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New policy challenges and reform needs for the EMU

Sixth ECB biennial conference on Fiscal Policy and EMU Governance
December 2023

Outline

Questions

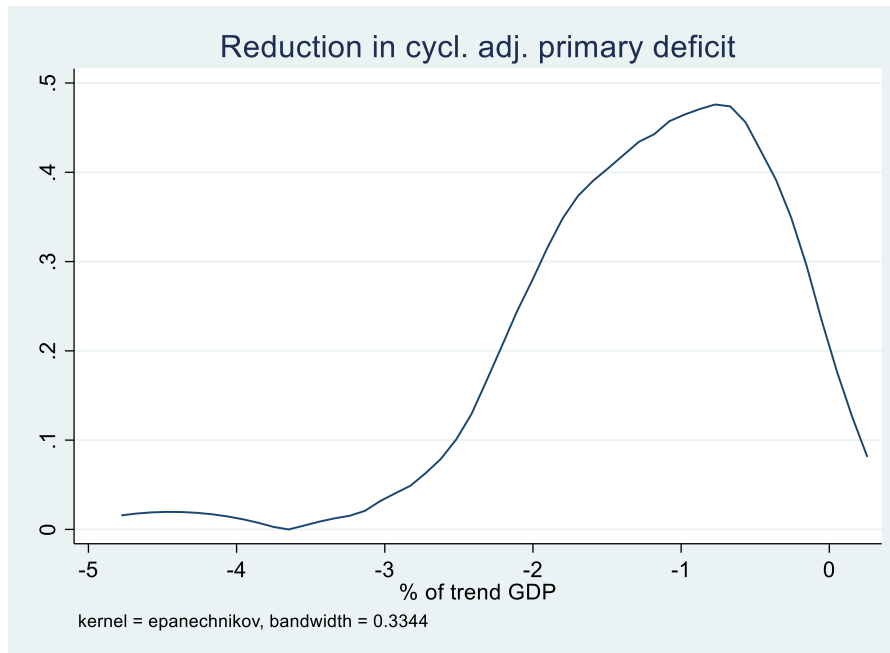
- How can countries restore “successfully” sound fiscal positions? – Lessons from history
- Are high public debt euro area countries “on track” for “success”?

My discussion

- “Our” EC10 contribution to the debate and the extensive literature on fiscal multipliers and large fiscal consolidations and expansions
 - Alesina and Perotti, (1995): “Fiscal expansions and adjustments”, Economic Policy
 - Alesina, Favero, Giavazzi, (2019): “Austerity”, Princeton University Press
- New/extended data, punchline holds
 - Simple descriptive evidence
 - No discussion on possible explanations for “whys”, nor on challenges (data availability and data revisions, identification, “outliers”, non-linearities)

Not all “*fiscal consolidations*” were “*successful*” at reducing public debt

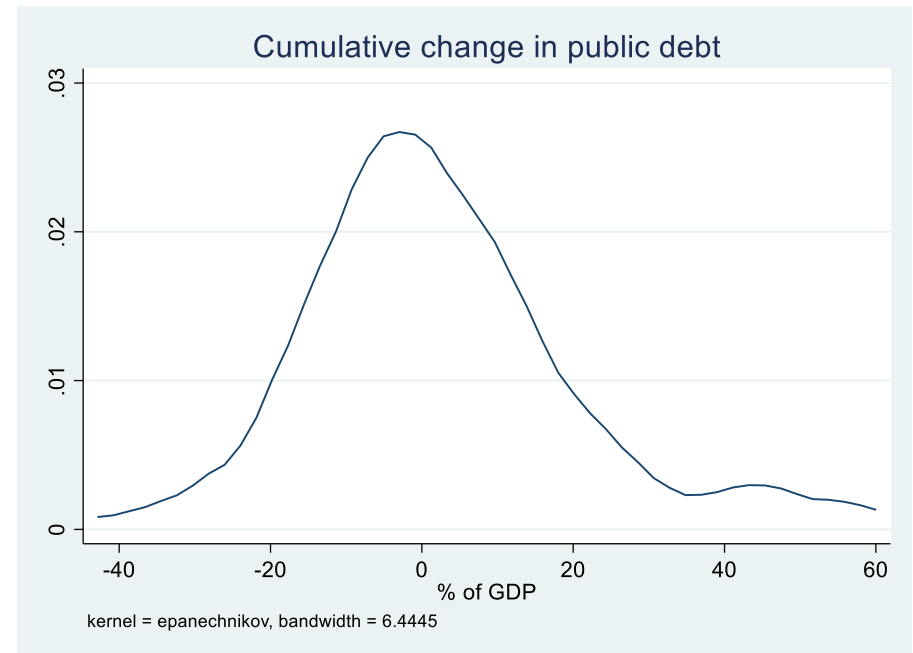
Distribution of Δ cyclically adjusted primary balance



- 21 OECD countries from 1960-2019
- 52 episodes of “*fiscal consolidations*”, 196 years (c.21% of obs.), average length 2.7 years, max length 7 years
- Average improvement in cycl. adj. primary balance of 1.4% of trend GDP

Source: OECD, Haver Analytics, Barclays Research

Distribution of Δ public debt

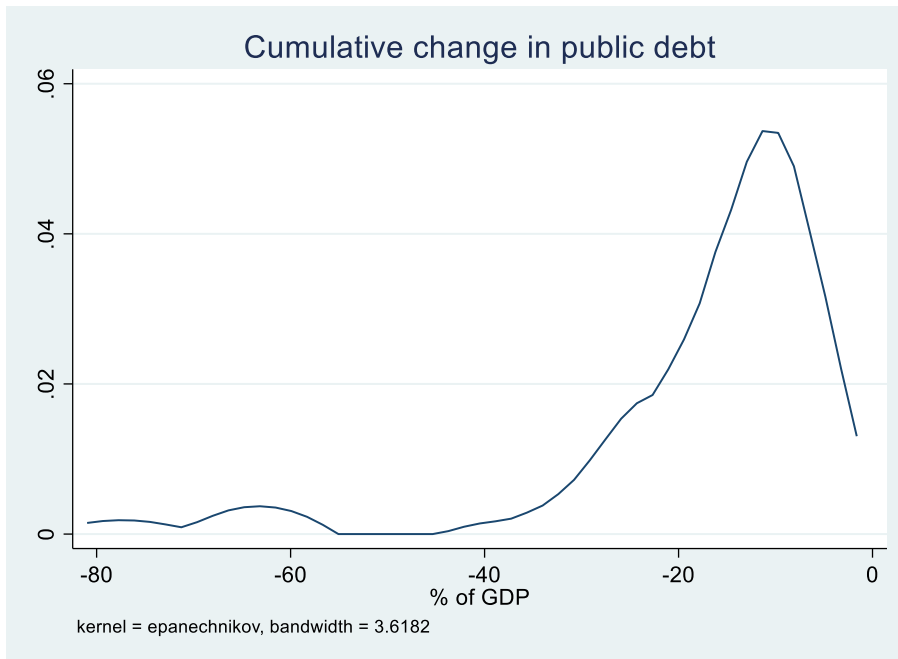


- Cumulative change in public debt averaged 5.7% of GDP
- In only about 40% of episodes, governments were “*successful*”. In these cases, public debt declined, on average, by 1.3% of GDP per year

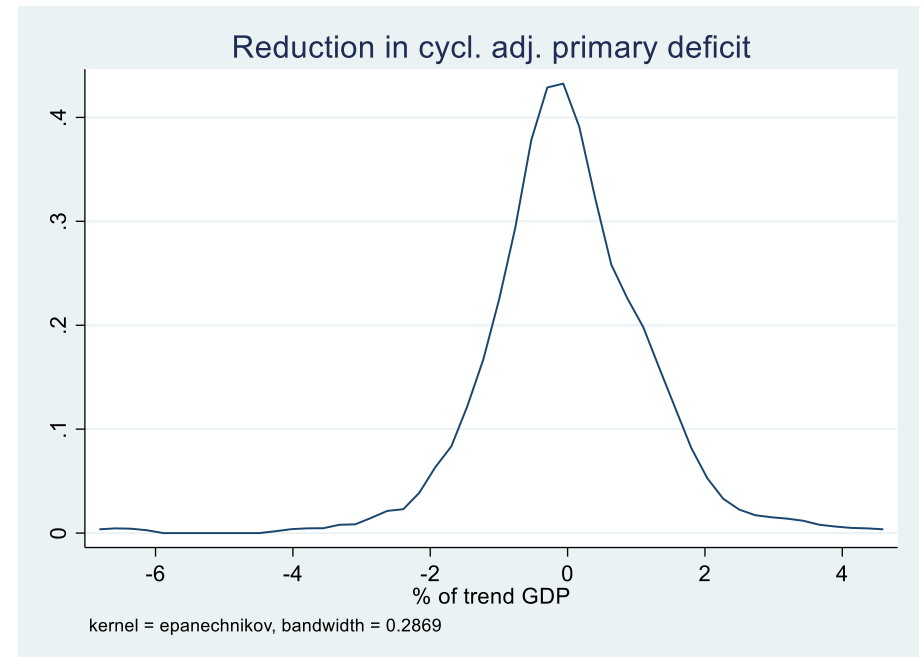
Source: OECD, Haver Analytics, Barclays Research

“Public debt reduction episodes” did not necessarily require sizable yearly fiscal tightening

Distribution of Δ public debt



Distribution of Δ cyclically adjusted primary balance



- 21 OECD countries from 1960-2019
- Episodes of sequential decline in public debt/GDP, cumulatively of at least 5% of GDP.
- 60 episodes, 287 years (c.28% of obs.), average length 3.9 years, max length 15 years
- Cumulative change in public debt/GDP across episodes averaged 16% of GDP

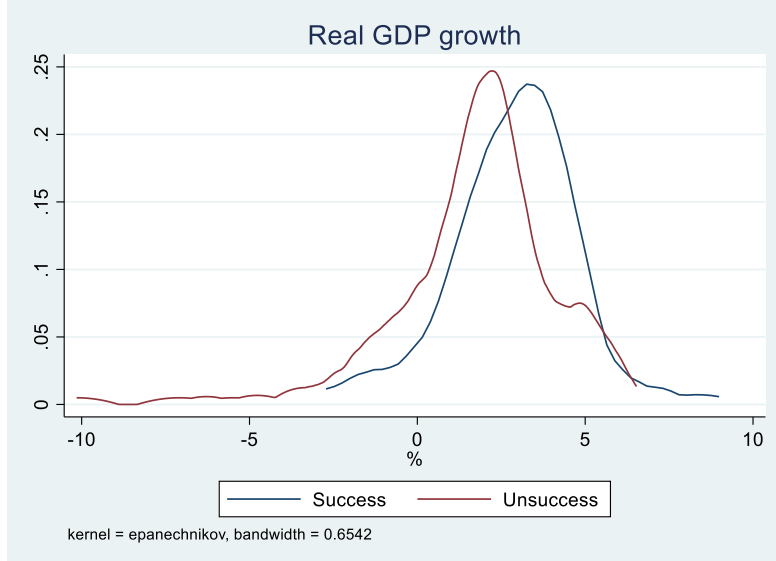
- Average improvement in cycl. adj. primary balance/trend GDP close to 0
- The cycl. adj. primary balance worsened (improved) in 46% (54%) of country-years in which public debt declined

Source: OECD, Haver Analytics, Barclays Research

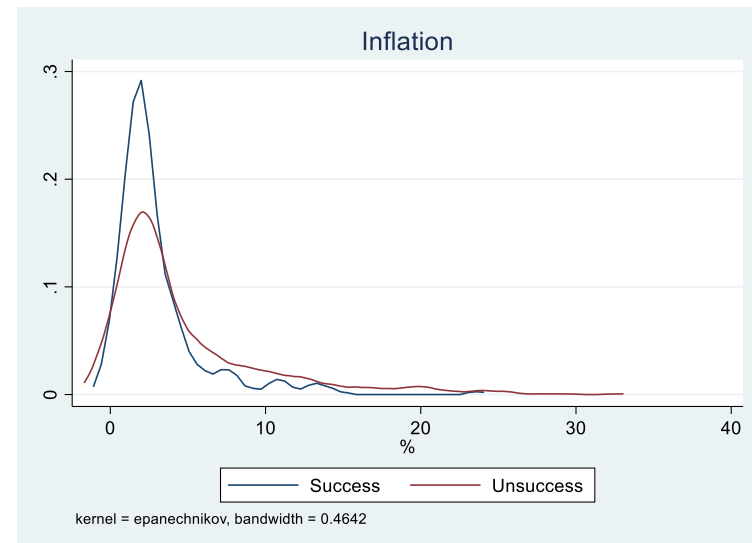
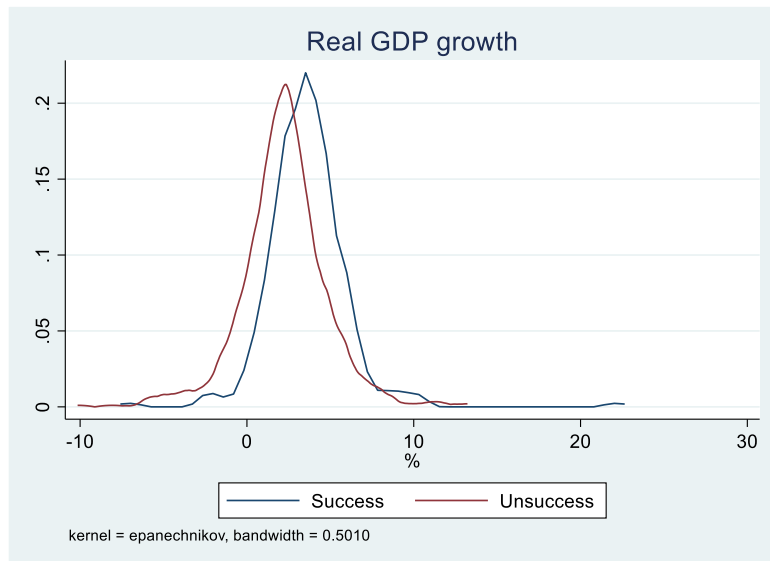
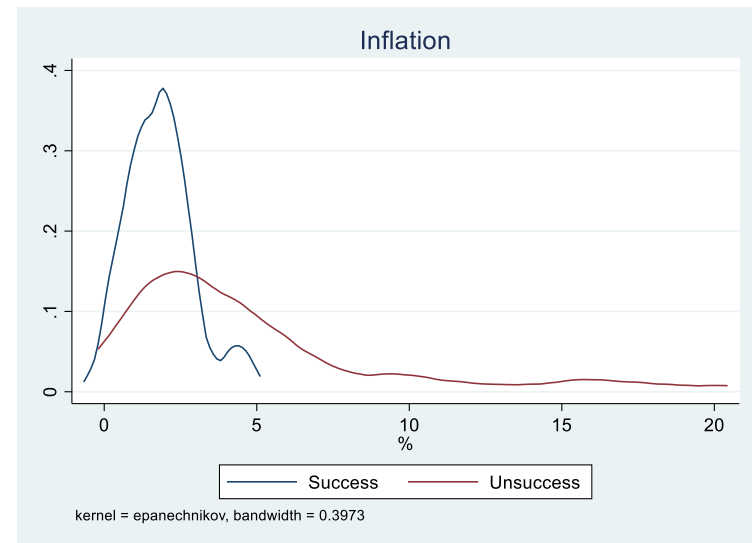
Source: OECD, Haver Analytics, Barclays Research

Macro outcomes differed in “successful” and “unsuccessful” episodes

Fiscal consolidations and growth



Fiscal consolidations and inflation

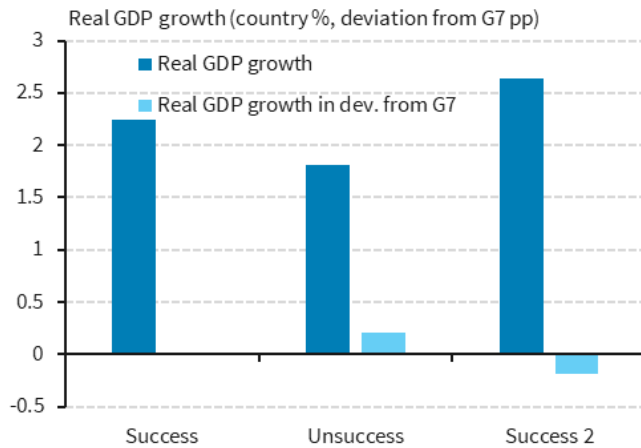


Source: OECD, Haver Analytics, Barclays Research

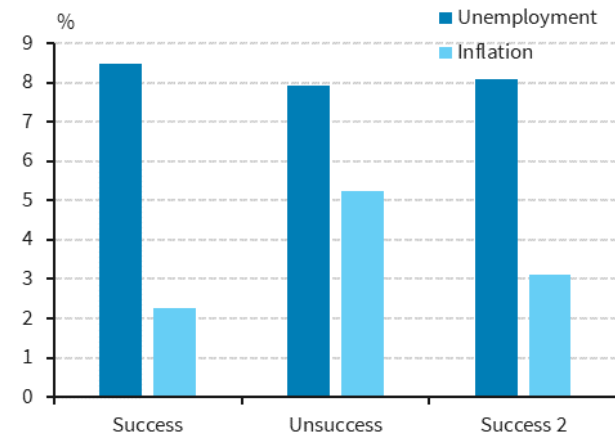
Source: OECD, Haver Analytics, Barclays Research

Road to success: macro and fiscal fundamentals the year before

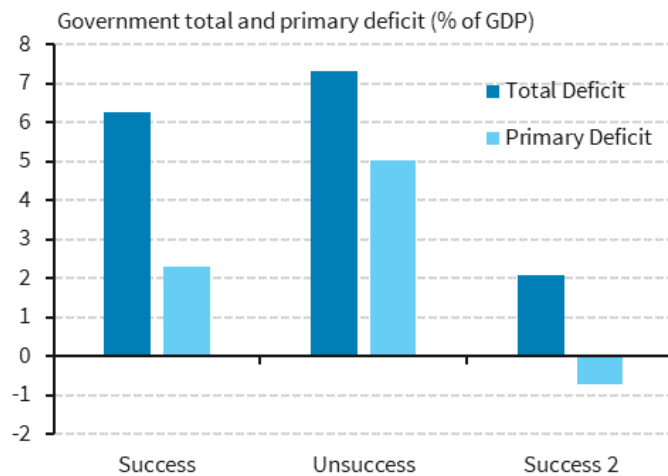
Mixed growth picture



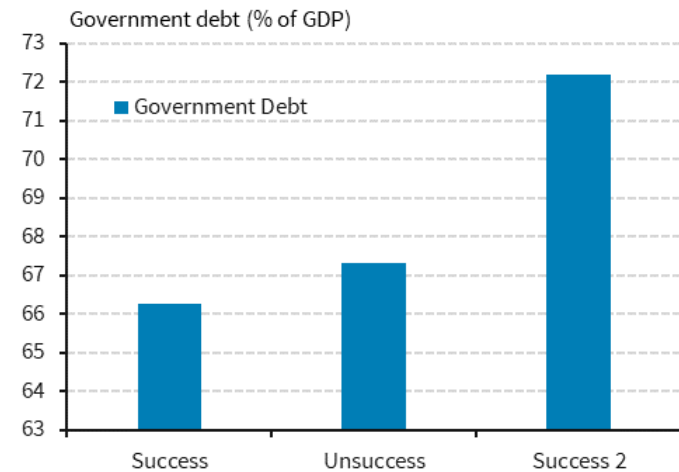
Lower average inflation



Lower government deficit



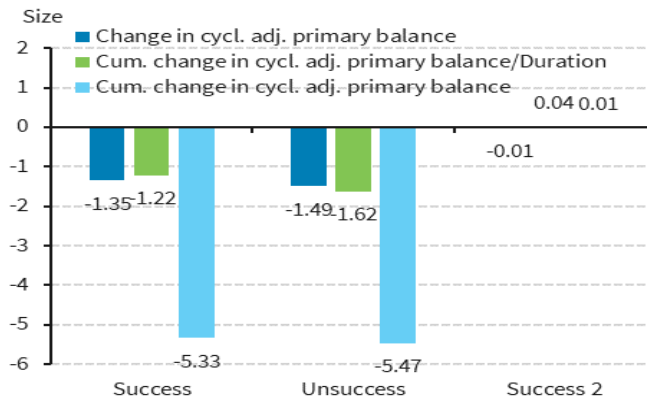
Mixed public debt picture



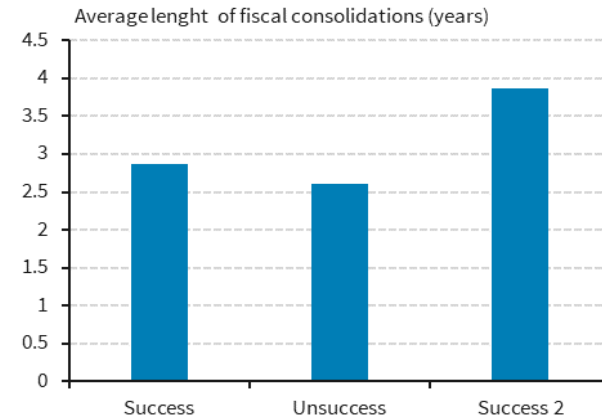
Source: OECD, Haver Analytics, Barclays Research

Road to success: size and composition of fiscal policy during the adjustment period

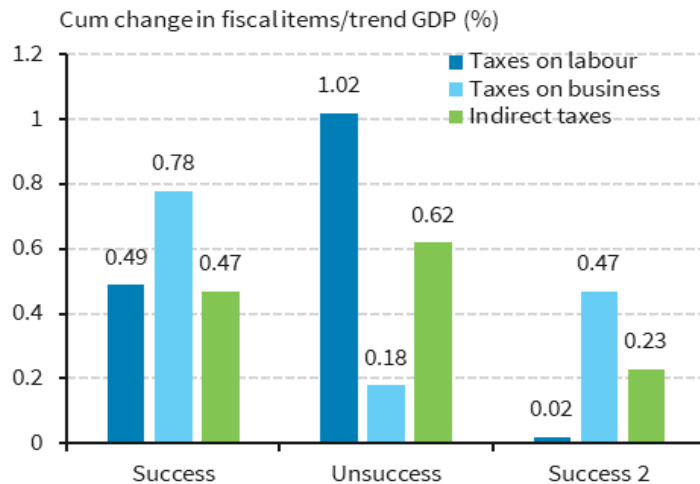
Smaller fiscal adjustments...



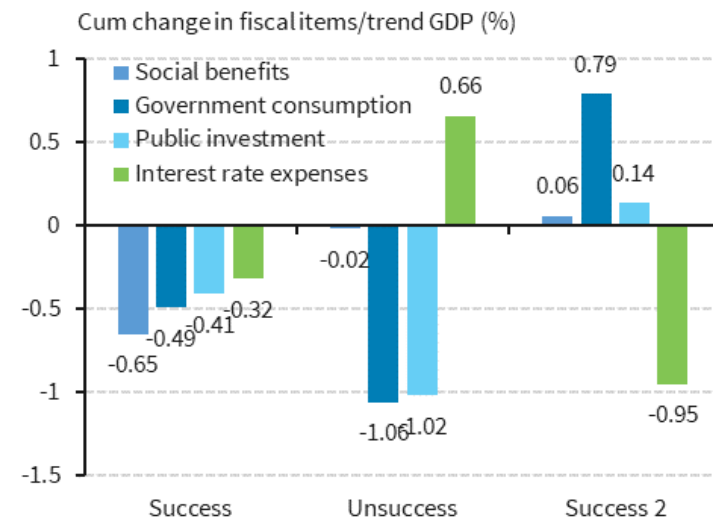
...over a longer period of time



Less reliant on labour taxes increases



Striking differences on public investment and interest rate bill



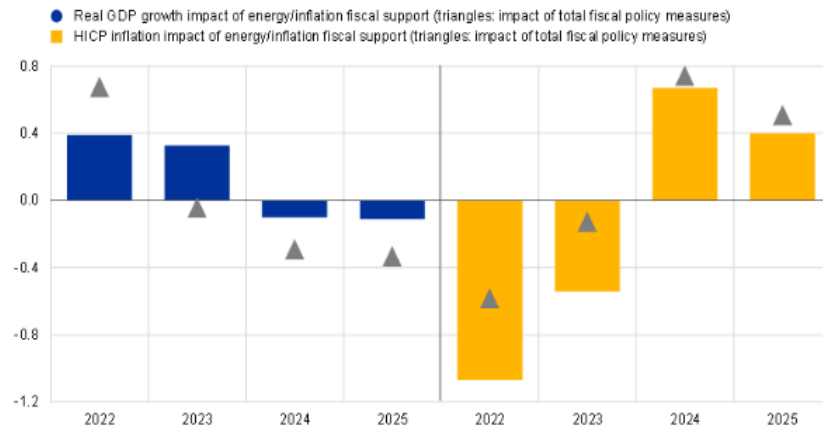
Source: OECD, Haver Analytics, Barclays Research

Fiscal policies in recent years: expansionary fiscal policy helped reducing inflation

Chart 5

Macroeconomic effects of euro area discretionary fiscal policy measures

(percentage points)



Sources: December 2022 Eurosystem staff macroeconomic projections for the euro area and ECB staff calculations.
Notes: Macroeconomic effects are shown at the euro area aggregate level as percentage point deviations from a baseline without the fiscal policy measures. Simulations are conducted under the simplifying assumption of fiscal shocks being exogenous and there being no monetary policy response.

Source: Bankowski, Bouabdallah, Checherita-Westphal, Freier, Jacquinot and Muggenthaler, "Fiscal policy and high inflation", ECB Economic Bulletin 2, 2023, ECB, Barclays Research

Table 6: Change in Standard VAT Rate

| | (1) | (2) | (3) | (4) | (5) | (6) | (7) | (8) |
|------------------------------------|---------------------|---------------------|---------------------|-----------------------|---------------------|---------------------|---------------------|-------------------------|
| Fiscal stance/impulse | $FISC_t$ | $CAPB_t$ | $\Delta CAPB_t$ | $\Delta CAPB_{adj,t}$ | $FISC_{t-1}$ | $CAPB_{t-1}$ | $\Delta CAPB_{t-1}$ | $\Delta CAPB_{adj,t-1}$ |
| $\Delta NEER_{t-1}$ | -0.28*** (-4.75) | -0.28*** (-4.86) | -0.28*** (-4.61) | -0.28*** (-4.63) | -0.26*** (-5.19) | -0.26*** (-5.31) | -0.24*** (-5.72) | -0.24*** (-5.78) |
| outputgap _t | 0.10 (1.44) | 0.06 (0.96) | 0.10 (1.48) | 0.10 (1.46) | 0.16* (1.85) | 0.13 (1.51) | 0.14 (1.46) | 0.13 (1.26) |
| fiscal stance/impulse | -0.06 (-0.71) | -0.08 (-1.02) | 0.01 (0.41) | 0.04 (0.86) | -0.05 (-0.98) | -0.06 (-1.23) | -0.01 (-0.21) | -0.05 (-0.71) |
| $\Delta VATrate_t$ | 0.39* (1.89) | 0.37* (1.74) | 0.39** (2.28) | 0.38* (2.06) | | | | |
| $\Delta VATrate_{t-1}$ | | | | | 0.22** (2.19) | 0.19* (1.78) | 0.21** (2.20) | 0.23** (2.31) |
| price _{t-1} | -0.06** (-2.09) | -0.06** (-2.32) | -0.05* (-1.97) | -0.05* (-2.02) | -0.06** (-2.22) | -0.06** (-2.29) | -0.04* (-1.82) | -0.04* (-1.78) |
| unitlabourcost growth _t | 0.13*** (3.17) | 0.14*** (3.59) | 0.13*** (3.36) | 0.13*** (3.32) | 0.11** (2.55) | 0.12** (2.79) | 0.13*** (3.39) | 0.13*** (3.53) |
| Time FE | YES | YES | YES | YES | YES | YES | YES | YES |
| Country FE | YES | YES | YES | YES | YES | YES | YES | YES |
| Observations | 354 | 354 | 354 | 354 | 353 | 353 | 350 | 350 |
| KP LM-Stat. (p) | 0.0103 | 0.00618 | 0.00295 | 0.00312 | 0.00314 | 0.00363 | 0.00353 | 0.00400 |

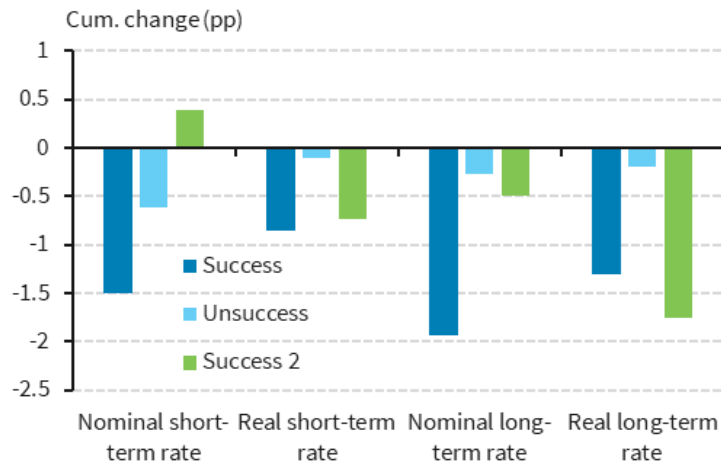
Notes: DV: HICP inflation. All regressions are performed on the balanced EA-19 sample, 1999-2019, pre-EMU observations weighted by 0.5, with two-step feasible GMM estimation. VAT rate data is not available for Cyprus and Malta; thus the effective sample comprises of only 17 countries. In columns (1) and (3) the output gap as well as the fiscal impulse variable are instrumented by their first lag (exact identification). In the other specifications only the output gap is instrumented by its first lag since lagged fiscal stance/impulse variables are considered exogenous and instrumenting the change in the CAPB was rejected due to underidentification. The same applies to unit labour cost growth throughout all specifications. The time dummies are partialled out. T-statistics based on Driscoll-Kraay standard errors in parentheses. Stars indicate significance at the 10% (*), 5% (**) and 1% (***) level.

Source: Cristina Checherita-Westphal, Nadine Leiner-Killinger, Teresa Schildmann, (2023), Euro area inflation differentials: the role of fiscal policies revisited, ECB WP 2774

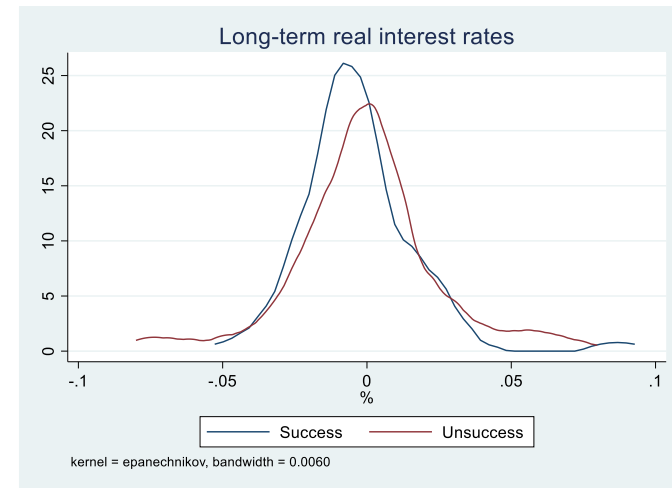
- Bankowski, Bouabdallah, Checherita-Westphal, Freier, Jacquinot and Muggenthaler, The effects of high inflation on public finances in the euro area, [ECB Occasional Paper 332](#)
- Checherita-Westphal, Leiner-Killinger, Schildmann, (2023), Euro area inflation differentials: the role of fiscal policies revisited, [ECB WP 2774](#)
- Chi Dao, Dizioli, Jackson, Gourinchas, and Leigh (2023), Unconventional fiscal policy in times of high inflation, [IMF WP 23/178](#)

Road to success: monetary and structural policies

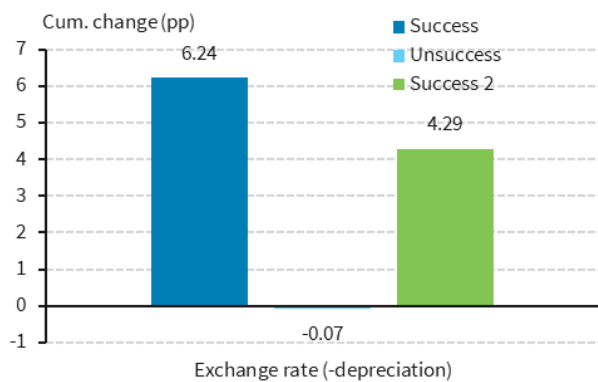
Divergence in short-term and...



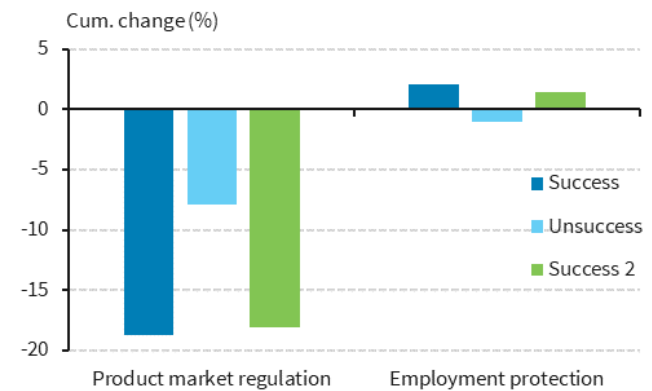
...and long-term real rates



Nominal effective exchange rate appreciation



Product markets liberalisation



Source: OECD, Haver Analytics, Barclays Research

Q1: How can countries restore “successfully” sound fiscal positions? – Key takeaways

- History suggests that:
 - governments should focus more on the composition of the fiscal policy: increase more business and indirect taxes rather than labour taxes; cut more current spending rather than public investment;
 - reforms that liberalised product markets were more extensive in successful episodes, which could have had a positive impact on growth;
 - short-term nominal and real interest rates fell by more in successful episodes on average. Statistically, however, the distributions of changes in nominal short-term rates were not different; and
 - long-term rates declined substantially and more than short-term rates. Statistically, the distributions of long-term nominal and real rates are different in successful and unsuccessful episodes. This signals a compression of risk premia. The decline in interest rate expenses was in fact another important factor contributing to the success.

Public debt stabilisation: how challenging will it be?

Italy

| Government Debt/GDP = 140% | Nominal interest rate paid on entire stock of debt (%) | | | | | | | | | | |
|----------------------------|--|------|------|------|-------------|------|------|-----|------|------|------|
| | 1 | 1.5 | 2 | 2.5 | 3.1 | 3.5 | 4 | 4.5 | 5 | 5.5 | 6 |
| -2 | 4.3 | 5.0 | 5.7 | 6.4 | 7.3 | 7.9 | 8.6 | 9.3 | 10.0 | 10.7 | 11.4 |
| -1.5 | 3.6 | 4.3 | 5.0 | 5.7 | 6.5 | 7.1 | 7.8 | 8.5 | 9.2 | 9.9 | 10.7 |
| -1 | 2.8 | 3.5 | 4.2 | 4.9 | 5.8 | 6.4 | 7.1 | 7.8 | 8.5 | 9.2 | 9.9 |
| -0.5 | 2.1 | 2.8 | 3.5 | 4.2 | 5.1 | 5.6 | 6.3 | 7.0 | 7.7 | 8.4 | 9.1 |
| 0 | 1.4 | 2.1 | 2.8 | 3.5 | 4.3 | 4.9 | 5.6 | 6.3 | 7.0 | 7.7 | 8.4 |
| 0.5 | 0.7 | 1.4 | 2.1 | 2.8 | 3.6 | 4.2 | 4.9 | 5.6 | 6.3 | 7.0 | 7.7 |
| Nominal GDP growth (% y/y) | | | | | | | | | | | |
| 1 | 0.0 | 0.7 | 1.4 | 2.1 | 2.9 | 3.5 | 4.2 | 4.9 | 5.5 | 6.2 | 6.9 |
| 1.5 | -0.7 | 0.0 | 0.7 | 1.4 | 2.2 | 2.8 | 3.4 | 4.1 | 4.8 | 5.5 | 6.2 |
| 2 | -1.4 | -0.7 | 0.0 | 0.7 | 1.5 | 2.1 | 2.7 | 3.4 | 4.1 | 4.8 | 5.5 |
| 2.5 | -2.0 | -1.4 | -0.7 | 0.0 | 0.8 | 1.4 | 2.0 | 2.7 | 3.4 | 4.1 | 4.8 |
| 3 | -2.7 | -2.0 | -1.4 | -0.7 | 0.1 | 0.7 | 1.4 | 2.0 | 2.7 | 3.4 | 4.1 |
| 3.6 | -3.5 | -2.8 | -2.2 | -1.5 | -0.7 | -0.1 | 0.5 | 1.2 | 1.9 | 2.6 | 3.2 |
| 4 | -4.0 | -3.4 | -2.7 | -2.0 | -1.2 | -0.7 | 0.0 | 0.7 | 1.3 | 2.0 | 2.7 |
| 4.5 | -4.7 | -4.0 | -3.3 | -2.7 | -1.9 | -1.3 | -0.7 | 0.0 | 0.7 | 1.3 | 2.0 |

France

| Government Debt/GDP = 110% | Nominal interest rate paid on entire stock of debt (%) | | | | | | | | | | |
|----------------------------|--|------|-------------|------|------|------|------|-----|-----|-----|-----|
| | 1 | 1.5 | 1.9 | 2.5 | 3 | 3.5 | 4 | 4.5 | 5 | 5.5 | 6 |
| -2 | 3.4 | 3.9 | 4.4 | 5.1 | 5.6 | 6.2 | 6.7 | 7.3 | 7.9 | 8.4 | 9.0 |
| -1.5 | 2.8 | 3.4 | 3.8 | 4.5 | 5.0 | 5.6 | 6.1 | 6.7 | 7.3 | 7.8 | 8.4 |
| -1 | 2.2 | 2.8 | 3.2 | 3.9 | 4.4 | 5.0 | 5.6 | 6.1 | 6.7 | 7.2 | 7.8 |
| -0.5 | 1.7 | 2.2 | 2.7 | 3.3 | 3.9 | 4.4 | 5.0 | 5.5 | 6.1 | 6.6 | 7.2 |
| 0 | 1.1 | 1.7 | 2.1 | 2.8 | 3.3 | 3.9 | 4.4 | 5.0 | 5.5 | 6.1 | 6.6 |
| 0.5 | 0.5 | 1.1 | 1.5 | 2.2 | 2.7 | 3.3 | 3.8 | 4.4 | 4.9 | 5.5 | 6.0 |
| Nominal GDP growth (% y/y) | | | | | | | | | | | |
| 1 | 0.0 | 0.5 | 1.0 | 1.6 | 2.2 | 2.7 | 3.3 | 3.8 | 4.4 | 4.9 | 5.4 |
| 1.5 | -0.5 | 0.0 | 0.4 | 1.1 | 1.6 | 2.2 | 2.7 | 3.3 | 3.8 | 4.3 | 4.9 |
| 2 | -1.1 | -0.5 | -0.1 | 0.5 | 1.1 | 1.6 | 2.2 | 2.7 | 3.2 | 3.8 | 4.3 |
| 2.5 | -1.6 | -1.1 | -0.6 | 0.0 | 0.5 | 1.1 | 1.6 | 2.1 | 2.7 | 3.2 | 3.8 |
| 3 | -2.1 | -1.6 | -1.2 | -0.5 | 0.0 | 0.5 | 1.1 | 1.6 | 2.1 | 2.7 | 3.2 |
| 3.5 | -2.7 | -2.1 | -1.7 | -1.1 | -0.5 | 0.0 | 0.5 | 1.1 | 1.6 | 2.1 | 2.7 |
| 4 | -3.2 | -2.6 | -2.2 | -1.6 | -1.1 | -0.5 | 0.0 | 0.5 | 1.1 | 1.6 | 2.1 |
| 4.2 | -3.4 | -2.9 | -2.4 | -1.8 | -1.3 | -0.7 | -0.2 | 0.3 | 0.8 | 1.4 | 1.9 |

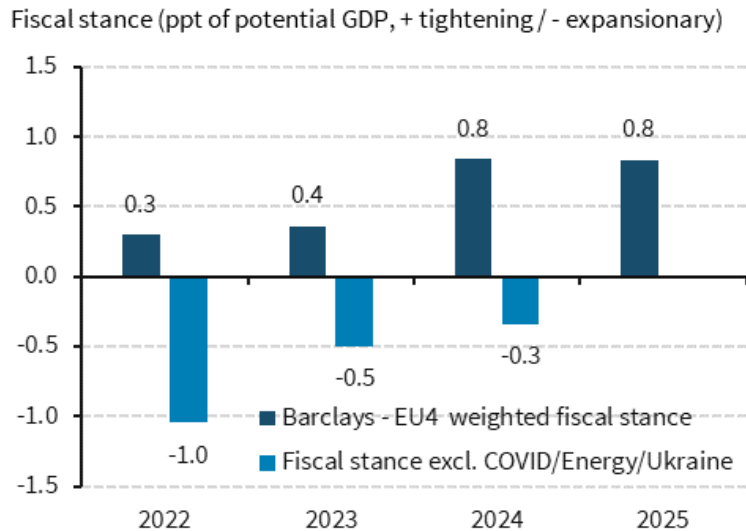
Primary Balance/GDP

| | Italy | France |
|------|-------|--------|
| 2023 | -1.4 | -3.1 |
| 2024 | -0.2 | -2.4 |

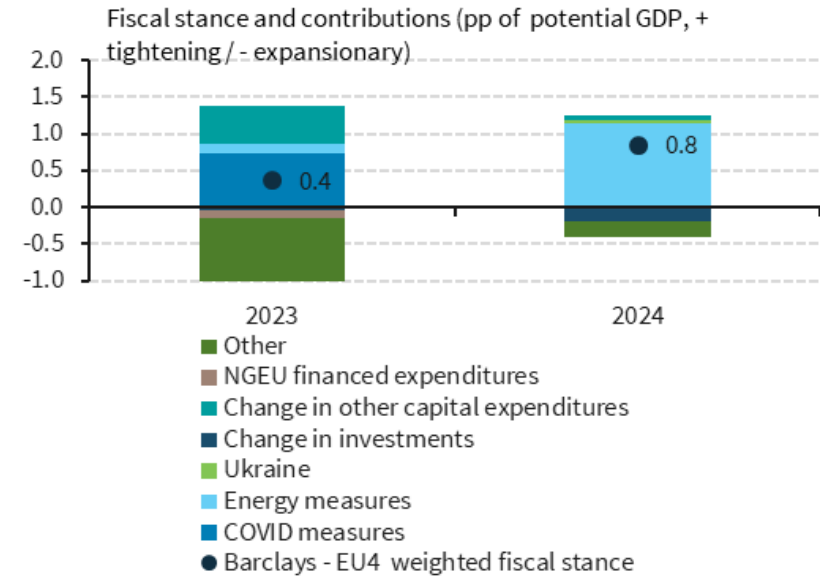
Source: Bloomberg, Eurostat, OECD. Barclays Research

EU4 fiscal stance: its composition and impact

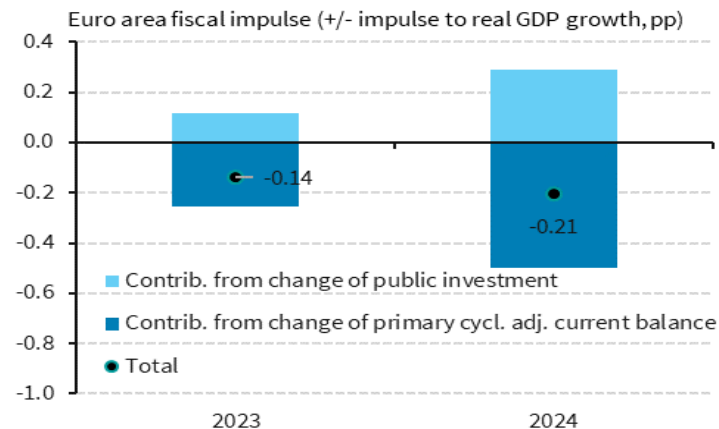
The fiscal stance still marked by...



...crisis-related measures



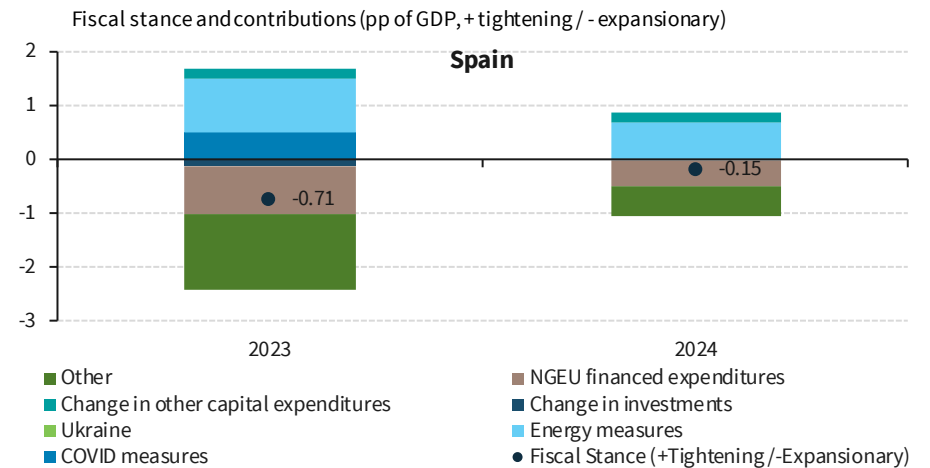
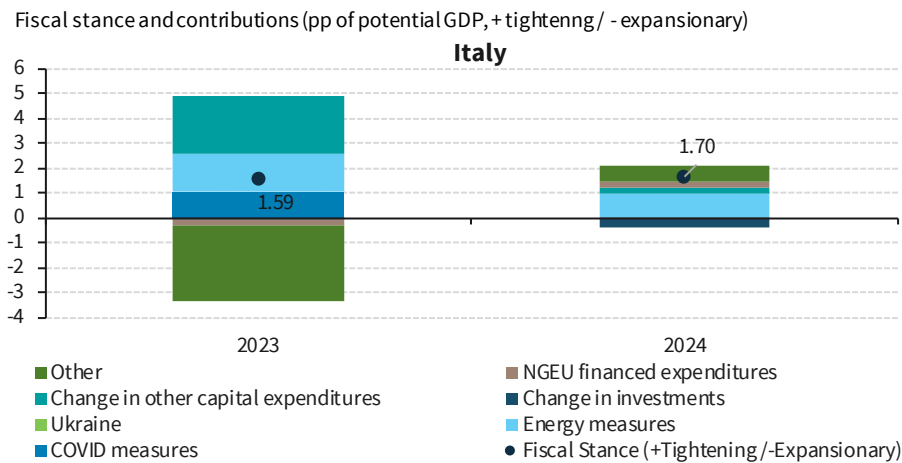
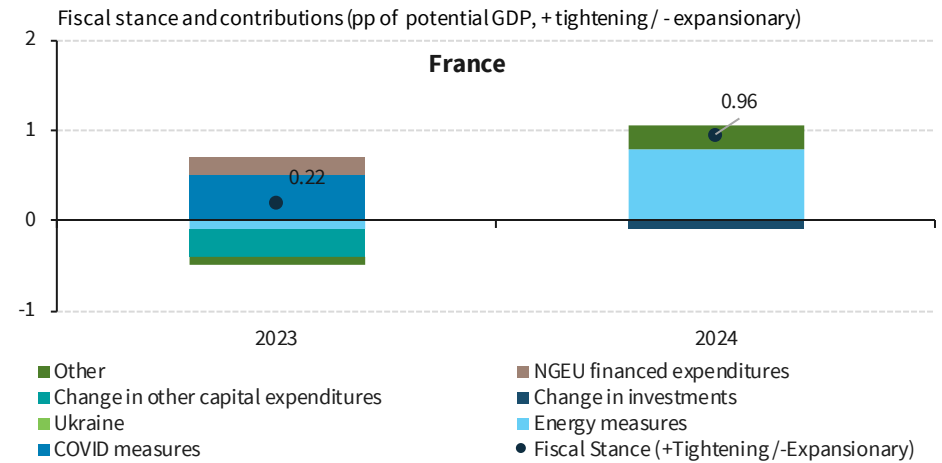
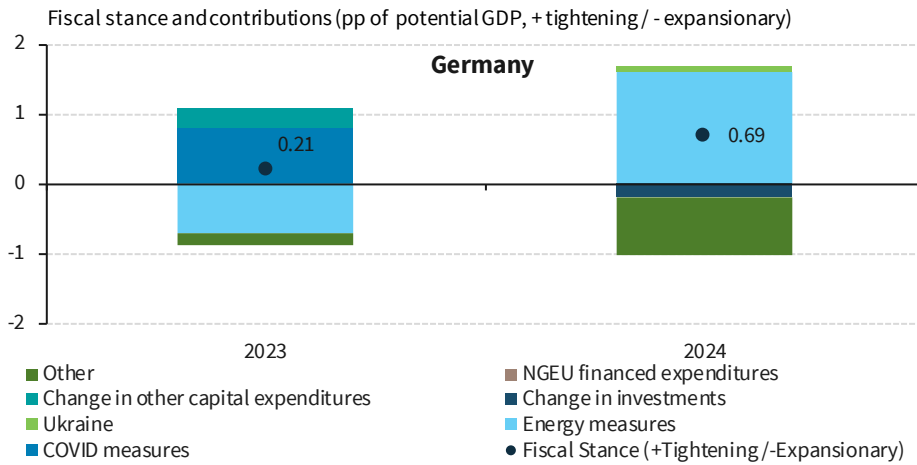
Fiscal policy will be only a very mild drag (if any) to growth



Source: Eurostat, OECD, Haver Analytics, Barclays Research

Fiscal policy outlook in EU4: unwinding crisis measures

Most of the improvement in structural primary balances are due to the “removal” of extraordinary expansionary measures taken during the pandemic and the energy crisis

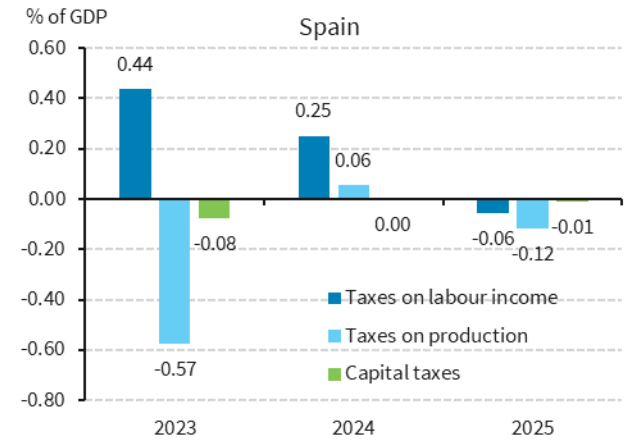
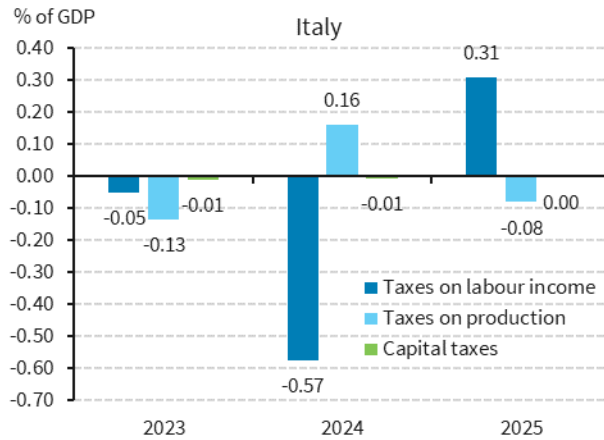
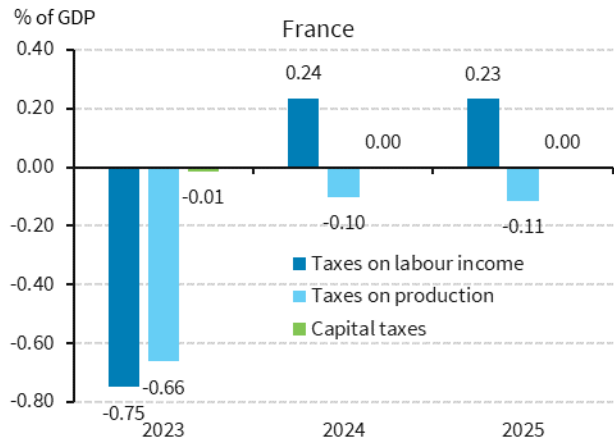


Note: Fiscal stance = change in the structural primary balance (as a % of potential GDP) accounting for the change in expenditures financed via RRF grants

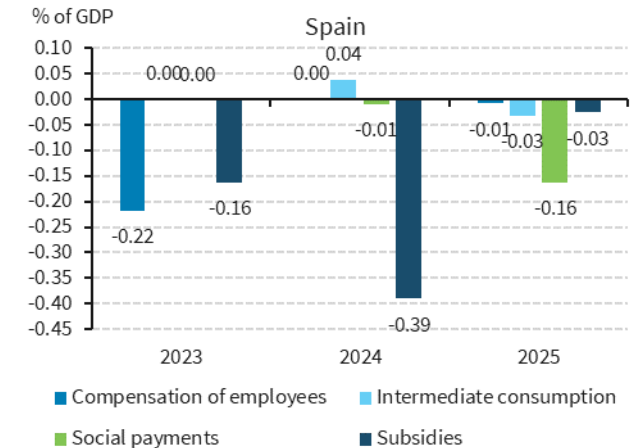
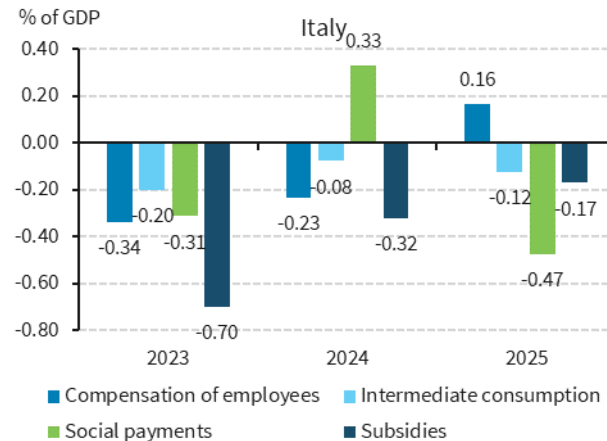
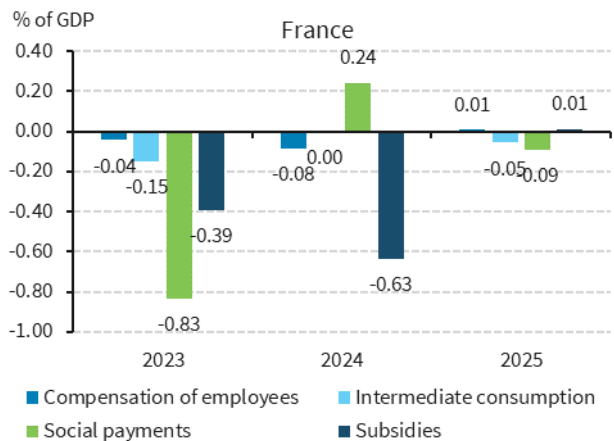
Source: Eurostat, Barclays Research

France, Italy, Spain 2023-25

Most action on taxes on labour income and...



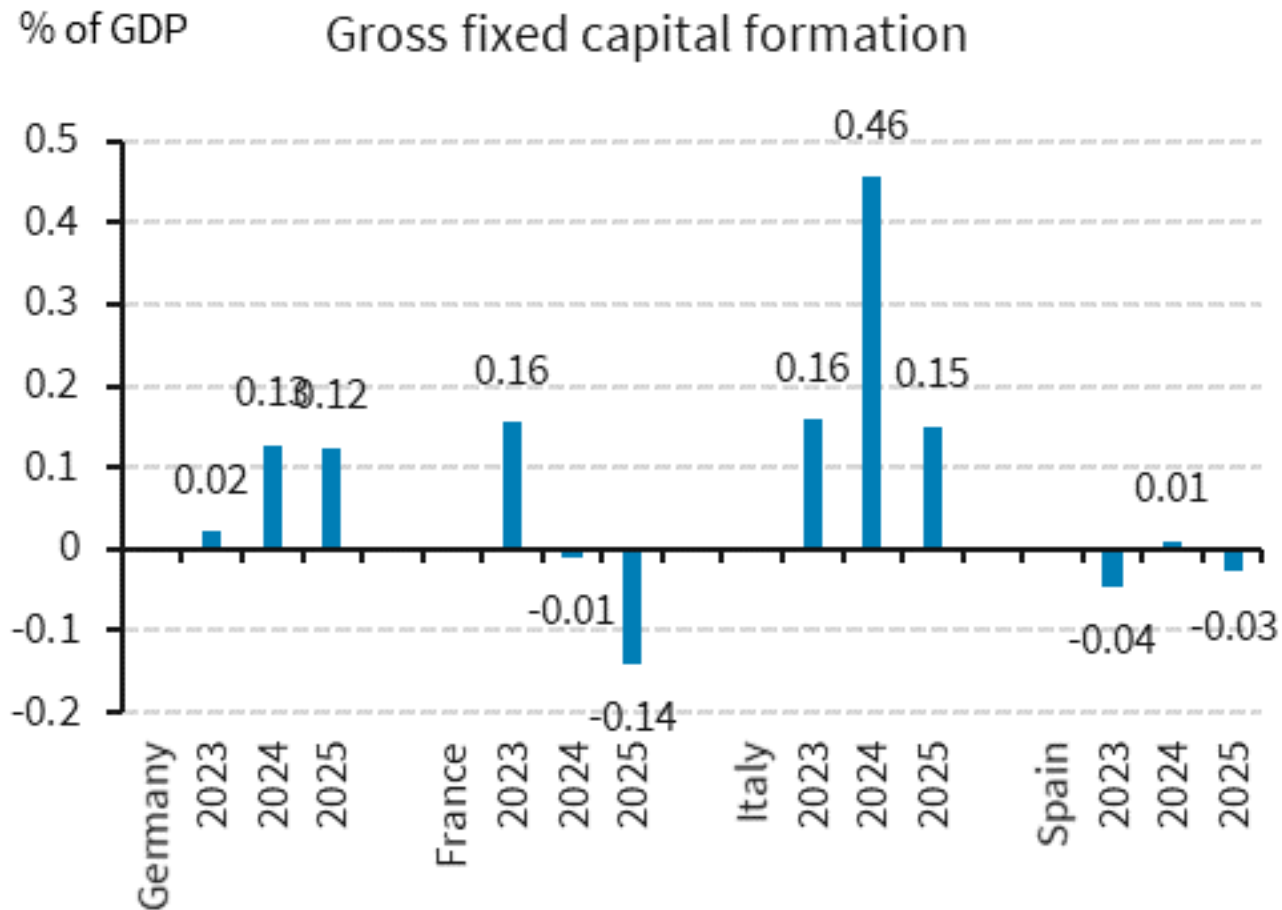
...the public sector wage bill



Source: Eurostat, OECD, Haver Analytics, Barclays Research

Public investment in EU4 2023-25

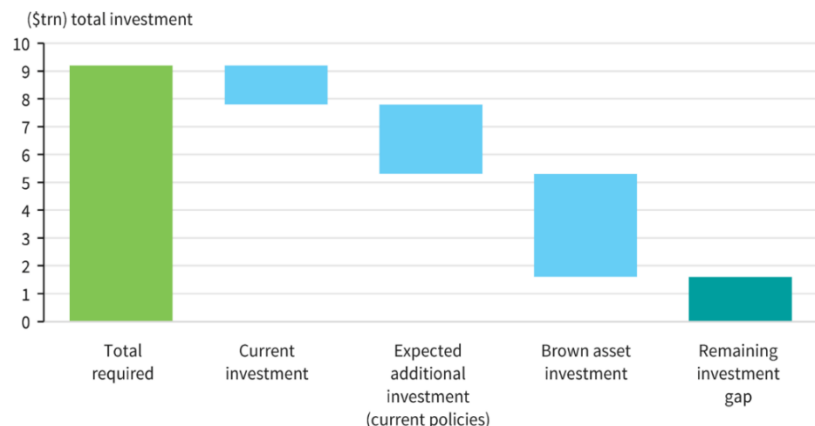
Safeguarded in most cases



Source: Eurostat, OECD, Haver Analytics, Barclays Research

Fiscal and monetary policies, green transition and assistance to Ukraine

Under McKinsey's estimate of \$9.2trn of annual investment needed to 2050 (the most extreme estimate we cite by some distance), a large gross investment gap remains, but net gains can be made by redirecting investment from 'brown' to 'green'



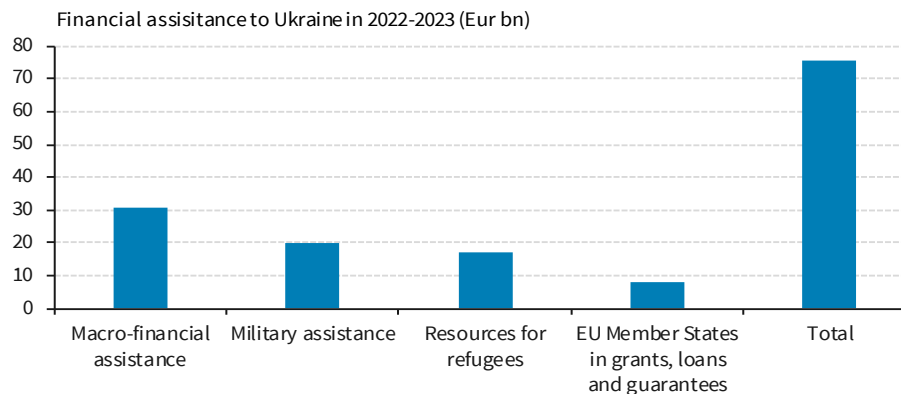
See Equity Gilt Study 2023, [The macroeconomics of the green transition](#)

Available EU public funds for Green Deal Industrial Plan (GDIP)

| Origin of funds | Amount available (2021-2027) |
|---|---|
| Remaining RRF loans | €225bn still available |
| New RRF grants | €20bn from auction of ETS allowances |
| Cohesion policy funds | €378bn, 30% dedicated to energy transition |
| • European Regional Development Fund | • €215bn |
| • European Social Fund | • €98bn |
| • Cohesion Fund | • €36.6bn |
| • Just Transition Fund | • €19.2bn |
| Connecting Europe Facility | €31.6bn |
| Innovation Fund | €38bn |
| Agricultural Fund for Rural Development | €95.5bn |
| InvestEU | €26.2bn guarantee for up to €372bn investment |
| National budgets - including state aid | - |

See Euro Themes, [A very big green deal for Europe](#)

EU financial assistance to Ukraine disbursed and budgeted as of August 2023



Source: European Commission, Barclays Research

Q2: Are major high public debt euro area countries “on track” for “success”? – Key takeaways

- Based on European Commission most recent forecasts and assessment of the Stability Programmes and Draft Budgets:
 - most of the reduction of government deficit due to unwinding of “crisis” measures;
 - in high-debt countries, it is likely that public debt-to-GDP ratios will increase further in 2024, although modestly. The reduction in the primary deficit/GDP ratio and nominal growth forecast by the European Commission might prove optimistic;
 - France, Italy, Spain: expected changes in spending and tax items of the government budgets in “ok” direction but not unusual that governments forecast spending based adjustments and deliver tax based ones.

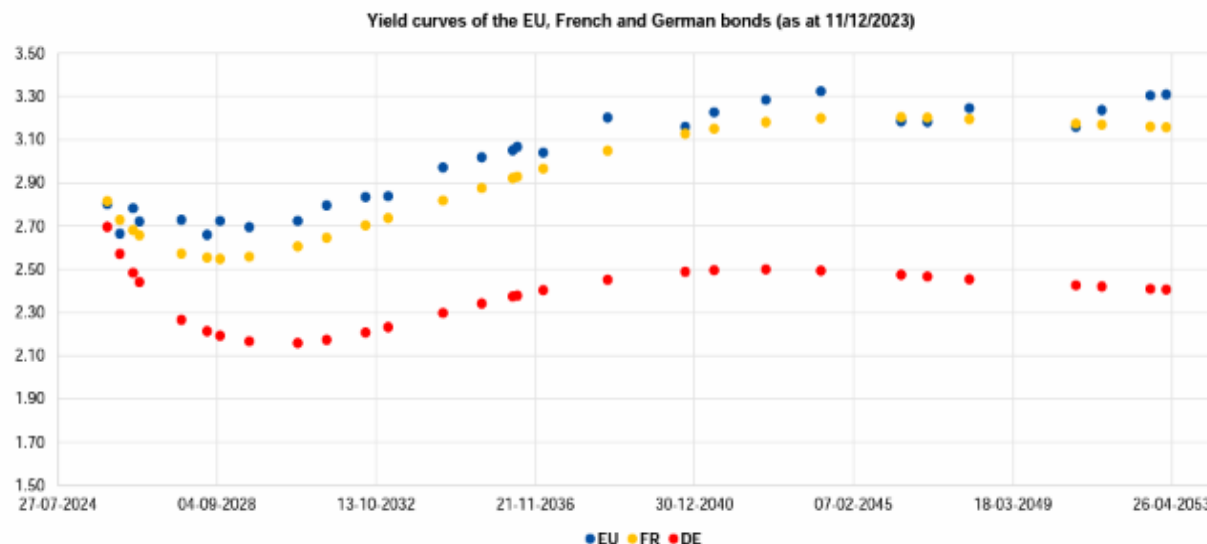
Further Q&As

What is your view on the appropriate trajectory for the euro area fiscal stance and the fiscal-monetary mix in the coming two years?

- Fiscal stance: one size does not fit all. Fiscal tightening needed to regain fiscal space and avoid fiscal crisis in high public debt countries. NO need for fiscal tightening at the EA level
 - Christina Romer @Brookings
 - Active use of fiscal policy/Automatic stabilisers?
 - Political economy of active use of fiscal policy
- Monetary stance: from restrictive to neutral (at least) needed to avoid deep recession, which would lead to inflation undershooting target.
 - What is the “new” normal? The past two years? The previous fifteen?
- Fiscal-monetary policy mix outside the ZLB and crisis times, but at times in which fiscal space is limited and cyclical/structural fiscal demands require ample fiscal space
 - Loose monetary policy helps reducing public debt/GDP ratios but it is not the only ingredient for success

Further Q&As – cont.

What are the lessons so far from issuing NGEU bonds?



Source: [European Commission](#)

- RRF up to €723.9bn (€338 grants, €385.8 loans) to be requested until August 2023. Total funds requested c.€630bn + NGEU's € 83bn contribution to other EU programmes NGEU potential issuance of €713bn. EU average annual funding needs to finance NGEU of c. €150bn per annum of which 30% issuance of NGEU Green Bonds. EU issuance between 2009-2019 cumulatively € 77.75bn. EU outstanding bonds € 443bn, majority allocated to NGEU.
- Strong demand, over-subscription to auctions, but at a premium to France.
- Liquidity premium, temporary nature of NGEU and several technical factors.
- Funding – unified single approach under a single EU-Bonds umbrella
- [EU Investor Survey results](#)

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