FISCAL POLICY TO CONTINUE TO SUPPORT EURO AREA GROWTH NEXT YEAR

In most European countries, the structural primary deficit should shrink next year. This reduction represents a negative fiscal impulse, raising concern that it would act as a headwind to growth. However, the level of the primary deficit is such that it still corresponds to an accommodative fiscal stance. Taking into account national fiscal policies as well as expenditures financed by the Recovery and Resilience Facility and other EU grants, fiscal policy in the euro area should have a significant positive impact on GDP growth next year, thereby accompanying and strengthening the ongoing recovery. In addition, it should enhance the effectiveness of the ECB's accommodative policy.

A recent working paper of the ECB concludes that *"in the current macroeconomic situation, fiscal and monetary policies reinforce each other and mutually create space for each other. This provides a strong case for coordination of the two policies in this situation."*[1]

Fiscal expansion enhances the effectiveness of monetary policy when interest rates are very low, whereas an accommodating monetary policy eases the financing constraint of the public sector. The conclusion of the research paper also reminds us that, in gauging the outlook for central bank policy, attention should be paid to fiscal policy considering its influence on growth and, indirectly, inflation.

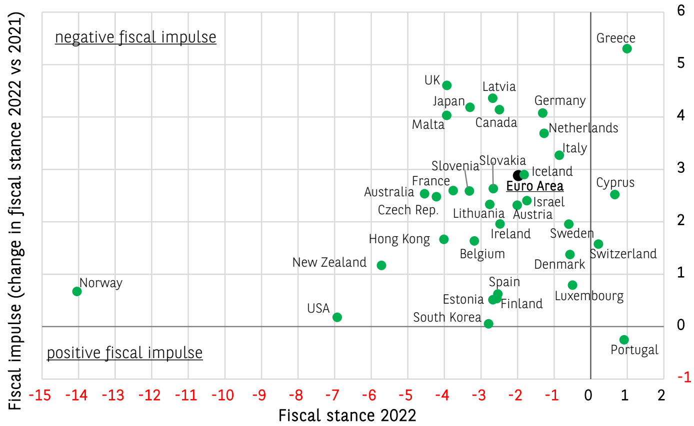
One can argue that, in normal times, this matters less because the contribution of public consumption to real GDP growth tends to be relatively stable and rather small. In the euro area, between 2016 and 2019, it has fluctuated between 0.2 and 0.4 percentage points[2]. Attention to fiscal policy matters more in times of huge fluctuations. The year 2021 has been exceptional in this respect with public consumption expected to contribute 0.8 percentage points to the growth of GDP[3]. However, next year it is forecast to drop to 0.2 percentage points, which will put the onus on private demand to keep the expansion going.

Analysing the role of fiscal policy is a complex issue and goes well beyond looking at public consumption. There is also public investment, transfers, tax revenues, etc. Interest charges are also an important factor. When debt that is maturing is refinanced at significantly lower interest rates, it may cause a decline in the overall budget deficit that is not related to any changes in terms of other expenditures or taxation, so this calls for focusing on the primary balance, the budget balance excluding interest charges. However, this is influenced by cyclical developments, due to the role of automatic stabilisers – such as lower unemployment benefits when activity picks up – so it is recommended to focus on the structural – i.e. cyclically-adjusted – primary balance.

This concept, expressed as a percentage of potential GDP, is used by the IMF and the European Fiscal Board (EFB) as the discretionary fiscal stance.[4] The fiscal impulse then corresponds to the year-on-year change in the structural primary balance. In explaining the difference between stance and impulse, the EFB makes the analogy with central

1. Krzysztof Bańkowski, Kai Christoffel and Thomas Faria, Assessing the fiscal-monetary policy mix in the euro area, ECB working paper 2623, December 2021.
2. On average, this corresponded to 14% of growth in GDP. As a reference, in 2019, in level terms, public consumption represented 20.6% of GDP. All numbers in this text are from the European Commission's Autumn Forecast (November 2021), unless stated otherwise.
3. In 2020, public consumption acted as a shock absorber in an economy hit by the pandemic. It contributed 0.3 percentage points to the change in real GDP whereas the other components all had negative contributions and real GDP contracted -5.9%. 2021 is exceptional. Real GDP is expected to expand 5.0%, on the back of a strong rebound in final demand, with an estimated contribution of public consumption 0.8 percentage points.
4. Source: European Fiscal Board, Assessment of the fiscal stance appropriate for the euro area in 2022, 16 June 2021. 'Discretionary' is used to emphasize the difference with cyclically-related fluctuations on the fiscal balance.

GENERAL GOVERNMENT CYCLICALLY ADJUSTED PRIMARY BALANCE AS % OF POTENTIAL GDP



SOURCE: IMF (FISCAL MONITOR DATABASE, OCTOBER 2021), BNP PARIBAS

> Taking into account national fiscal policies as well as expenditures financed by the Recovery and Resilience Facility and other EU grants, fiscal policy in the euro area should have a significant positive impact on GDP growth next year, thereby accompanying and strengthening the ongoing recovery. In addition, it should enhance the effectiveness of the ECB's accommodative policy.

bank policy: *"a contractionary measure such as an increase in the main refinancing rate can still be consistent with an accommodative or very accommodative monetary policy depending on the starting point."* Another way to put it is that an accommodative fiscal stance – a sizeable structural primary deficit- implies that at some point in the past, the fiscal impulse has been very positive, leading to favourable second-round effects, the so-called multiplier effect of fiscal policy. To the extent that this impulse is of a rather recent nature, it makes sense to also focus on the level of the primary balance (the fiscal stance) in assessing how past and expected policy influences the economic outlook. It can also be argued that a primary deficit implies that part of the public expenditures are financed by debt, which should be growth-supportive in comparison to running a primary surplus[5]. These considerations matter when interpreting the chart. It shows that for 2022, the fiscal stance should remain very supportive for economic activity –most countries are forecasted to have sizeable structural primary deficits- whereas the fiscal impulse is expected to be negative in most countries, thereby acting as a headwind.

However, the European Commission quite rightly emphasizes that *"in view of the exceptional circumstances triggered by the COVID-19 pandemic, the presence of sizeable transfers from the EU budget (such as those from the (RRF[6] or other EU grants), and the significant uncertainty surrounding the output gap estimates, conventional indicators such as the change in the structural budget balance or the 'expenditure benchmark' are not deemed suitable to measure the fiscal stance in the current context."*[7] For these reasons, the European Commission has developed a new measure of the fiscal stance, which includes expenditures financed at the national level as well as those financed by the RRF and other EU grants.[8] *"The difference between the change in net primary expenditure (as defined above) relative to the 10-year average potential GDP growth can then be interpreted as a measure for the overall fiscal stance."* For 2022, it expects a positive impact of nearly 1% of GDP. This is a positive development because it accompanies and strengthens the ongoing recovery. In addition, it enhances the effectiveness of the ECB's accommodative policy.

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5. This supposes that the public deficit is not causing an increase in interest rates (absence of a crowding-out effect) and that households do not associate the public deficit with a future increase in taxes (absence of Ricardian equivalence).
6. RRF stands for Recovery and Resilience Facility.
7. Source: European Commission, Communication from the Commission to the European Parliament, the Council, and the European Central Bank on the 2022 Draft Budgetary Plans: Overall Assessment, COM(2021) 900 final, 24 November 2021.
8. In this calculation, the impact of crisis-related temporary emergency measures is excluded.