

## Appendix: Euro Area Fiscal Policy

Catherine Mathieu and Henri Sterdyniak, OFCE

At the end of 2007 euro area countries had succeeded in bringing their deficit to 0.6% of GDP. There was a 1.9% of GDP surplus in the primary structural balance, according to OECD estimates (Economic Outlook, June 2008) and the public debt had decreased to 66% of GDP.

The crisis has led government deficits to rise strongly. The rise in deficits can be explained by the automatic fall in tax revenues and the rise in some expenditure (cyclical balance); the implementation of stimulus packages; and also the overreaction of tax revenues to the output fall. In addition, national governments have introduced permanent measures during the crisis. Decomposing these four components of the government balance is particularly difficult due to the depth of the recession.

However, the cyclical balance seems to explain most of the rise in the euro area deficit<sup>1</sup> (see Table 1). At the euro area level, the fiscal impulse (excluding overreaction of tax revenues) amounted to 0.6% of GDP in 2008, 2009 and 2010. We expect fiscal policy to become contractionary in 2011 (by 0.5%). The structural government balance (excluding stimulus measures) did not dramatically deteriorate during the crisis<sup>2</sup>.

**Table 1: Public finances in the euro area**

% of GDP except *	2007	2008	2009	2010	2011
<i>GDP growth*</i>	2.8	0.6	-3.9	1.0	2.0
Output gap**	0.0	-1.4	-7.3	-8.2	-8.2
Government balance	-0.6	-1.9	-6.4	-7.0	-6.4
Net interest payments	2.5	2.6	2.6	2.8	2.9
Cyclical balance	0	-0.6	-3.3	-3.7	-3.7
Stimulus packages		-0.2	-1.3	-1.1	-0.3
Overreaction of revenues			-1.2	-0.6	-0.4
Structural primary balance	1.9	1.5	2.0	1.2	0.9
Cumulated fiscal impulse		0.6	1.2	1.8	1.3
Stock-flow adjustment	-	3.2	0.6	0.3	-
Public debt	66.0	69.3	78.2	84.0	87.4

\* %. \*\* Based on pre-crisis trend output growth as estimated by OECD (June 2008). Source: European Commission, OECD, authors' estimates

<sup>1</sup> This view is not shared by other members of the EUROFRAME group

<sup>2</sup> Although the situation may differ at country level. For instance housing tax revenues have fallen substantially in countries like Ireland and Spain, following the housing markets collapse.

The large increases in government deficits and debts have been relatively well accepted by markets. Long-term public interest rates have not increased, which gives new evidence of the absence of a direct link between public deficits and interest rates. The US interest rate decreased from 4% in July 2008 to 2.5% in January 2009, before rising to 3.5% in mid-2009. The German interest rate fell from 4.4 % in July 2008 to 3.0% in January 2009 before stabilising at 3.25% in mid-2009. Real interest rates remain below potential output. On the whole, markets do not demand significant risk premia to own public assets<sup>3</sup>. They do not expect an inflationary risk: the differential between non-indexed and price-indexed assets interest rates show that markets currently expect an average of 1.8% inflation over the next ten years, in the US and in the euro area.

Three scenarios can be considered for the coming years. In the grey scenario, domestic demand does not accelerate, GDP growth remains low and there is no factor pushing interest rates up. In the pink scenario, private demand accelerates vigorously, GDP growth generates a strong rise in tax revenues and a fall in some public expenditure; governments reduce deficits and output growth is satisfactory, although not excessive. There are no inflationary pressures and hence no significant rise in interest rates. In the red scenario, private demand accelerates, but governments maintain an excessive deficit which leads to an acceleration in inflation and hence interest rates to rise. This red scenario is not currently anticipated by markets. Markets trust governments to cut public deficits when consumption and investment grow again. They realise that current deficits are cyclical in nature and related to stabilisation efforts from national governments rather than excessive deficits resulting from loss of control of public finances.

It is difficult to make projections for public finances. They depend on potential output growth estimates. At the end of 2010, the euro area unemployment rate will be at 10% (i.e. an over-unemployment of around 3%); productivity losses will amount to 4% (i.e. an over-labour force of 4%); the number of discouraged workers will be 1.5%. Should these 8.5% be considered as permanently lost?

If so, and under an annual 2% GDP growth, an annual 1% of GDP fiscal effort of is required to stabilise the public debt in 2013. But can GDP grow by 2% together with such a fiscal contraction? A spontaneous 3% rise in private spending would be needed.

---

<sup>3</sup> However markets have bet on risks of euro area dislocation and risk default in some euro area countries, creating markets to cover these risks. Hence the risk premium on the Irish public debt reached 2.4 percent in March 2009 before decreasing to 1.5 percent en September.

**Table 2a: Public finances (grey scenario)**

% of GDP except *	2011	2012	2013	2014	2015
<i>PIB*</i>	1.7	2.0	2.0	2.0	2.0
Output gap**	-8.8	-8.8	-8.8	-8.8	-8.8
Government balance	-6.1	-4.6	-3.7	-2.8	-1.8
Net interest payments	2.9	3.1	3.2	3.3	3.3
Cyclical balance	-4.0	-4.0	-4.0	-4.0	-4.0
Stimulus packages	-0.3	0.0			
Overreaction of revenues	-0.4	0.0			
Structural primary balance	1.5	2.5	3.5	4.5	5.5
Cumulated fiscal impulse	0.7	-0.6	-1.6	-2.6	-3.6
Public debt	87.4	88.3	88.4	87.7	86.1

\* %.

\*\*Based on pre-crisis trend output growth as estimated by OECD (June 2008).

In a pink scenario, with a progressive reduction in the output gap, fiscal policy would be less restrictive. However the credibility of this scenario is also questionable. Private spending would need to rise spontaneously by 4%.

**Table 2b: Euro area public finances (pink scenario)**

% of GDP except *	2011	2012	2013	2014	2015
<i>PIB*</i>	1.7	3.0	3.5	3.5	3.0
Output gap**	-8.8	-7.8	-6.3	-4.8	-3.8
Government balance	-6.1	-4.6	-3.5	-2.5	-1.5
Net interest payments	2,9	3.1	3.2	3.3	3.3
Cyclical balance	-4.0	-3.5	-2.8	-2.2	-1.7
Stimulus packages	-0.3	0.0			
Overreaction of revenues	-0.4	0.0			
Structural primary balance	1.5	2.0	2.5	3.0	3.5
Cumulated fiscal impulse	0.7	-0.1	-0.6	-1.1	-1.6
Public debt	87.4	87.6	86.4	84.3	81.7

\* %\*\* Based on pre-crisis trend output growth as estimated by OECD (June 2008).

In all cases, fiscal consolidation should not be implemented before private spending revival is ensured.