LUISS SCHOOL OF EUROPEAN POLITICAL ECONOMY

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FISCAL SPACE IS BACK

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IT'S NOT A JOKE INVENTED by Krugman: the EC is pushing for expansionary fiscal policy, but it will recommend the contrary to euro area countries. The resulting effect will be contractionary. This schizophrenic behavior is argued in the EC's recently issued Communication 727[1]. The reasoning is that the Commission's Autumn economic forecasts point to anemic growth, as well as lasting underemployment of labor and capital. Combined with stagnant exports, these factors will drive Europe into a low-growth-low-inflation trap à la Japanese.

The Commission candidly states that "the fiscal requirements contained in the country-specific recommendations of the Council would lead […] to a moderately restrictive fiscal stance for the euro area as a whole in 2017 and 2018, while the economic situation would seem to call for an expansionary fiscal stance". The reason for such a call is a far from pre-crisis level of GDP in the EA eight years after the financial crisis, higher debt-to-GDP ratios in most countries, not despite, but because of a restrictive fiscal stance, while potential GDP has also fallen because of scarce investment and high unemployment, which have reduced both physical capital and skills.

However, the rules of the SGP focus on deficit and debt and require fiscal consolidation until the medium term objective is reached, while no tool exists to make a country's fiscal policy more expansionary. Moreover, the EU tools concern individual country budgets. Thus, it could be a chance occurrence that the overall fiscal stance of the EA is appropriate and able to complement monetary policy. As stressed by the ECB, monetary policy alone cannot carry the whole burden of the recovery, and structural reforms take time and money to be implemented. In particular, when policy interest rates reach a zero lower bound, spillover effects and fiscal policy multipliers, positive or negative, are higher. Thus, fiscal policy has a crucial role to play and the EA fiscal stance should be expansionary in order to relieve the overburdened monetary policy.

We agree completely with the Commission's *analysis*, detailed up to this point, but not its *conclusion*, which, after invoking new institutions to oversee the economic policy of the whole

[1] EC COM(2016) 727 final

EA, resigns itself to the paradox: "those who do not have fiscal space want to use it; those who have fiscal space do not want to use it".

But, the Commission may be wrong , according to a study by the OECD.

The OECD study[2] on "Using the fiscal levers to escape the low growth trap" finds that in the current environment of low inflation and monetary policy stimulus, interest rates close to the zero lower bound have increased fiscal space for countries with high debt-to GDP ratios as well. The decline in interest payments has resulted in unexpected savings for governments. Further savings will materialize as old debt at higher yields mature. Italy, followed by France, will profit most from these savings. The OECD foresees up to 2% in GDP budget gains for Italy, under the assumption of 15% of debt rolled over each year and 3.5% if the rolled over debt is 25% of the initial one[3]. There is space for the needed investment in anti-seismic construction, infrastructure, active labor, and anti-poverty policies, without incurring negative reactions in the financial markets. For Italy, France, and other Southern European countries, the large slack that weakens potential output is an additional reason for fiscal expansion to enhance growth and inclusiveness. In fact, the years of recession and slow growth have increased poverty, especially among the young, and stretched the social fabric. Financial markets appreciate increases in the economy's resilience. Only guardians of the rule book cannot.

In the OECD in general, governments could use fiscal levers to finance productivity-enhancing measures for 3-4 years without increasing the debt-to-GDP ratio in the medium term. Of course, the selected activities should be able to increase output beyond the financing cost, as output is expected to increase up to 0.7% in the first year.

Expansionary fiscal policy will not only be possible for individual countries, but **coordinated fiscal action will increase growth by an additional 0.2 pp** on average, after one year, above uncoordinated fiscal policies.

There are, of course, different ways to measure fiscal space. The Irish experience at the outbreak of the financial crisis has already taught us that the EU sustainability rule of 60% public debt to GDP ratio was flawed. The OECD, in this study, adopts two methods. The first measures the distance between the current debt level and the debt limit at which a country loses market access, i.e., is unable to refinance its debt. The second is based on sustainability and is expressed as the primary surplus that will stabilize debt in the long term. As always, both methodologies have limits: the latter depends on assumptions on pension and health care costs. Both depend on assumptions on potential output, real interest rate, etc..

Still, the analysis provides important results: **there is now room to finance, through debt, a productivity-enhancing fiscal expansion equal to 0.5% of GDP for 3-4 years on average**.

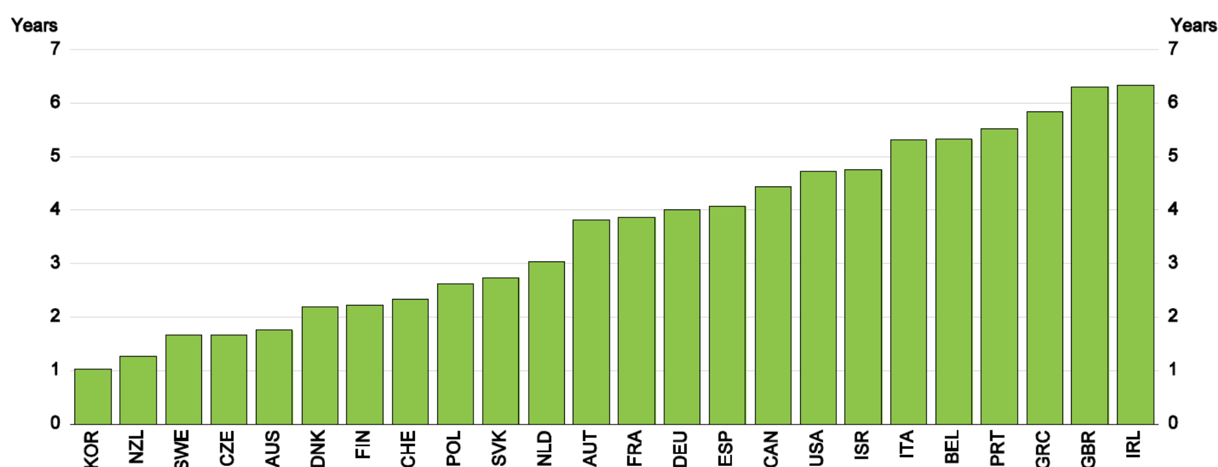
For individual countries, this window of opportunity spans from more than 6 years in Ireland, more than 5 years in Italy, more than 4 in Germany and France, and only one year in Korea (Figure 7 below). Given the low interest rate, well-selected and monitored public investment will raise output more than debt, reducing the debt-to-GDP ratio. The results depend on the country's initial level of capital stock, public investment, and debt.

[2] OECD, Using the fiscal levers to escape the low growth trap, Nov. 2016

[3] For France the gains will be around 1.5% and more than 2% respectively.

This seems a much more promising escape from the low-inflation-low-growth trap than any multisecular process for building a single fiscal entity for the euro Area.

Figure 7. Number of years which a permanent investment increase can be funded with temporary deficits



Note: A no-policy change scenario is compared to a scenario with a permanent increase of public investment by 0.5% of GDP and a temporary deficit increase of the same amount during the number of years reported in this figure. The number of years is set so that the debt level in 2040 is the same in the no-policy change scenario and in the investment shift scenario. Public investment has decreasing marginal returns as estimated in Fournier (2016), and the other structural parameters estimated in Fall and Fournier (2015) are homogenous across countries. The country-specific parameters that can influence the computation the most are the initial public investment level, the initial capital stock level, the initial public debt level and the interest rate to growth rate gap.

Source: OECD calculations based on Mourougane *et al.*, forthcoming.