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PRESS RELEASE

Towards a new policy mix in the euro area?
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The global economic and financial crisis that raged from 2007 to 2010 has highlighted a number of weaknesses in the euro area's macroeconomic reference framework. For one thing, it served as a reminder that fiscal policy has a stabilising role to play in a liquidity trap.

Since the end of 2012 and the clear easing of financial tensions related to the sovereign debt crisis, the economic recovery is underway. At the moment, growth is solid and widespread across countries and sectors but the underlying inflation dynamics remain weak. In this context, Eurosystem monetary policy decisions are striving to preserve the conditions needed to ensure a lasting return of inflation rates to levels below, but close to 2 %.

The automatic stabilisers are the most appropriate instruments for making sure that fiscal policy contributes to stabilising the economic cycle. They can be backed up by a discretionary counter-cyclical policy, especially in the event of a sharp economic slowdown. But an optimal fiscal policy also implies that public finances remain sustainable. In this respect, while the sustainability of public finances is a concern in the (medium to) long run, the stabilisation objective only covers the short run. The short-term fluctuations triggered by the economic cycle are therefore tolerated as long as the sustainability objective is reached on average over the entire cycle. Currently, there are big differences in sustainability among the euro area countries, a situation that calls for a country-specific approach. The need for fiscal consolidation for reasons of sustainability may in some circumstances be at variance with the stabilisation objective, especially in a period of faltering economic recovery.

Starting out from the macroeconomic objectives of fiscal policy, the article suggests a rule for an optimal fiscal policy that reconciles stabilisation and sustainability objectives. This rule is then applied retrospectively and prospectively to a certain number of individual euro area countries.

The fiscal position of the euro area as a whole is calculated mechanically by aggregating the individual Member States' budget positions; fiscal policy at the level of the euro area as a whole is consequently the result of the policy pursued at national level because fiscal policy is the prerogative of the Member States. In the years 2012-2013, against the background of the deterioration in the economic situation, the fiscal policy pursued in the euro area as a whole was restrictive. From 2014 on, however, it became broadly neutral, which seems appropriate in view of the economic circumstances. Recent information about the economic situation points to a further improvement, something which could require a more restrictive policy.

One question that is often asked is whether Germany should be the growth engine for the euro area. It is thus assumed that the approach of addressing the German balance of payments current account surplus through expansionary fiscal policy (essentially through public investment in infrastructure) would shore up economic activity in the other euro area countries. Some studies nevertheless indicate that the geographical breakdown of the spillover effects of such investments may be uneven: they note that it is in Germany's neighbours – in particular, the small to medium-sized economies – that the biggest impact can be expected, while the impact on non-neighbouring countries further away should remain fairly limited.

The current European fiscal framework mainly targets the sustainability of public finances and restricts the role of fiscal policy when it comes to stabilising the economic cycle. So this raises the question of whether the EU fiscal framework needs to be adapted. In order to give fiscal policy a more active role in the policy mix, several changes have already been made, such as taking the economic situation more closely into consideration when deciding the budgetary effort that needs to be made and also setting up a European Fiscal Board. One other change could be to review the way in which public investment is taken into account when assessing fiscal policy under the European fiscal framework, so that this expenditure is given more favourable treatment. And finally, one might take under consideration, under certain conditions, to put a European stabilisation mechanism in place in order to ensure that the optimal fiscal policy for the euro area as a whole corresponds to that for the individual countries.

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