Annual Report 2018

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Secretariat of the EFB

Working group meeting: The launch of the 2019 European semester cycle
European Parliament, Brussels, 22 November 2018
The EFB and the European Semester

• **June:** Assessment of the fiscal stance appropriate for the euro area in $t+1$

• **Autumn:** Retrospective assessment of the implementation of the Stability and Growth Pact in $t-1$

• **No real-time assessment**

• **Chronology:**
  - EFB established in October 2015
  - Board members appointed in October 2016
  - Fully operational in early 2017
  - First publication: June report 2017 (fiscal stance in 2018)
Main tasks of the EFB

Evaluation of the implementation of the Union fiscal framework

Cooperate with the national fiscal councils; exchange best practices

Assessment of fiscal stance
- Retrospective
- Prospective

Advance suggestions for the future evolution of the Union fiscal framework

Annual Report 2018

Chapter 2: SGP implementation in 2017

Chapter 3: Independent fiscal institutions

Chapter 4: Fiscal stance in 2017

Chapter 5: Flexibility review 2015-2017

Chapter 6: Future evolution of SGP

June Report 2018

Assessment of the fiscal stance appropriate for 2019
Main messages of annual report 2018

• **Macro-economy of euro area and EU in 2017 markedly better than expected** in terms of real GDP growth; inflation also slightly higher

• **SGP not adjusted to better economic conditions** due to (i) asymmetry of rules and (ii) discretion applied to soften requirements

• **Use of windfalls lopsided:**
  (i) countries with favourable public finances took advantage;
  (ii) high-debt countries spent important part of higher revenues

• **On aggregate, marginal fiscal consolidation** was appropriate. **But at country level, missed opportunity** to secure a faster reduction of high debt and build fiscal buffers where needed.

• **Some national IFIs successful in strengthening public scrutiny,** others faced issues of information and coordination

• Recent attempts to simplify SGP not effective or not followed through with consistently. **Overhaul of SGP needed:** EFB proposes simplification of the framework coupled with review of governance
Implementation of the EU fiscal framework in 2017

MACROECONOMIC SITUATION: SOLID AND BETTER THAN EXPECTED

EU: outcomes vs. forecasts
- GDP growth +2.4% (+1.9%)
- Pot. GDP growth +1.7% (+1.4%)
- Output gap -0.1% (-0.2%)

FISCAL POSITION IMPROVED

<table>
<thead>
<tr>
<th></th>
<th>2016</th>
<th>2017</th>
</tr>
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<tbody>
<tr>
<td>Deficit</td>
<td>-1.6%</td>
<td>-1.0%</td>
</tr>
<tr>
<td>Structural bal.</td>
<td>-1.2%</td>
<td>-0.8%</td>
</tr>
<tr>
<td>Debt</td>
<td>84.8%</td>
<td>83.1%</td>
</tr>
<tr>
<td>In EDP</td>
<td>5</td>
<td>2</td>
</tr>
<tr>
<td>At MTO</td>
<td>6</td>
<td>13</td>
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SGP IMPLEMENTATION: MUCH FORBEARANCE

Lack of symmetry: rules and discretion softened adjustment requirements while economy performed better than expected

Windfalls only partially used for consolidation
Euro area: 1/3 of higher revenue used to raise expenditure compared to plans

Lopsided use of windfalls:
- Less fiscal adjustment by high-debt and EDP countries
- More by those already enjoying a healthier fiscal position

2017: a missed opportunity
to secure a faster reduction of high debt and build fiscal buffers where needed
Notable cases of forbearance in 2017 fiscal surveillance cycle

- **SI**: Required **fiscal adjustment weaker than implied by matrix** of requirements in spring 2016

- **SI and PT**: Final assessment: **ad hoc correction to the expenditure benchmark** by COM, adjusting the medium-term reference rate

- **IT**: Final assessment benefited from:
  1. **generous reading** of structural balance indicator;
  2. carryforward of flexibility from previous years, **although safety margin not observed**;
  3. **quantification** of refugee-related costs not in line with past practice

- **BE**: COM concluded on **no sufficient evidence to establish a significant deviation**, although evidence from 2018 spring forecast and ample use of **margin of broad compliance**

- **BE and IT**: **Insufficient debt reduction** but no procedure launched due to broad interpretation of ‘**relevant factors’**

- **FR and ES**: Continued to follow a ‘**nominal strategy**’ under the EDP, i.e. replaced adjustment with windfalls
Recent initiatives to improve the SGP

- More prominence to expenditure benchmark in preventive arm of SGP
- Use of expenditure benchmark in corrective arm of SGP
- Attempt to clarify reading of the two indicators in assessing compliance with SGP
- Plausibility tool for output gap estimates
- Country-specific changes to commonly agreed methodology for output gap estimates
- Introduction of 'margin of discretion' on top of existing flexibility

In sum, recent innovations have increased complexity; they have been added to, not simplified, existing provisions
Independent fiscal institutions

Role in 2017 fiscal surveillance cycle in 9 countries based on IFI questionnaire

• Some IFIs helped with the implementation of rules: Italy, Romania
• Others remained silent
• Different reactions reflect different mandates and constraints:
  o Role in preparing forecasts
  o Timing and coverage of assessment
  o Availability of information
• Information issue: IFIs do not have the same real-time information as the Commission
• Coordination issue: IFIs not involved in discussions between Commission and governments
Fiscal stance in the euro area: marginally restrictive

**July 2016** Commission and Council guidance: *broadly neutral fiscal stance*

**Nov 2016** Commission guidance: *fiscal expansion of up to 0.5% of GDP*
- No major change in economic outlook
- Not feasible without at least some countries breaching the SGP
- Coming at an advanced stage of the recovery
- Not backed by the Council

**Outturn** as estimated in spring 2018: *marginally restrictive fiscal stance*
- Fine on aggregate, structural primary balance improving by 0.1% of GDP
- Generally improved country composition
- But notable exceptions:
  - Italy and EDP countries (France, Spain): no/insufficient consolidation
  - Germany: consolidated even further
  - Some countries did not use the higher-than-expected revenue to reduce their high debt but to increase expenditure
Review of flexibility in 2015-2017

- **January 2015**: COM Communication on ‘Making the best use of the flexibility’ within the existing rules of the SGP
- **Early 2016**: Commonly agreed position reached with the Council

**Our main findings:**

- **Flexibility for cyclical conditions**: marginal modulation of fiscal efforts compared to benchmark of 0.5% adjustment per year
- **Element of asymmetry**: more modulation for bad economic times coupled with tendency to underestimate good times when they occur
- **Not much of an incentive to invest or reform**: the two countries that applied for the investment clause did not actually increase investment; only few countries used the reform clause, and assessment of implementation was not always conclusive
- **No visible impact on compliance**: Member States failed to meet even much reduced adjustment requirements
- **Unusual event clause**: applied quite frequently, with considerable degree of discretion
## Proposal for a new fiscal framework

### CURRENT SGP

**TWO FISCAL ANCHORS:**
- Maintain balanced budget over the cycle, with deficit ceiling at 3%
- Reduce debt to 60%

**FOUR FISCAL REQUIREMENTS:**
- Structural budget balance
- Nominal budget balance
- Net expenditure growth
- Short-term debt dynamics

**MANY FLEXIBILITY PROVISIONS:**
- Fiscal adjustment modulated over the cycle
- Flexibility clauses: investment, structural reforms
- Several escape clauses covering different contingencies: economic downturn, unusual events

**SURVEILLANCE:**
- Annual surveillance cycle

**GOVERNANCE:**
- Commission and Council

### NEW FISCAL RULES

**ONE FISCAL ANCHOR:**
- Reduce debt to 60%

**ONE FISCAL REQUIREMENT:**
- Net expenditure growth

**ONE ESCAPE CLAUSE:**
- Covering different contingencies (economic downturn, unusual events)

**LESS INVASIVE SURVEILLANCE:**
- 3-year surveillance cycle

**UPGRADED GOVERNANCE:**
- Commission and Council
- Independent bodies to produce economic assessment including for escape clause
Proposal for a new fiscal framework (fits on one page!)

**OBJECTIVE**
Debt below 60% of GDP

**FISCAL REQUIREMENT**
(Net) primary expenditure growth capped at level ensuring decline of debt ratio

**MONITORING COMPLIANCE**
Expenditure growth exceeds cap by more than 1% of GDP?

- **NO**
  - Compensate deviation over time
- **YES**
  - Exceptional circumstances? Involvement of independent body
    - **NO**
      - Sanctions
    - **YES**
      - Escape clause
Thank you for your attention

https://ec.europa.eu/european-fiscal-board
Background slides
**Background: Ch. 2 – Forecasts and outturns in 2017 (euro area)**

- **Sizeable GDP growth surprise!**
- **Similar revision of real and potential GDP level**
- **Fiscal position improved**
- **But windfalls only partially used for consolidation**

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<thead>
<tr>
<th></th>
<th>Spring 2016</th>
<th>Spring 2018</th>
<th>Revisions</th>
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<tbody>
<tr>
<td></td>
<td>Commission forecasts (SF16)</td>
<td>Stability and convergence programmes (SCPs)</td>
<td>Outturn vs SF16</td>
</tr>
<tr>
<td>Real GDP</td>
<td>1.7</td>
<td>1.7</td>
<td>2.3</td>
</tr>
<tr>
<td>Nominal GDP</td>
<td>3.1</td>
<td>3.1</td>
<td>3.3</td>
</tr>
<tr>
<td>Potential GDP</td>
<td>1.1</td>
<td>1.3</td>
<td>1.5</td>
</tr>
<tr>
<td>Total revenue</td>
<td>2.8</td>
<td>2.9</td>
<td>3.7</td>
</tr>
<tr>
<td>Total expenditure</td>
<td>2.2</td>
<td>1.8</td>
<td>2.4</td>
</tr>
<tr>
<td>Primary expenditure</td>
<td>2.4</td>
<td>2.1</td>
<td>2.7</td>
</tr>
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| Euro area - 18(1)         |   |   |   |   |   |
| Real GDP                  | 9973 | 9983 | 10152 | 1.8% | 1.7% |
| Nominal GDP               | 10858 | 10874 | 10991 | 1.2% | 1.1% |
| Potential GDP             | 10015 | N/A  | 10187 | 1.7% | -   |
| Total revenue             | 4995  | 4996  | 5071  | 1.5% | 1.5% |
| Total expenditure         | 5170  | 5147  | 5172  | 0.0% | 0.5% |
| Primary expenditure       | 4939  | 4919  | 4958  | 0.4% | 0.8% |

| Output gap, % of potential GDP | -0.4 | -0.6 | -0.4 | 0.0 | 0.3 |
| Budget balance              | -1.6 | -1.4 | -0.9 | 0.7 | 0.5 |
| Primary balance             | 0.5  | 0.7  | 1.0  | 0.5 | 0.3 |
| Structural primary balance  | 0.7  | 1.0  | 1.3  | 0.6 | 0.3 |
• In good times, expenditure benchmark more stringent than structural balance indicator
• Few but relevant borderline cases
**Background: Ch. 2 – Overall assessment for borderline cases**

- Discrepancies between indicators interpreted in favour of the structural balance

- Assessment highly judgemental often lacking of convincing explanation (forbearance?)

- Replicability by independent assessor remains a challenge
Aggregate fine and generally improved composition, but notable exceptions:

- Italy and EDP countries (France, Spain): no/insufficient consolidation
- Germany: consolidated even further

Structural adjustment, euro area:

- **Autumn 2016**: no consolidation
- **Outturn**: compliance.

By group of countries:

- **EDP countries**: again nominal strategy
- **Countries in preventive arm**: consolidation beyond requirements in some countries, offset by deviation in Italy
- **Countries at/above MTO**: Germany consolidated further, other countries used some of their fiscal space.
Net expenditure growth, euro area:

- Lower than expected
- Still slightly above medium-term potential growth

By group of countries:

- **Countries in preventive arm:** reduced expenditure growth compared to plans
- **EDP countries:** faster net expenditure growth than planned, above medium-term growth
Background: Ch. 5 – Adjustment requirements (2015-2017)

Flexibility did not necessarily improve the balance between stabilisation and sustainability

For countries in bad times: averted pro-cyclical contraction but implied major departure from sustainability needs

For countries in normal or good times: flexibility entailed a pro-cyclical fiscal expansion
Some Member States failed to observe the more comfortable adjustment path.

Italy stands out: although flexibility and other clauses lowered the total requirement from 1.5% to 0.1% of GDP, the structural balance deteriorated by 0.9% of GDP in 2015-2017.
• Does the design of the flexibility framework offer adequate incentive and ownership to comply with EU fiscal rules?

• Italy is an example where the targeted structural budget balance (in level) has never been observed, while continuing to benefit from flexibility

<table>
<thead>
<tr>
<th>ITALY</th>
<th>2015</th>
<th>2016</th>
<th>2017</th>
<th>2018</th>
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<tbody>
<tr>
<td>Structural budget balance</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>required no clauses</td>
<td>(-0.9)</td>
<td>(-0.5)</td>
<td>(-0.8)</td>
<td>(-1.1)</td>
</tr>
<tr>
<td>required with clauses</td>
<td>(-0.9)</td>
<td>(-1.3)</td>
<td>(-1.2)</td>
<td>(-1.4)</td>
</tr>
<tr>
<td>outturn</td>
<td>(\downarrow)(-1.0)</td>
<td>(\downarrow)(-1.7)</td>
<td>(\downarrow)(-1.7)</td>
<td>?</td>
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• However, the recurring failure to comply with fiscal targets did not lead to a formal breach of EU fiscal rules.

• This can be mostly explained by the possibility to cumulate the margin of broad compliance that comes on top of the different flexibility provisions
• Commission assessment of whether reforms have been fully implemented was sometimes not conclusive.

• Most of the times, the assessment pointed to limited or some progress in the implementation of reforms. Is it enough?
**Medium term:** proposed rule achieves same debt reduction as current debt rule

**Short term:** proposed rule allows for greater economic stabilisation

*Note:* The adjustment path under the expenditure rule is computed assuming that the economy is growing at its potential rate and that inflation is at 2%. The adjustment path under the debt rule is computed based on actual projections for GDP and inflation. Implicit interest rates are computed assuming that long-term nominal rates converge to 5% over ten years, and interest expenditures increase in line with the expected roll-over schedule of debt. 'Net expenditure growth' refers to the growth rate of primary expenditures at current prices, net of discretionary revenue measures and cyclical.