commission

Also thanks to past labour market reforms, the recovery has been job-rich; the rate of unemployment has declined considerably. Broader definitions of unemployment are higher but have also dropped and are close to levels recorded before 2007.

The euro area is in good times

Aggregate output is climbing above potential

(output gap of the euro area)

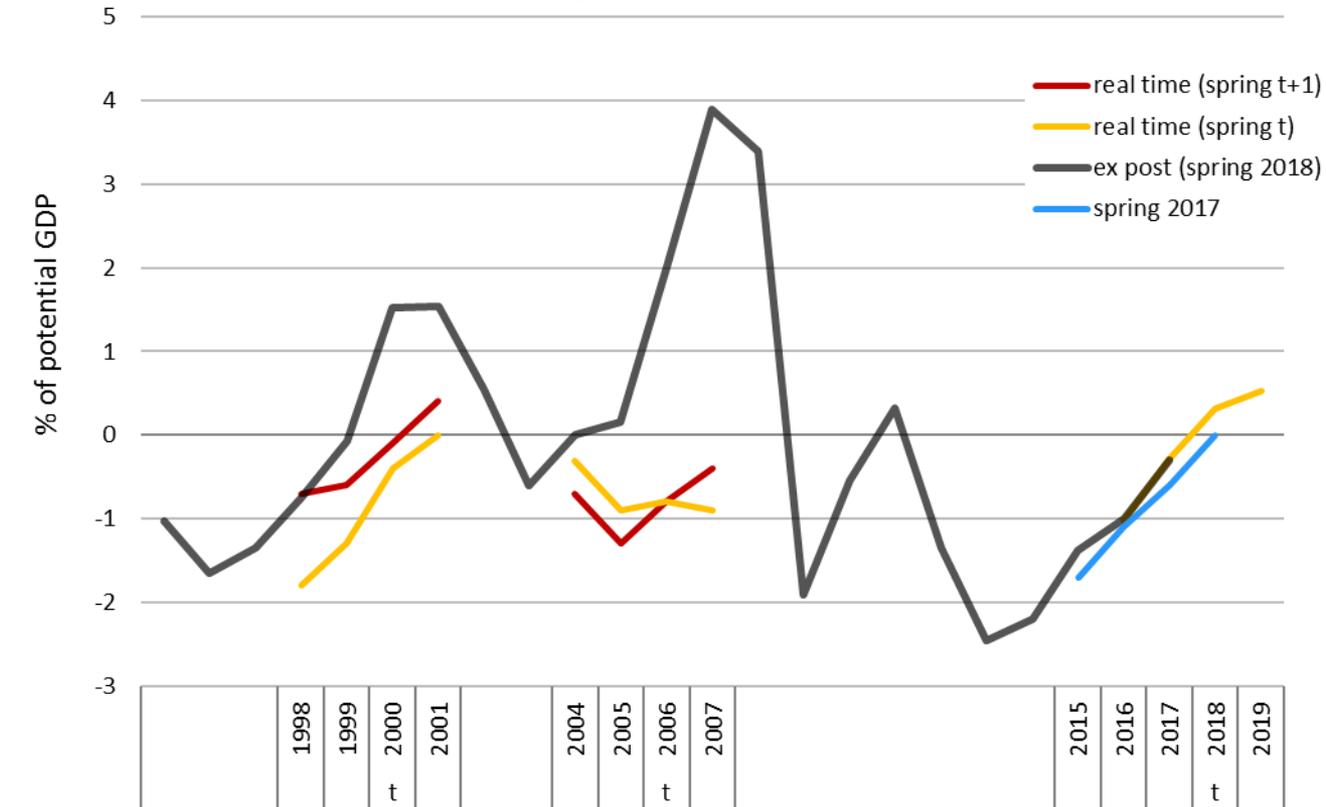


Estimates of the degree of economic slack in the euro area economy support a consistent story: the output gap has been narrowing and is expected to turn positive in the course of 2018-2019.

The euro area is in good times

Good times are underestimated when they occur

(euro area output gaps in past booms: real time vs. ex post)

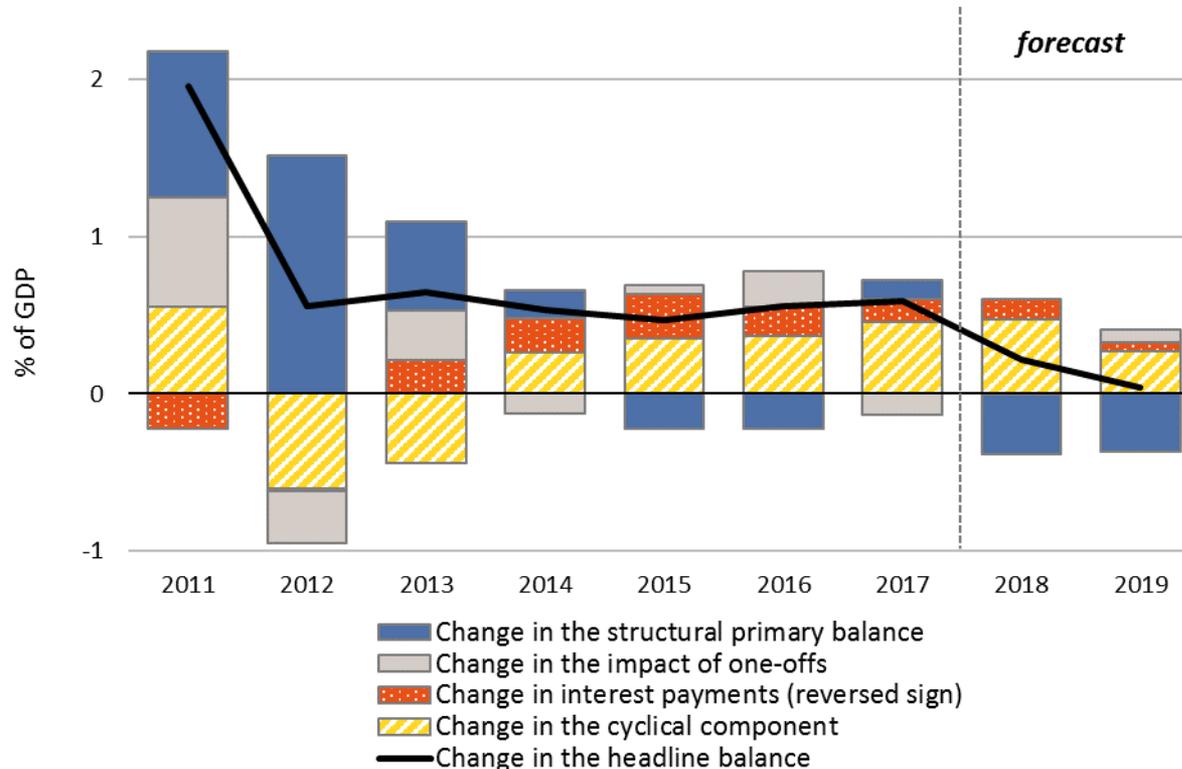


Source: European Commission

Real-time output gap estimates are uncertain, but revisions are not random. There is a clear tendency to underrate good times when they happen. We need to learn from mistakes of the past.

Are good times again being wasted?

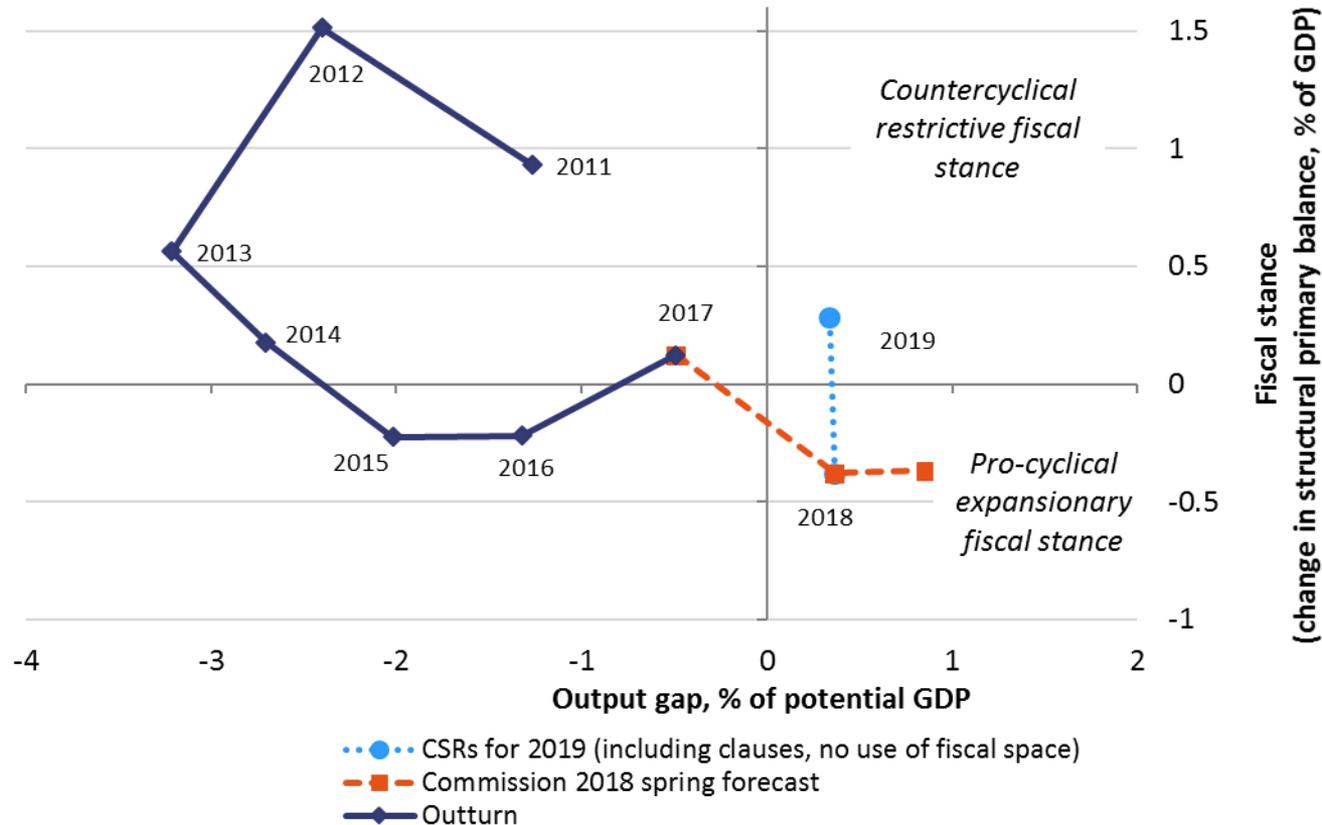
Discretionary fiscal measures are deteriorating the fiscal position (drivers of the change in the nominal budget balance)



Projections for 2018 point to an expansionary fiscal stance (we advised a neutral fiscal stance). Unless new measures are taken, in 2019 the budgetary benefits of the expansion will be entirely spent.

A somewhat restrictive fiscal stance appropriate in 2019

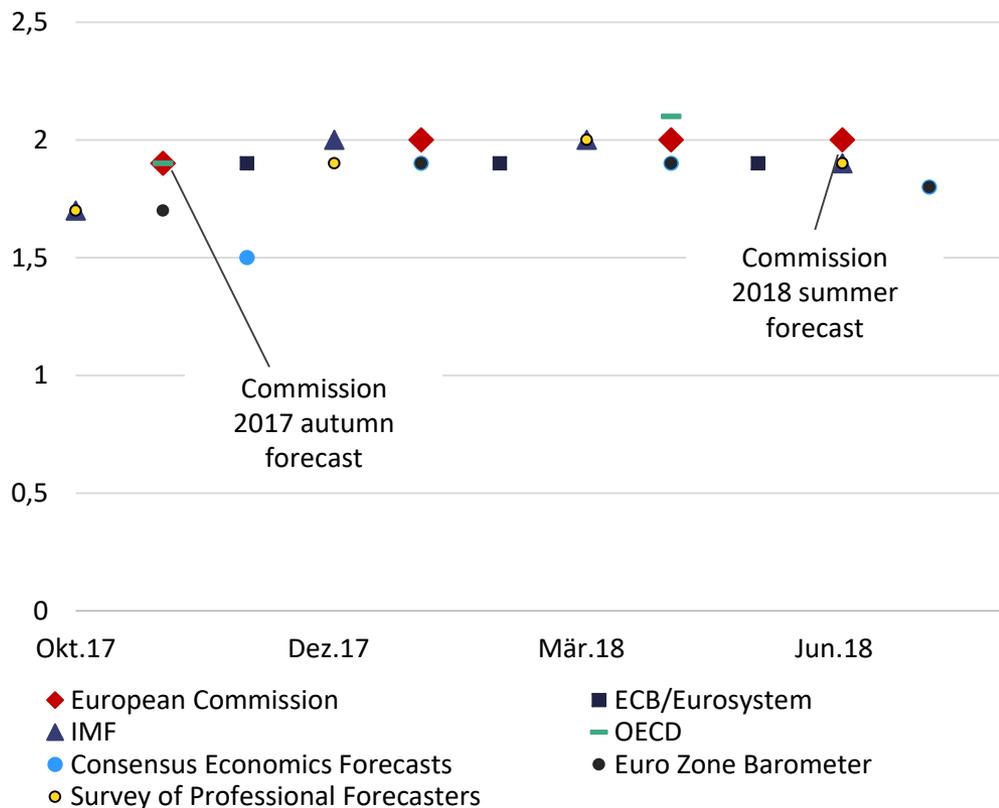
Compliance with the Stability and Growth Pact would be appropriately countercyclical
(fiscal stance in the euro area)



The macroeconomic outlook warrants a somewhat restrictive fiscal stance in 2019. Implementing the SGP (as per the country-specific recommendations issued in May) would deliver the appropriate outcome. Corrections of current budgetary trends are needed.

Update on the economic outlook

Expected growth in 2019 unchanged, risk assessment more negative? (Real GDP growth projections of various forecasters)

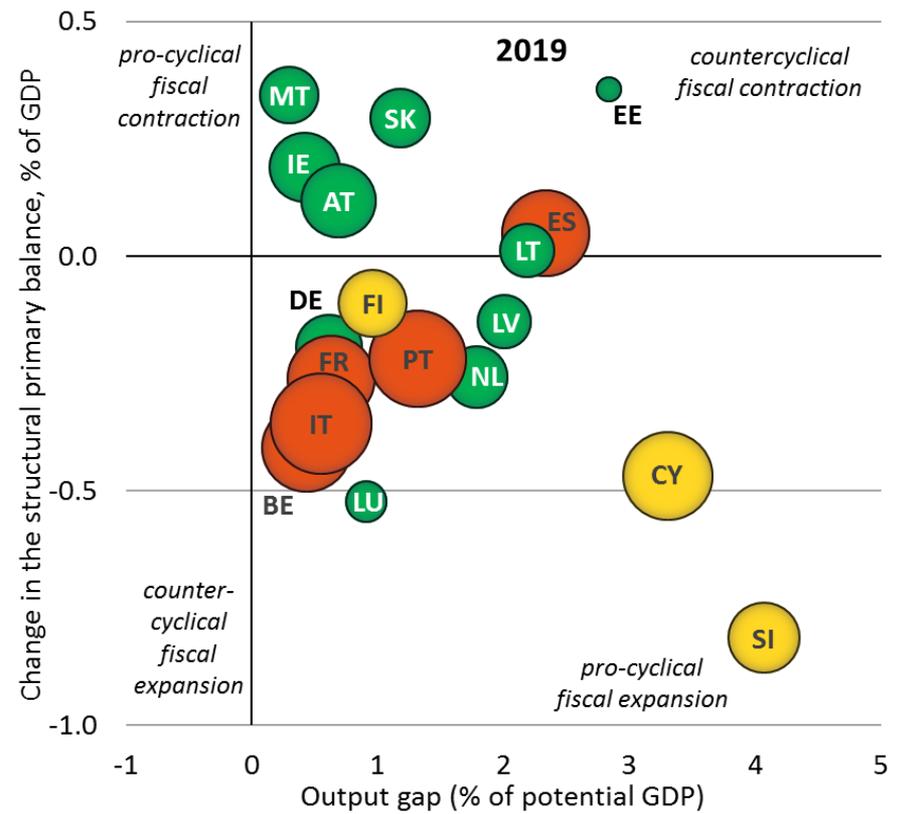
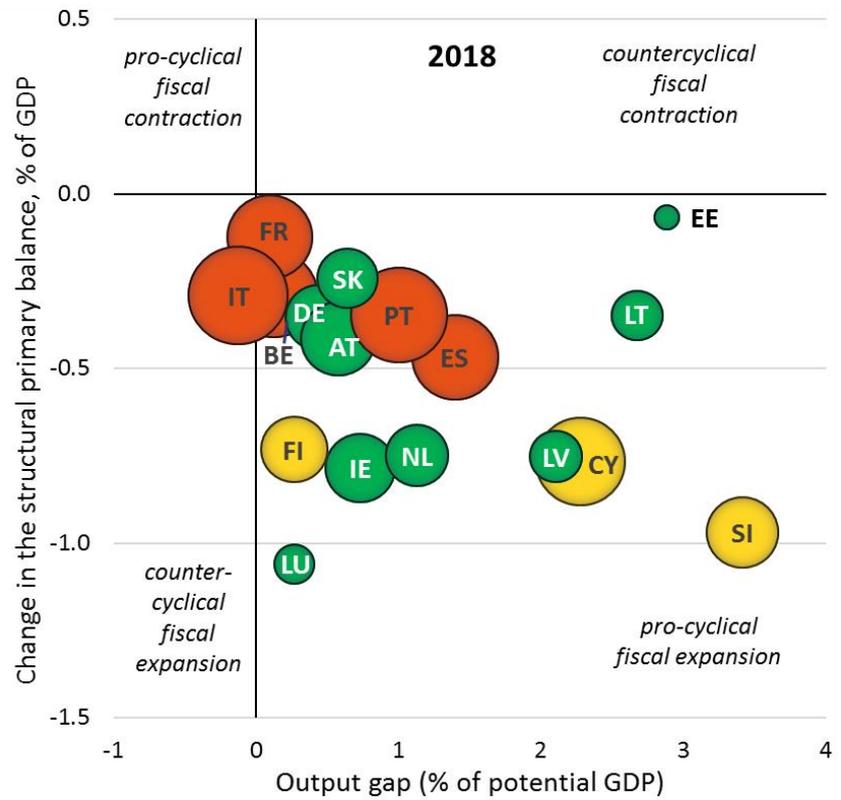


In July, the Commission maintained its forecast for 2019 unchanged compared to spring, but noted an increase in downside risks (protectionism, political uncertainty and volatility on financial markets). The ECB has revised its growth forecast slightly downwards but finds that risks remain balanced, due to upside risks for the labour market and wages.

Differentiation across countries needed

Fiscal expansion originates in high-debt countries

(fiscal stance, cyclical conditions and sustainability in euro area Member States; Commission spring 2018 forecast)



Worryingly, the fiscal expansion in 2018-2019 emerging from current budgetary trends largely originates in countries with higher sustainability risks. These countries should not miss the window of opportunity to build fiscal buffers and reduce vulnerabilities.

Governance framework needs to be upgraded

Two complementary elements

Central stabilisation function

- Addressing large symmetric and asymmetric shocks
- Sufficiently funded
- Based on independent economic judgement
- Access conditional on compliance with fiscal rules



European Investment Stabilisation Function:
step in the right direction,
but narrow focus on country-specific shocks,
very limited size,
and automatic trigger

Reform of Stability and Growth Pact

- Simpler and stronger rules
- Enhanced transparency
- Greater role for independent analysis and advice
- Needed to ensure even-handed assessment of compliance



Review of fiscal framework
currently envisaged
only after 2020

The EFB acknowledges the political difficulty of achieving both at the same time. Still, a central stabilisation function will neither work politically nor economically without better EU fiscal rules.

Thank you for your attention