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Assessment of the fiscal stance appropriate for the euro area in 2020

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European Fiscal Board

**Assessment of the
fiscal stance appropriate for the euro area in 2020**

25 June 2019

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KEY MESSAGES

For 2020, the European Fiscal Board recommends a neutral fiscal stance in the euro area, with appropriate country differentiation. We provided our advice for 2019 under the prevailing assumption that the strong growth observed until mid-2018 would continue. This has not materialised and the economy has weakened, in particular in some countries. But the central scenario for 2020 is that the economy will strengthen again. Therefore, our recommendation is a neutral fiscal stance for the euro area as a whole, with appropriate differentiation across countries. In particular, the countries that have not yet achieved their medium-term budgetary objective (MTO) need to progress towards it as required by the Stability and Growth Pact and those with very high debt need to reduce their debt steadily. By contrast, core Member States with large available fiscal space are advised to use more of it.

Economic growth in the euro area weakened in the second half of 2018. Following a string of negative growth surprises towards the end of 2018, economic activity is now expected to expand at a meagre 1.2% in 2019 on account of both external and domestic factors, according to the Commission 2019 spring forecast (Graphs 1.1 and 1.2). On the external side, a slowdown in world trade and manufacturing has substantially dampened foreign demand. Escalating trade tensions and a tightening of global financing conditions have been the main contributing factors. A number of temporary domestic factors are also at play in the largest euro area Members: a slump in the automotive sector, social protests and political uncertainty.

The outlook for domestic and external demand is expected to improve. The ongoing slowdown has been concentrated in the manufacturing sector, which is capital intensive, and therefore has had a limited impact on the labour market: net job creation is projected to continue both this year and in 2020, albeit at a slower pace, thanks to a continuing expansion in

the services sector. The unemployment rate in 2020 is forecast to fall below 7½%, the lowest level since the euro's introduction (Graph 1.3), and the ongoing tightening in the labour market is supporting wage growth and domestic demand in 2020. At the same time, global economic activity should rebound in 2020, as emerging economies are expected to benefit from improved financing conditions thanks to a more accommodative monetary policy in the United States going forward. Fiscal stimulus in a number of major economies, most notably China, will also support the global economy.

Monetary policy continues to be accommodative. Inflation is expected to remain muted throughout 2020 at around 1½% (Graph 1.4). The ECB announced in March 2019 a new series of quarterly targeted longer-term refinancing operations, starting in September 2019 and ending in March 2021, to preserve favourable bank lending conditions. On 6 June 2019, it updated its forward guidance by announcing that interest rates will remain at their present levels at least through the first half of 2020. Although lending to firms has moderated since the third quarter of 2018 due to weak growth in the latter part of 2018 and the first part of 2019 (Graph 1.5), an accommodative monetary policy stance and further improvements in financing conditions should support credit growth in 2020. Finally, after an appreciation of 3.9% in 2018, the real effective exchange rate in the euro area is expected to decline by 2.8% in 2019 and 1.3% in 2020.

Overall, economic growth in the euro area is expected to regain some momentum in the second half of 2019, with the economy operating around capacity. Thanks to resilient domestic demand, a pickup in global trade and the abating of negative country-specific factors in the largest Member States, GDP growth is expected to pick up at 1.5% in 2020, according to the Commission (Graph 1.1). Similarly, other main forecasters expect growth to be in a range

of 1.3% to 1.5%. This is broadly in line with current estimates of potential growth. Conventional measures of the output gap, from the European Commission, the IMF and the OECD, continue to indicate that the euro area is operating broadly at capacity (Graph 1.6). Despite a still subdued inflation rate, robust nominal wage growth supports this assessment (Graph 1.7).

However, the economic outlook is subject to significant downside risks. The forecasts for 2019 and 2020 have been progressively revised downward (Graph 1.8), and further negative surprises are possible. A flare-up of further trade tensions between the United States and China, and between the US and the EU, would adversely affect external demand and investment. The outlook for external demand is further subject to the risk of a weaker-than-expected recovery of emerging economies, particularly China. Substantial uncertainty also remains around an orderly withdrawal of the United Kingdom from the EU. On the domestic front, a prolonged phase of high sovereign yields in high-debt countries could generate further stress for the banking sector, and lead to a tightening of credit conditions. On the upside, however, business confidence may be more resilient to trade tensions than is currently assumed, and domestic headwinds may dissipate faster than expected. Internal demand could therefore prove stronger than anticipated.

All Member States are expected to benefit from the economic expansion in 2020, but important differences persist. The growth outlook across the euro area is less uneven than in the past (Graph 1.9). Some country-specific weaknesses, however, remain: at 0.7%, economic growth in Italy is expected to be less than half the euro area average in 2020. On the other hand, Ireland, Malta and Slovakia are expected to grow more than twice as fast as the rest of the euro area. The unemployment rate for next year is also expected to remain highly uneven, spanning from 2.7% in Germany to 16.8% in Greece. In particular, unemployment

in Greece, Spain and Italy is expected to remain above pre-crisis levels (Graph 1.10).

The budget deficit in the euro area is set to remain stable at 0.9% of GDP, as deficit-reducing factors are expected to be offset by policy measures. Three factors are expected to support a deficit reduction on aggregate. First, economic conditions should help improve the budget balance, albeit only marginally (Graph 2.1). Second, interest payments are set to decline further, although less than in previous years. Member States can therefore benefit from these first two factors to improve their budget balances, but to a much lesser extent than what was observed in 2014-2018. Third, expenditure-increasing one-off measures in 2019 are coming to an end in 2020. Overall, the three factors would entail a reduction of the nominal deficit by 0.3% of GDP in 2020 if they were not offset by new deficit-increasing discretionary measures. With the exception of Italy, all euro area Member States are forecast to keep their deficit below the 3% of GDP reference value in 2020 (1).

Based on announced policies, in 2020 the euro area fiscal stance is expected to be on the expansionary side. Taking into account only the fiscal measures that Member States have already adopted or sufficiently documented, the structural primary balance is expected to deteriorate by 1/3 of a percent of GDP on aggregate. Consistent with this, net expenditure – i.e. primary government expenditure net of certain items outside the control of government and net of revenue measures – is expected to grow faster than potential GDP, leading to a weakening of fiscal situations (Graph 2.4). In an economy expected to operate at or above capacity, such a stance could turn out mildly pro-cyclical (Graph 2.2).

(1) The Commission forecast does not take into account the VAT hike in Italy already legislated as a safeguard clause, as in past years governments found ways to render the hike ineffective. This assumption has an impact on the Commission forecast for the deficit and the debt.

While the expected change in the structural primary balance is limited, it is somewhat outside the normal margins of uncertainty. Moreover, a clear differentiation across countries is warranted.

In some countries, public debt remains very high and is hardly declining, due to expansionary fiscal policies. Debt ratios are expected to decline – benefiting from the favourable combined effect of growth and interest rates – in all euro area countries except Italy, where debt is likely to reach 135% of GDP according to the Commission forecast ⁽²⁾ (Graph 2.5). Sustainability also remains an issue in other countries where the debt ratio is close to or above 100% of GDP: Belgium, Greece, Spain, France and Portugal. Yet, these countries are expected to account for a large share of the projected fiscal expansion in 2020 (Graphs 2.6 and 2.8), as they already do in 2019 (Graph 2.7).

A neutral fiscal stance for the euro area can be achieved by combining consolidation and use of fiscal space at the country level.

Under the baseline scenario of a soft growth patch in 2019 and an economic pickup in 2020, the euro area as a whole does not need any discretionary support from fiscal policy in 2020. Automatic stabilisers can take care of limited growth surprises. At the country level, the Stability and Growth Pact provides a sound basis for national fiscal stances (Graph 2.9). In case of a severe downturn in the euro area or the EU as a whole, the Pact includes some provisions for additional margins. However, as we pointed out in our June 2018 report, lacking a central fiscal capacity, the current framework is not equipped to significantly mitigate the impact of such events.

- Countries that have not achieved their MTO (Belgium, Estonia, Ireland, Spain, France, Italy, Latvia, Portugal, Slovenia, Slovakia and Finland) should improve their underlying position as required by the Pact. Countries with a very high debt – Italy, in

particular – need to bring debt on a firm downward path. By building fiscal buffers, these countries would also be better prepared to face future downturns.

- It is estimated that seven countries will overachieve their MTO in 2019 and thus have available fiscal space for 2020 (Germany, Greece, Cyprus, Luxembourg, Malta, the Netherlands and Austria); it is estimated that Lithuania will be at its MTO in 2019. It is currently estimated that among the seven, two of the largest euro area economies, Germany and the Netherlands, will be above their MTO in 2019 by more than 1% of GDP. Both the favourable environment of very low interest rates and weaker economic activity suggest that it would be timely for these countries to use at least part of their available fiscal space in 2020, in particular to increase spending on investment and enhance potential growth. This may also have positive spillover effects on countries that are fiscally constrained.

Budgetary trends need adjustment to achieve the appropriate country mix.

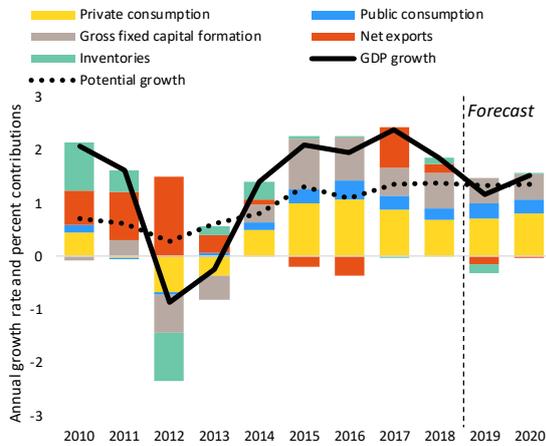
Based on currently adopted measures, which do not yet include the 2020 budget laws, a vast majority of countries needing to consolidate will not do so adequately. Some are even expected to go in the opposite direction (Belgium, Spain, Italy, Portugal and Slovakia), resulting in a more expansionary aggregate fiscal stance than allowed by the Pact (Graphs 2.10 and 2.11). This requires correction. As for overachievers, the Netherlands is expected to make a significant use of its available fiscal space in 2020. In Germany, the use of fiscal space is expected to be more limited than in the Netherlands and also more limited than in 2019.

⁽²⁾ See footnote 1.

1. THE MACROECONOMIC OUTLOOK

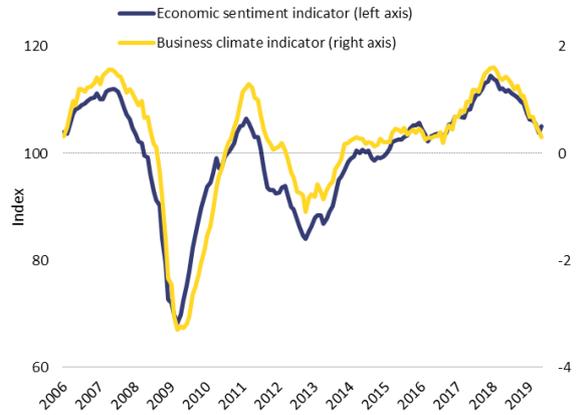
After a soft patch in 2019, growth in the euro area is expected to pick up in 2020. While economic conditions across Member States differ less than in the past, weaknesses remain in a number of Member States.

Graph 1.1: GDP growth and contributions, euro area



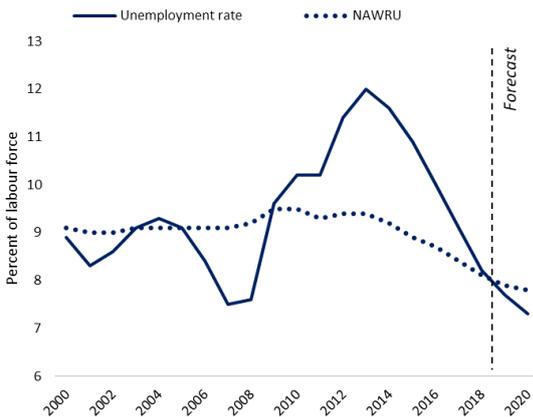
Source: European Commission.

Graph 1.2: Economic survey indicators, euro area



Source: European Commission.

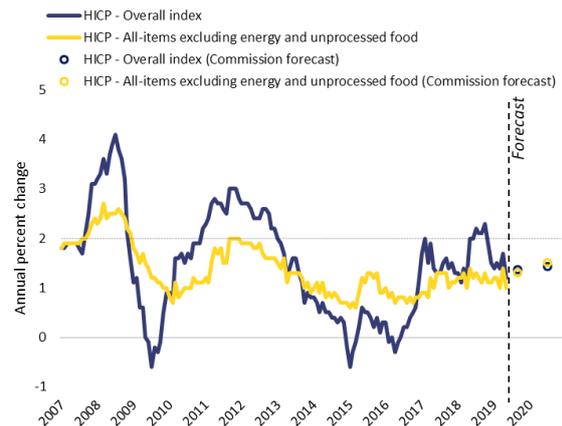
Graph 1.3: Unemployment rate, euro area



Source: European Commission.

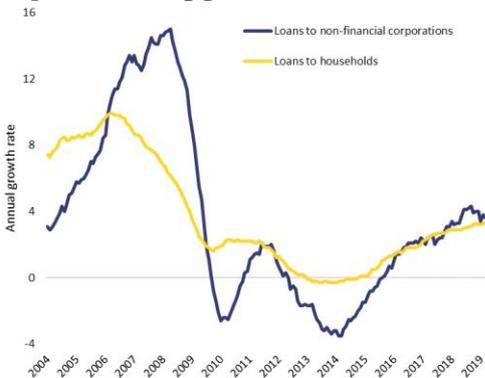
Note: NAWRU refers to the non-accelerating wage rate of unemployment.

Graph 1.4: Inflation rate, euro area



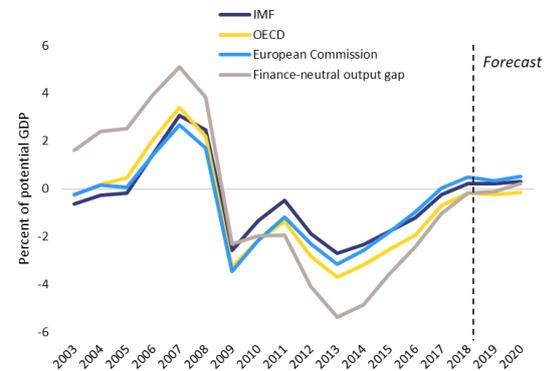
Source: European Central Bank.

Graph 1.5: Lending growth, euro area



Source: European Central Bank.

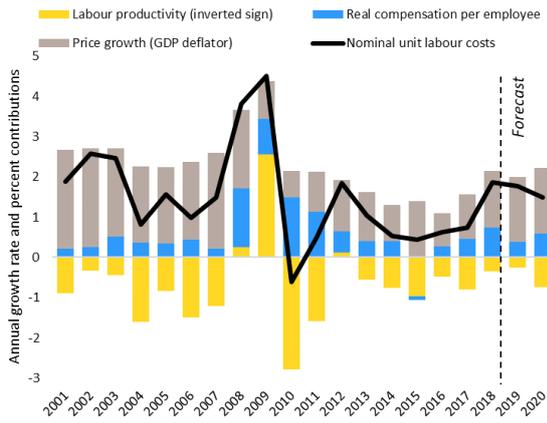
Graph 1.6: Output gap, euro area



Source: European Commission, OECD, IMF.

Note: The finance-neutral output gap is derived from an extended HP filter that takes into account short-term real interest rates, credit growth and house price inflation.

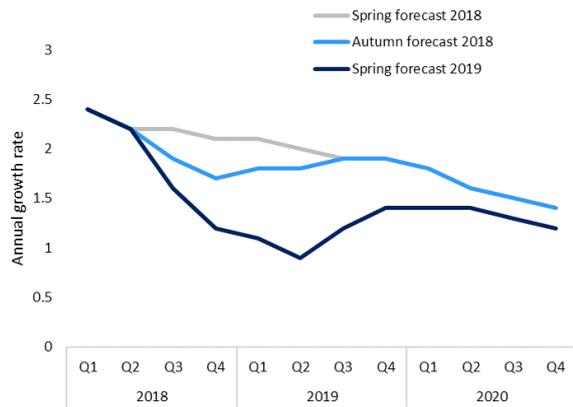
Graph 1.7: Unit labour costs, euro area



Source: European Commission.

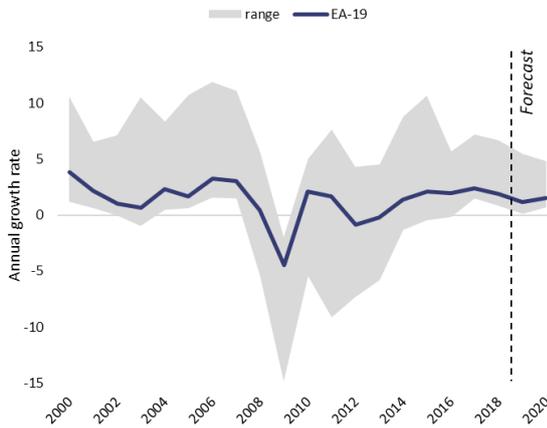
Note: Nominal unit labour costs are the ratio between nominal compensation per employee and output per employee; nominal compensation is the product of real compensation and the GDP deflator.

Graph 1.8: GDP growth across vintages, euro area



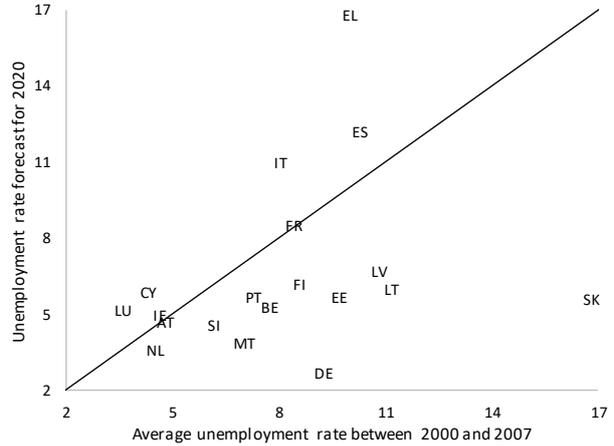
Source: European Commission.

Graph 1.9: Growth dispersion in the euro area



Source: European Commission, European Fiscal Board calculations.

Graph 1.10: Unemployment across Member States

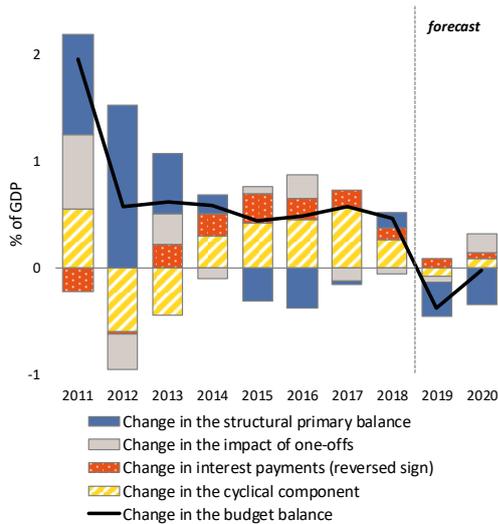


Source: European Commission, European Fiscal Board calculations.

2. FISCAL POLICY DEVELOPMENTS

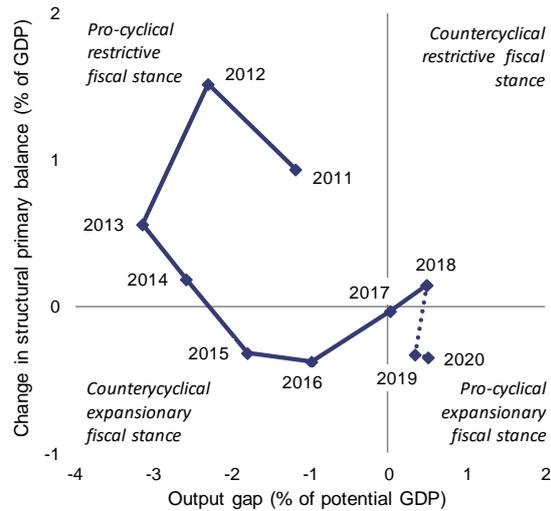
The aggregate budget balance is set to remain unchanged in 2020, as the pro-cyclical expansionary fiscal stance offsets deficit-reducing factors. Net expenditure continues to grow faster than potential GDP. High-debt countries account for a large share of the expected fiscal expansion. For many countries, there is no need for discretionary fiscal stabilisation, while sustainability challenges remain. In several countries, the measures currently adopted or sufficiently described for 2020 are far from adequate to ensure compliance with fiscal requirements; compliance is not ensured at the aggregate level either. Some of the available fiscal space is being used.

Graph 2.1: Drivers of the change in the general government budget balance; euro area aggregate



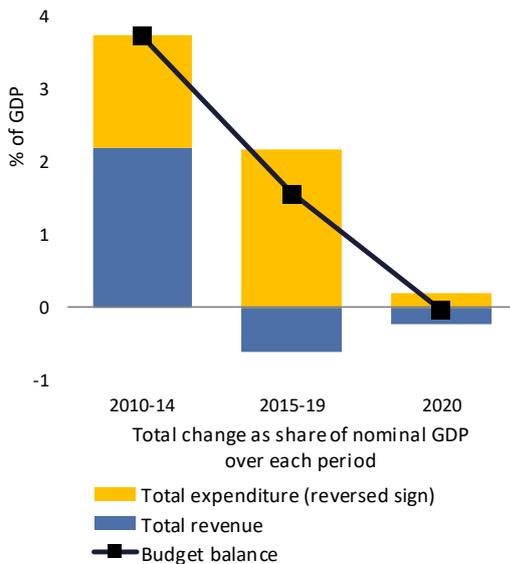
Source: European Commission, European Fiscal Board calculations.
Notes: (1) The forecast for 2020 does not yet include the draft budgetary plans of euro area Member States. (2) A decrease in interest payments is shown as an improvement in the headline balance.

Graph 2.2: Fiscal stance in the euro area



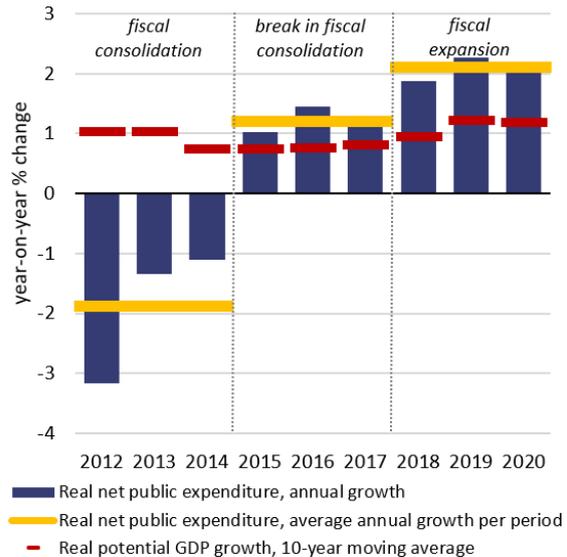
Source: European Commission, European Fiscal Board calculations.
Note: The forecast for 2020 does not yet include the draft budgetary plans of euro area Member States.

Graph 2.3: Government revenue and expenditure; euro area aggregate



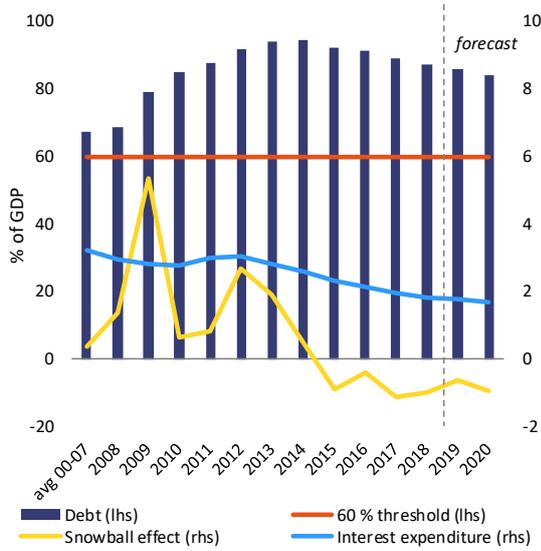
Source: European Commission, European Fiscal Board calculations.
Note: The forecast for 2020 does not yet include the draft budgetary plans of euro area Member States.

Graph 2.4: Net government expenditure growth; euro area aggregate



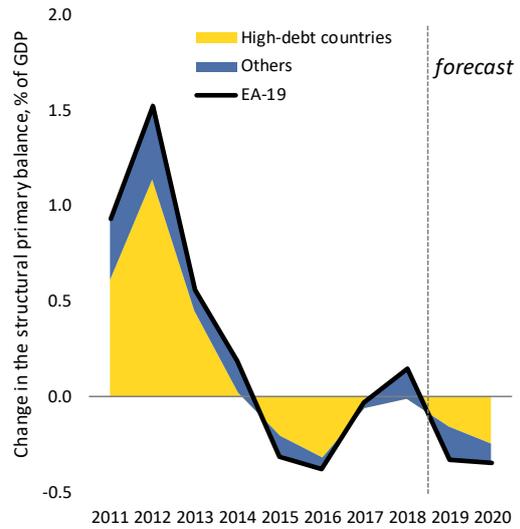
Source: European Commission, European Fiscal Board calculations.
Note: (1) For the definition of net expenditure, see the glossary. (2) The forecast for 2020 does not yet include the draft budgetary plans of euro area Member States.

Graph 2.5: Government debt developments; euro area aggregate



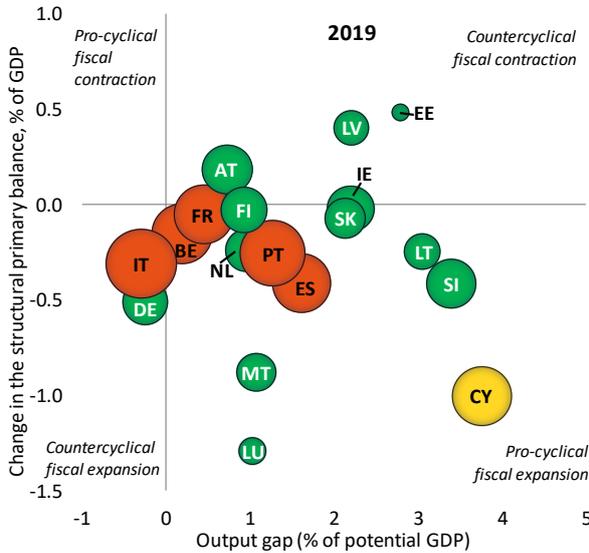
Source: European Commission, European Fiscal Board calculations.
Notes: (1) The forecast for 2020 does not yet include the draft budgetary plans of euro area Member States. (2) The snowball effect measures the combined effect of interest expenditure and nominal GDP growth on the debt-to-GDP ratio.

Graph 2.6: Contributions of countries to the aggregate fiscal stance



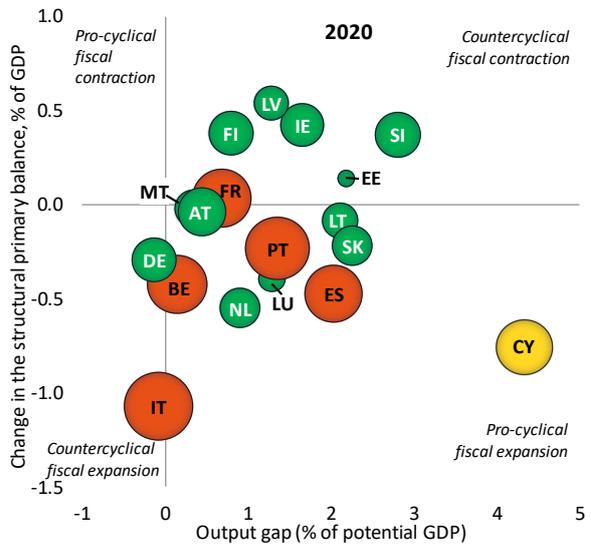
Source: European Commission, European Fiscal Board calculations.
Notes: (1) High-debt countries: Belgium, Greece, Spain, France, Italy, Cyprus and Portugal. Others: the remaining countries of the euro area. (2) The forecast for 2020 does not yet include the draft budgetary plans of euro area Member States.

Graph 2.7: Fiscal stance, cyclical conditions and sustainability in euro area Member States in 2019



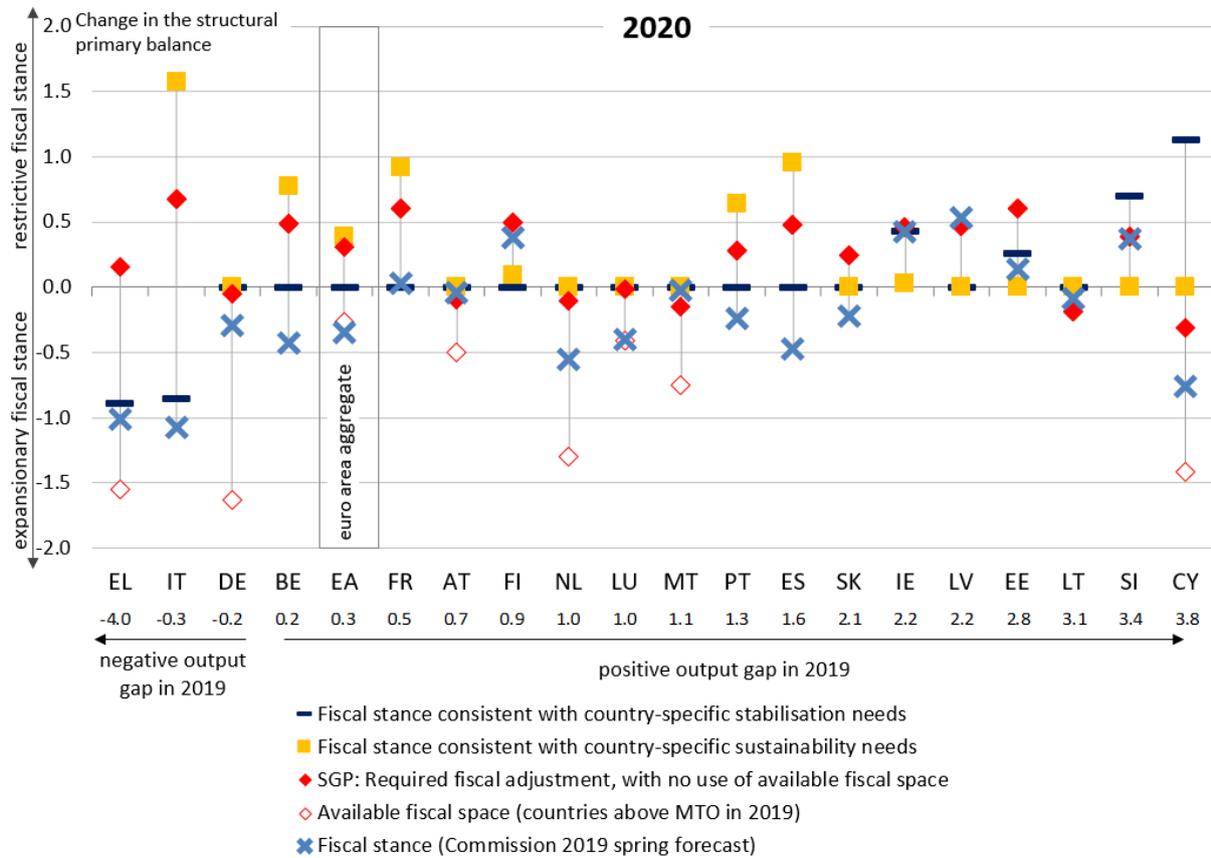
Source: European Commission, European Fiscal Board calculations.
Notes: (1) The size of bubbles reflects the ratio of government debt to GDP. (2) The colours indicate medium-term sustainability risks: red = high; yellow = medium; green = low, as measured by the Commission's S1 indicator and debt sustainability analysis. (3) Greece: output gap: -4.0% of GDP; change in SPB: -2.9% of GDP.

Graph 2.8: Fiscal stance, cyclical conditions and sustainability across euro area Member States in 2020



Source: European Commission, European Fiscal Board calculations.
Notes: (1) The size of bubbles reflects the ratio of government debt to GDP. (2) The colours indicate medium-term sustainability risks: red = high; yellow = medium; green = low, as measured by the Commission's S1 indicator and debt sustainability analysis. (3) Greece: output gap: -1.9% of GDP; change in SPB: -1.0% of GDP. (4) The forecast for 2020 does not yet include the draft budgetary plans of euro area Member States.

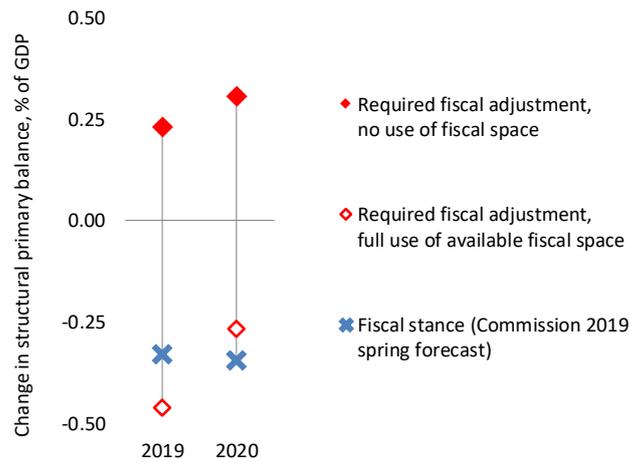
Graph 2.9: Overview: expected national and aggregate fiscal stances, fiscal requirements, stabilisation and sustainability



Source: European Commission, European Fiscal Board calculations.

Notes: (1) Countries are ordered by increasing level of output gap in 2019. (2) Stabilisation: a neutral fiscal stance (i.e. letting automatic fiscal stabilisers operate without any additional discretionary measures) is appropriate when the output gap recently changed signs or is expected to narrow at a sufficient pace. If not, the stabilisation point shows the fiscal stance consistent with a reduction of the output gap by 25% (50% in the case of Greece) compared to its 2019 level, using a uniform fiscal multiplier of 0.8. (3) Sustainability needs are assessed using the Commission's S1 indicator. S1 measures the total cumulative adjustment needed in 2019-2023 to bring the debt-to-GDP ratio to 60% by 2033. For countries where S1 is positive, we assume that sustainability needs are addressed by implementing S1 in a uniform manner over 5 years, i.e. one fifth of S1 is implemented in 2020. (4) In countries where S1 is negative, debt is already below 60% of GDP or expected to decline below it by 2033, therefore no additional consolidation is needed. (5) The Commission has not published S1 for Greece based on its 2019 spring forecast. (6) For consistency, the fiscal requirements (diamonds) are recalculated in terms of change in the structural primary balance, while in official documents they are formulated in terms of change in the structural balance. (7) Required fiscal adjustment, no use of fiscal space where available: Member States implement the structural adjustment required under the Stability and Growth Pact, including the leeway granted ex ante for 2019 under the flexibility clauses in the preventive arm or carried over from previous years for Belgium, Latvia, Lithuania, Austria and Finland. Member States that have achieved their MTO keep their structural balance unchanged. (8) A country has available fiscal space in 2020 if its structural balance in 2019 is above its MTO. (9) The forecast for 2020 does not yet include the draft budgetary plans of euro area Member States.

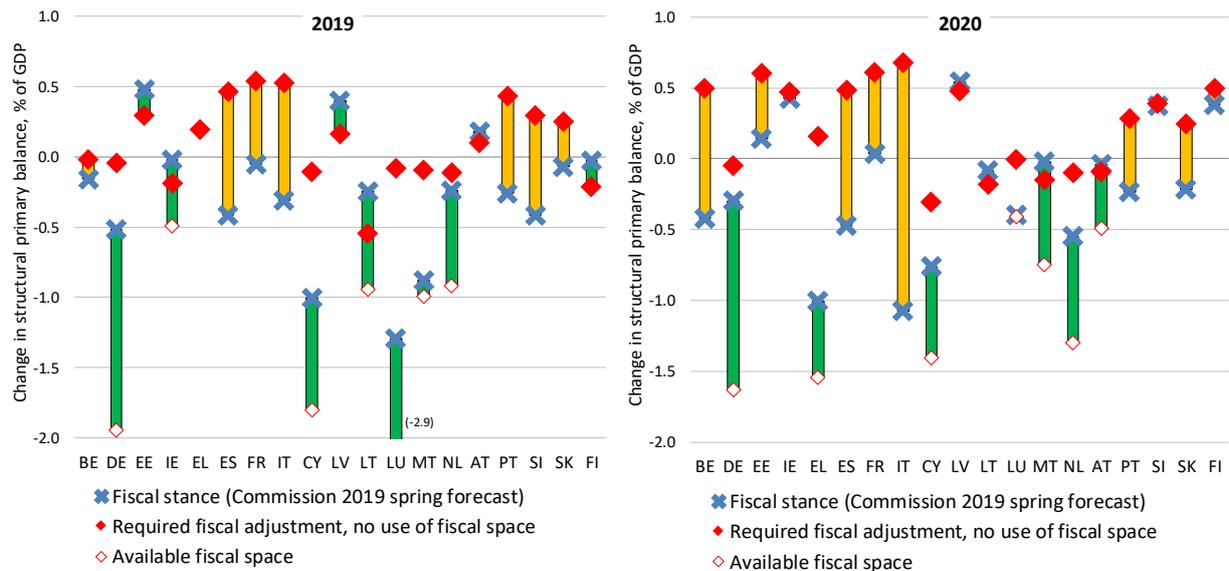
Graph 2.10: Euro area fiscal stance – current projections and Stability and Growth Pact requirements



Source: European Commission, European Fiscal Board calculations.

Notes: (1) A country has available fiscal space in 2020 if its structural balance in 2019 is above its MTO. (2) Required fiscal adjustment, no use of fiscal space: countries implement the structural adjustment required under the Stability and Growth Pact, including the leeway granted under the flexibility clauses in the preventive arm. Countries that have achieved their MTO keep their structural balance unchanged. (3) Required fiscal adjustment, full use of available fiscal space: same as above, except that countries that have overachieved their MTO in 2019 return to it in 2020. (4) The forecast for 2020 does not yet include the draft budgetary plans of euro area Member States. (5) For consistency, the fiscal requirements (diamonds) are recalculated in terms of change in the structural primary balance, while in official documents they are formulated in terms of change in the structural balance.

Graph 2.11: Expected national fiscal stances and Stability and Growth Pact requirements



Source: European Commission, European Fiscal Board calculations.

Notes: (1) Required fiscal adjustment, no use of fiscal space: Member States implement the structural adjustment required under the Stability and Growth Pact, including the leeway granted ex ante under the flexibility clauses in the preventive arm or carried over from previous years (in 2019: Belgium, Latvia, Lithuania, Austria and Finland). Member States that have over-achieved their MTO keep their structural balance unchanged. (2) A country has available fiscal space in 2020 if its structural balance in 2019 is above its MTO. (3) The green bars indicate that the expected fiscal stance is in line with (or more restrictive than) the required change in the structural balance, the yellow bars indicate that it is not. (4) The forecast for 2020 does not yet include the draft budgetary plans of euro area Member States. (5) For consistency, the fiscal requirements (diamonds) are recalculated in terms of change in the structural primary balance, while in official documents they are formulated in terms of change in the structural balance. (6) Possible unusual event clauses for 2019 (including for Italy, which has requested an allowance of 0.2% of GDP) need to be confirmed in spring 2020 and are therefore not included in this graph. (7) Greece in 2019: available fiscal space: -4.0% of GDP, change in SPB: -2.9% of GDP.

Key indicators for the euro area

Output		LTA⁽¹⁾	2015	2016	2017	2018	18Q1	18Q2	18Q3	18Q4	19Q1
Economic sentiment	<i>Indicator</i>	100.6	103.2	104.1	110.1	111.2	113.2	111.8	110.9	108.9	106.0
Gross domestic product	<i>% ch. on prev. period</i>						0.4	0.4	0.1	0.2	0.3
	<i>% ch. on prev. year</i>	1.6	2.1	2.0	2.4	1.9	2.4	2.2	1.6	1.2	1.1
Labour productivity	<i>% ch. on prev. period</i>						-0.1	0.0	-0.1	-0.1	0.1
	<i>% ch. on prev. year</i>	0.8	1.0	0.6	0.8	0.3	0.8	0.5	0.2	-0.2	-0.1
Private consumption		LTA⁽¹⁾	2015	2016	2017	2018	18Q1	18Q2	18Q3	18Q4	19Q1
Consumer confidence	<i>Balance⁽²⁾</i>	-10.0	-7.8	-8.1	-5.4	-4.9	-3.6	-4.7	-5.1	-6.4	-7.0
Retail confidence	<i>Balance⁽²⁾</i>	-8.0	1.2	0.6	2.3	1.3	3.0	0.5	1.8	-0.3	-1.0
Private consumption	<i>% ch. on prev. period</i>						0.5	0.2	0.1	0.2	
	<i>% ch. on prev. year</i>	1.3	1.8	2.0	1.6	1.3	1.7	1.4	1.0	1.0	
Retail sales	<i>% ch. on prev. period</i>						0.1	0.9	0.0	0.7	0.8
	<i>% ch. on prev. year</i>	0.9	2.9	1.6	2.5	1.6	1.6	1.9	1.2	1.7	2.3
Investment		LTA⁽¹⁾	2015	2016	2017	2018	18Q1	18Q2	18Q3	18Q4	19Q1
Capacity utilisation	<i>Level (%)</i>	81.2	81.2	81.6	83.0	83.9	83.8	83.8	84.0	83.6	83.2
Production expectations (manufacturing)	<i>Balance⁽²⁾</i>	6.7	8.0	7.7	16.5	16.1	17.9	16.9	15.6	14.1	8.8
Gross fixed capital formation	<i>% ch. on prev. period</i>						0.0	1.5	0.5	1.3	
	<i>% ch. on prev. year</i>	1.6	3.1	4.5	2.6	3.0	3.3	2.8	3.4	3.5	
- equipment investment	<i>% ch. on prev. period</i>						-0.3	2.3	0.4	0.5	
	<i>% ch. on prev. year</i>		5.1	5.5	5.6	4.8	5.7	6.3	4.9	2.8	
- construction investment	<i>% ch. on prev. period</i>						2.9	1.4	0.2	0.8	
	<i>% ch. on prev. year</i>		0.3	2.4	5.4	5.6	5.8	6.4	4.7	5.5	
Change in stocks	<i>Contrib. to GDP (pp)</i>	0.0	0.0	-0.1	0.0	0.1	0.2	-0.1	0.4	-0.4	
Labour market		LTA⁽¹⁾	2015	2016	2017	2018	18Q1	18Q2	18Q3	18Q4	19Q1
Employment expectations (manufacturing)	<i>Balance⁽²⁾</i>	-9.6	-2.3	-1.3	7.6	9.1	11.0	10.0	8.1	7.4	3.4
Employment expectations (services)	<i>Balance⁽²⁾</i>	5.6	5.8	8.1	11.1	13.0	13.9	14.0	12.6	11.5	9.8
Employment	<i>% ch. on prev. period</i>						0.4	0.4	0.2	0.3	0.3
	<i>% ch. on prev. year</i>	0.8	1.0	1.3	1.6	1.5	1.6	1.6	1.4	1.3	1.3
Employment (000)	<i>ch. on prev. period</i>		1510	2027	2469	2348	676	616	385	465	543
Compensation of employees (per head, nominal)	<i>% ch. on prev. period</i>						0.5	0.6	0.7	0.4	
	<i>% ch. on prev. year</i>	2.0	1.6	1.5	1.6	2.3	2.0	2.2	2.6	2.3	
Unemployment rate	<i>% of lab. force</i>		10.9	10.0	9.1	8.2	8.5	8.3	8.0	7.9	7.8
Unemployment (000)	<i>ch. on prev. period</i>		-1518	-1139	-1493	-1372	-266	-414	-349	-156	-231
International transactions		LTA⁽¹⁾	2015	2016	2017	2018	18Q1	18Q2	18Q3	18Q4	19Q1
World trade	<i>% ch. on prev. period</i>						0.9	0.2	1.3	-0.9	
	<i>% ch. on prev. year</i>		2.0	1.5	4.7	3.4	4.2	3.8	3.9	1.6	
Export order books	<i>Balance⁽²⁾</i>	-17.8	-10.7	-11.4	-1.4	1.2	3.5	2.9	1.1	-2.6	-7.3
Trade balance (merchandise)	<i>Billion EUR</i>		238.6	265.0	239.4	194.5	56.7	50.8	41.6	44.5	
Exports of goods and services	<i>% ch. on prev. period</i>						-0.7	1.1	0.2	1.2	
	<i>% ch. on prev. year</i>	5.0	6.2	3.4	5.2	3.1	3.9	4.0	2.8	1.9	
Imports of goods and services	<i>% ch. on prev. period</i>						-0.5	1.3	1.1	1.1	
	<i>% ch. on prev. year</i>	4.7	6.5	4.8	3.9	3.1	2.8	2.7	3.6	3.2	
Prices		LTA⁽¹⁾	2015	2016	2017	2018	18Q1	18Q2	18Q3	18Q4	19Q1
Headline inflation (HICP)	<i>% ch. on prev. year</i>		0.0	0.2	1.5	1.8	1.3	1.7	2.1	1.9	1.4
Core inflation	<i>% ch. on prev. year</i>		0.9	0.9	1.1	1.2	1.2	1.2	1.2	1.2	1.1
Monetary and financial indicators		LTA⁽¹⁾	2015	2016	2017	2018	18Q1	18Q2	18Q3	18Q4	19Q1
Nominal interest rates (3-month)	<i>Level</i>		-0.02	-0.26	-0.33	-0.32	-0.33	-0.33	-0.32	-0.32	-0.31
Nominal interest rates (10-year)	<i>Level</i>		0.63	0.18	0.37	0.46	0.61	0.48	0.37	0.37	0.12
ECB repo rate	<i>Level</i>		0.1	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Bilateral exchange rate EUR/USD	<i>Level</i>		1.11	1.11	1.13	1.18	1.23	1.19	1.16	1.14	1.14
	<i>% ch. on prev. period</i>						4.3	-3.1	-2.3	-1.9	-0.5
	<i>% ch. on prev. year</i>		-16.5	-0.3	2.0	4.6	15.3	8.2	-1.0	-3.1	-7.5
Nominal effective exchange rate	<i>% ch. on prev. period</i>						0.9	-1.1	0.7	-0.7	-1.2
	<i>% ch. on prev. year</i>		-9.5	2.9	2.4	2.5	6.2	3.5	0.6	-0.1	-2.2

Sources: European Commission, ECB, CPB Netherlands Bureau for Economic Policy Analysis.

Notes: (1) LTA = Long-term average. (2) Balance: the difference between positive and negative answers, in percentage points of total answers.

GLOSSARY

Automatic fiscal stabilisers: Features of the tax and spending regime which react automatically to the economic cycle and reduce its fluctuations. As a result, the budget balance in percent of GDP tends to improve in years of high growth and deteriorate during economic slowdowns.

Discretionary fiscal policy: Change in the budget balance and in its components under the control of government. It is usually measured as the residual of the change in the budget balance after the budgetary impact of automatic stabilisers and interest payments has been excluded (see also Fiscal stance).

Expenditure benchmark: A mechanism applied under the preventive arm of the Stability and Growth Pact imposing an upper limit on the growth rate of government primary expenditure net of discretionary revenue measures. The objective of the benchmark is to ensure that a country stays at its MTO or on the adjustment path towards it (see also Net expenditure).

Fiscal space: Leeway to run an expansionary fiscal policy. While there is no generally accepted definition, in this document a country is considered to have fiscal space in year t if its structural balance in year $t-1$ is estimated above its MTO. Barring other considerations, the country may use this fiscal space, i.e. let its structural balance deteriorate at most until it is back at its MTO.

Fiscal stance: A measure of the direction and extent of discretionary fiscal policy. In this document, it is defined as the annual change in the structural primary budget balance. When the change is positive, the fiscal stance is said to be restrictive; when the change is negative, it is said to be expansionary.

Margin of discretion: A new interpretation of existing EU legislation of how to assess compliance with the requirements under the preventive arm of the Stability and Growth Pact. Under certain conditions, the European Commission may find that the fiscal adjustment in a Member State is adequate even if it falls short of the recommended adjustment. The Commission indicated that it would apply the margin of discretion only in 2018.

Medium-term budgetary objective (MTO): According to the Stability and Growth Pact, stability programmes and convergence programmes present a medium-term objective for the budgetary position. It

is country-specific to take into account the diversity of economic and budgetary developments and fiscal risks to the sustainability of public finances. It is defined in structural terms (see Structural balance).

Net expenditure: Primary government expenditure net of certain items not directly under the control of government (expenditure backed by EU funds and the cyclical component of unemployment benefit expenditure) and using investment expenditure smoothed over four years. It is also net of discretionary revenue measures and revenues mandated by law, and corrected for the impact of one-offs (see also Expenditure benchmark).

Output gap: The difference between actual output and estimated potential output at a particular point in time. A business cycle typically includes a period of positive output gaps and a period of negative output gaps. When the output gap is closed, the economy is in line with its potential level (see Potential GDP). Observations indicate that a standard business cycle usually lasts up to 8 years, suggesting that the output gap is normally expected to close roughly every 4 years.

Potential GDP: The level of real GDP in a given year that is consistent with a stable rate of inflation. If actual output rises above its potential level, constraints on capacity begin to bind and inflationary pressures build; if output falls below potential, resources are lying idle and inflationary pressures abate (see also Production function approach and Output gap).

Production function approach: A method to estimate the sustainable level of output of an economy compatible with stable inflation based on available labour inputs, the capital stock and their level of efficiency. Potential output is used to estimate the output gap, a key input in the estimation of the structural balance.

S0 indicator: A composite indicator published by the European Commission to evaluate the extent to which there might be a fiscal stress risk in the short term, stemming from the fiscal, macro-financial and competitiveness sides of the economy. A set of 25 fiscal and financial-competitiveness variables proven to perform well in detecting fiscal stress in the past is used to construct the indicator.

S1 indicator: Medium-term sustainability indicator published by the European Commission. It indicates the additional adjustment, in terms of change in the

structural primary balance, required over 5 years to bring the general government debt-to-GDP ratio to 60% in 15 years' time, including financing for any future additional expenditure arising from an ageing population.

S2 indicator: The long-term sustainability indicator of the European Commission. It shows the upfront adjustment to the current structural primary balance required to stabilise the debt-to-GDP ratio over the infinite horizon, including financing for any additional expenditure arising from an ageing population.

Stabilisation: Economic policy intervention to bring actual output closer to potential output. In the Economic and Monetary Union (EMU), this is expected to be achieved, in normal economic times, through the ECB's monetary policy (for common shocks) and national automatic fiscal stabilisers (for country-specific shocks). When this is not sufficient, discretionary fiscal policy can also play a role.

Structural balance: The headline budget balance corrected for the impact of the economic cycle and net of one-off and other temporary measures. The structural balance gives a measure of the underlying trend in the budget balance.

Structural primary balance: The structural budget balance net of interest payments.

Sustainability of public finances: The ability of a government to service its debt. From a purely theoretical point of view, this basically assumes that the government debt level does not grow faster than the interest rate. While conceptually intuitive, an agreed operational definition of sustainability has proven difficult to achieve. The European Commission is using three indicators of sustainability with different time horizons (S0, S1 and S2) which are complemented by a debt sustainability analysis that includes sensitivity tests on government debt projections and alternative scenarios.

Zero lower bound (ZLB): When the short-term nominal interest rate is at or near zero, the central bank is limited in its capacity to stimulate economic growth by lowering policy rates further. To overcome the constraint imposed by the ZLB, alternative methods to stimulate demand are generally considered, such as asset purchase programmes. The root cause of the ZLB is the issuance of paper currency, effectively guaranteeing a zero nominal interest rate and acting as an interest rate floor. Central banks cannot encourage spending by lowering interest rates, because people would hold cash instead.