

The euro area fiscal stance

This article discusses the concept of an appropriate euro area aggregate fiscal stance in the context of the institutional architecture of Economic and Monetary Union (EMU). To this end, it assesses recent initiatives towards a better coordination of national fiscal policies with a view to ensuring an appropriate euro area-wide fiscal stance which balances the objectives of sustainable public finances and macroeconomic stabilisation.

There is widespread agreement that national fiscal policies need to ensure that public debt is sustainable, while automatic stabilisers can operate freely to cushion country-specific shocks. At the same time, in the event of a very severe crisis, such as the deep recession in 2008-09, automatic fiscal stabilisers alone may not be sufficient to absorb the shock, and additional discretionary action may be required, provided this does not endanger medium-term fiscal sustainability. These elements are all embedded in the rules of the Stability and Growth Pact (SGP). However, there are no rules in the SGP for countries that have over-achieved their targets.

There may be circumstances in which the independent conduct of national fiscal policies does not result in an appropriate aggregate euro area fiscal stance. This article reviews the proposals of the Five Presidents' Report⁵⁹ in this respect, including the setting-up of a European Fiscal Board – which is expected to become operational by September 2016 – to advise the European Commission on an appropriate fiscal stance both at national and European level within the rules of the SGP. In the longer run, the report envisages the creation of a euro area treasury to improve joint decision-making regarding economic and fiscal policies and the setting-up of a euro area macroeconomic stabilisation function.

1 Introduction

In Economic and Monetary Union, fiscal policies are a national responsibility. In this respect, they need to ensure the sustainability of government debt and cushion country-specific shocks. Sustainable public finances are a prerequisite for ensuring price stability within the euro area. At the same time, in a monetary union, fiscal policy remains a major tool available to national governments to deal with country-specific circumstances. In the absence of a fiscal authority at the centre, national fiscal policies are governed by the EU's common fiscal framework, the Stability and Growth Pact, which was agreed in 1997 to operationalise the Maastricht Treaty's budgetary rules.⁶⁰ Within the SGP, national fiscal policies are considered a

⁵⁹ See *Completing Europe's Economic and Monetary Union*, European Commission, Brussels, June 2015, available at https://ec.europa.eu/priorities/sites/beta-political/files/5-presidents-report_en.pdf

⁶⁰ See also "EMU and the conduct of fiscal policies", *Monthly Bulletin*, ECB, January 2004.

matter of common concern – they should be coordinated and should not be allowed to impose disproportionate costs on other EMU participants.⁶¹

The SGP framework guides Member States towards achieving sound fiscal positions and provides room to cushion normal cyclical fluctuations via automatic stabilisers. Member States set medium-term budgetary objectives (MTOs) which are intended to anchor progress towards sustainable public finances, while allowing budgetary room for manoeuvre. Adjustments required to meet the MTO are defined in structural terms (i.e. net of the impact of the cycle and one-off measures) and therefore generally allow the full operation of automatic stabilisers. These should be sufficient to deal with normal cyclical developments at national level. Under such circumstances, discretionary fine-tuning of the cycle via active fiscal policy measures is typically regarded as not very effective.⁶² At the same time, the SGP does not contain any rules on the conduct of fiscal policy for countries that have over-achieved their minimum requirements. In this regard, it is asymmetric.

The EU's current fiscal governance framework contains no rules or instruments to directly manage the aggregate euro area fiscal stance, which is a key difference when compared to fiscal federations such as the United States. In fact, in the absence of fiscal policy instruments at the central level, the euro area-wide fiscal stance is merely the sum of individual euro area countries' fiscal stances. However, in some situations, a more active management of the euro area-wide fiscal policy stance may appear warranted from an aggregate perspective. The SGP does contain provisions permitting countries to provide fiscal stimulus in exceptional circumstances, provided that this does not endanger medium-term fiscal sustainability. At the same time, the SGP does not oblige those countries with fiscal room for manoeuvre to make use of it. There is therefore no guarantee that the coordination of national fiscal policies through the SGP results in an appropriate aggregate euro area fiscal stance. In the light of this, the Five Presidents' Report, "Completing Europe's Economic and Monetary Union", released in mid-2015, highlights the need to reflect on ways to ensure that "the sum of national budget balances leads to an appropriate fiscal stance at the level of the euro area as a whole".⁶³

The Five Presidents' Report contemplates, as steps within a comprehensive overhaul of the institutional architecture of EMU, a more active steering of the euro area-wide fiscal stance. In this context, it envisages the setting-up of a euro area treasury to achieve more collective decision-making on fiscal policy. The report also proposes the creation of a central macroeconomic stabilisation function to

⁶¹ See Article 121 of the Treaty on the Functioning of the European Union, which states that "Member States shall regard their economic policies as a matter of common concern and shall coordinate them within the Council", and Article 126, which states that "Member States shall avoid excessive government deficits". Article 126 goes on to say that compliance with budgetary discipline shall be examined on the basis of two criteria, the deficit ratio and the debt ratio, in relation to certain reference values (specified as 3% and 60% of GDP respectively in Protocol (No 12) on the excessive deficit procedure).

⁶² See "Fiscal policy influences on macroeconomic stability and prices", *Monthly Bulletin*, ECB, April 2004, and "The operation of automatic fiscal stabilisers in the euro area", *Monthly Bulletin*, ECB, April 2002.

⁶³ See *Completing Europe's Economic and Monetary Union*, op. cit.

complement automatic stabilisers at the national level if national budgets become overwhelmed by very large macroeconomic shocks.

When assessing the “appropriateness” of the fiscal stance both at the national and the euro area level, the European Commission will in future be advised by a new European Fiscal Board, which is scheduled to become operational by September 2016. According to the Five Presidents’ Report, the European Fiscal Board “should lead to better compliance with the common fiscal rules, a more informed public debate, and stronger coordination of national fiscal policies”.⁶⁴

Against this background, this article discusses the concept of an appropriate euro area aggregate fiscal stance in the context of the EU’s institutional framework. To this end, it assesses the recent initiatives towards better coordination of national fiscal policies with a view to ensuring an appropriate euro area-wide fiscal stance which balances the objectives of sustainable public finances and macroeconomic stabilisation.

The article is structured as follows. Section 2 briefly reviews developments in the euro area fiscal stance over the last decade. Section 3 then discusses the concept of an appropriate euro area aggregate fiscal stance. Section 4 reflects on the limits on coordinating the euro area fiscal stance within the current EU fiscal framework. From this analysis, Section 5 derives institutional considerations relating to the work of the envisaged European Fiscal Board as well as a euro area treasury and a euro area fiscal capacity. Section 6 concludes.

2 Recent developments in the euro area fiscal stance

The fiscal stance aims to capture governments’ discretionary policy actions.

Two principal ways of measuring the fiscal stance are used in practice (see Box 1). First, the change in the cyclically adjusted primary balance, which removes the cyclical component and interest payments from the headline budget balance. Second, bottom-up estimates of discretionary policy measures, which sum up the outcomes of policy measures included in national budgets.

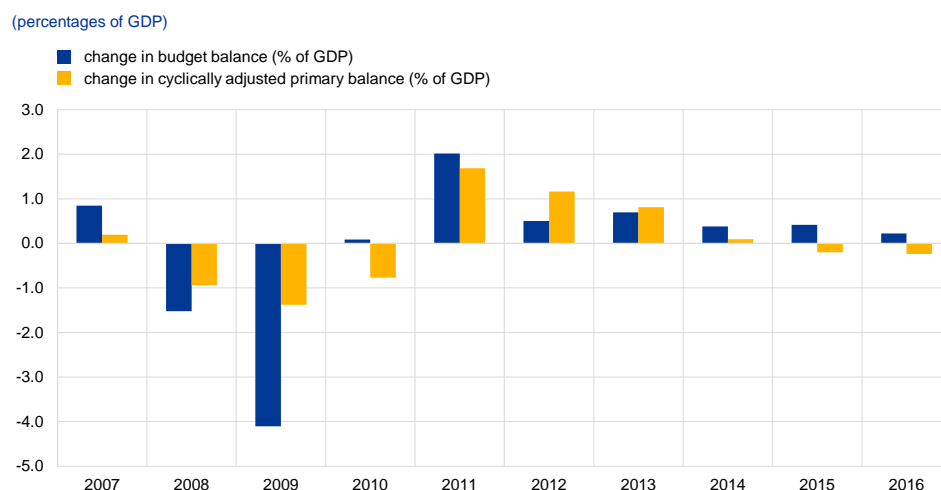
As Chart 1 shows, following several years of tightening, the euro area aggregate fiscal stance appears now to have turned mildly expansionary. The chart depicts the fiscal stance for the period 2007-16 as measured by the change in the cyclically adjusted primary budget balance. It shows that the fiscal stance was loosening in 2008-10, reflecting the impact of several stimulus measures, including the European Economic Recovery Plan (EERP), which the Commission launched in November 2008 and which amounted to about 1.5% of GDP for the euro area. This was followed by a tightening euro area aggregate fiscal stance over the period 2011-13, reflecting comprehensive consolidation packages in euro area countries to restore debt sustainability and correct the excessive deficits that had emerged during the sovereign debt crisis. In 2014 the fiscal stance was broadly neutral in the

⁶⁴ See *Completing Europe’s Economic and Monetary Union*, op. cit.

absence of broad-based fiscal adjustment measures in most euro area countries. According to the European Commission's 2016 winter forecast, the euro area aggregate fiscal stance is expected to be mildly expansionary in 2015-16.

Chart 1

Changes in headline and cyclically adjusted primary budget balances of the euro area aggregate



Sources: AMECO, ECB calculations.

Box 1

Measuring the fiscal stance

The initial impulse that fiscal policies provide to the economy is transmitted through several channels, which differ according to the government's ability to influence budgetary outcomes in the short term. A major channel operates via "automatic fiscal stabilisers", which provide an automatic buffer to private demand through built-in features of government budgets. Notably, during a downturn, without the government taking any action, unemployment and social security benefits increase, while tax revenues tend to fall, thereby contributing to a smoothing of the business cycle. The magnitude of these automatic stabilisers is closely related to the size of the welfare system and the tax system.⁶⁵ Furthermore, fiscal policies can impact on economic activity through the implementation by governments of discretionary budgetary measures that affect public expenditure and revenues.⁶⁶

The concept of the fiscal stance aims to capture only that part of the initial fiscal impulse to economic activity that stems from the discretionary policy actions of governments. Two principal ways of measuring the fiscal stance are used in practice. First, the change in the cyclically adjusted primary balance,⁶⁷ which removes the cyclical component and interest payments from the

⁶⁵ Another impact relates to governments paying interest on public debt, which presents a financial flow between the government and the economy. However, in the short term, the ability of governments to influence the size of the interest payments is limited and works mainly via debt management strategies.

⁶⁶ For an overview of the fiscal impulse and its components, see Section 3.2 of van Riet, A. (ed.), "Euro area fiscal policies and the crisis", *Occasional Paper Series*, No 109, ECB, 2010, pp. 22-26.

⁶⁷ Variants of this measure, such as the change in the structural balance or in the structural primary balance (see Box 3), are also used in practice.

headline balance. Second, bottom-up estimates of discretionary policy measures, which sum up the outcomes of policy measures included in national budgets.

The fiscal stance as measured by the cyclically adjusted primary balance is difficult to gauge in real time. First, the separation of policy-induced changes in the headline budget balance from the impact of the business cycle requires the size of the output gap to be captured, i.e. actual output relative to its potential. Real-time estimates of the latter – an unobservable variable – are, however, subject to frequent ex post revisions. This distorts the proper measurement of the fiscal stance in real time, attributing too much or too little of the fiscal impulse to discretionary policy action.⁶⁸ Second, the fiscal stance may be distorted in real time through developments in government revenues which result from their response to economic growth that is not in line with standard elasticities. In an economic upswing, for example, the fiscal stance being measured may signal an increase in government revenues, which in real time is assessed to have resulted from discretionary policy action. Ex post, however, this may turn out to have been due to revenue windfalls related to transitory developments in tax bases connected with temporary fluctuations in, for example, asset prices and oil prices.

By contrast, bottom-up estimates of discretionary policy measures aim to identify the impact of individual tax and spending measures. On the revenue side, identifying a measure and gauging its impact against a no-policy baseline is relatively straightforward. On the expenditure side, distinguishing a spending measure from the impact of other economic developments (e.g. unemployment, demographic developments) is less clear cut and requires expenditure developments to be measured against a benchmark, which should ideally be exogenous. For example, under the SGP's preventive arm, the expenditure benchmark is based on a long-term average of potential output growth, while the bottom-up approach under the corrective arm is based on trend growth. These growth variables are also non-observable.⁶⁹

Overall, policy recommendations regarding the fiscal stance need to acknowledge the caveats surrounding its measurement. Not only is the “exact” size of discretionary fiscal policy measures difficult to capture in real time, but so is the direction of the fiscal stance. In fact, whether the stance is tightening or loosening, and whether it is doing so in an economic environment that is improving or deteriorating, cannot be concluded with certainty given the difficulties surrounding the determination of a country's position in the cycle.

⁶⁸ For a discussion, see Kamps, C., De Stefani, R., Leiner-Killinger, N., Ruffer, R. and Sondermann, D., “The identification of fiscal and macroeconomic imbalances – unexploited synergies under the strengthened EU governance framework”, *Occasional Paper Series*, No 157, ECB, 2014.

⁶⁹ For a discussion, see “The assessment of fiscal effort”, *Monthly Bulletin*, ECB, October 2014.

3 What is an appropriate euro area fiscal stance?

3.1 The fiscal stance and the trade-off between sustainability and stabilisation

Discretionary fiscal policies are generally considered a weak macroeconomic stabilisation tool during normal economic cycles. First, it takes time to adopt and implement a fiscal measure, especially major new programmes (“implementation lag”). Second, fiscal measures in support of the economy tend to be difficult to reverse once implemented, facing resistance from benefiting groups. Third, it is difficult to get the size, timing and economic mechanism of a fiscal impulse measure exactly right. Consequently, there is, for example, a risk that the economic impact of a discretionary fiscal stimulus will start to be felt only once the economy is already picking up, rendering the instrument pro-cyclical rather than counter-cyclical.⁷⁰

There is therefore broad consensus that automatic fiscal stabilisers represent “the first line of defence” by being a predictable and systematic response to normal asymmetric shocks.⁷¹ In particular, during a downturn, without the government taking any action, unemployment and social security benefits increase, while tax revenues tend to fall, thereby contributing to a smoothing of the business cycle. Within the euro area, the magnitude of such automatic fiscal stabilisers varies across countries, but is relatively large on average when compared to, for example, the United States, given the euro area countries’ more extensive welfare and tax systems.⁷²

Under exceptional circumstances, automatic stabilisers alone may be regarded as insufficient to cushion the very detrimental and prolonged impact of deep swings in the cycle.⁷³ At the same time, the effectiveness of a discretionary fiscal stimulus is generally larger in such circumstances. While there is considerable uncertainty surrounding the size of short-term fiscal multipliers, recent evidence indicates that multipliers may be larger in deep recessions or financial crises or when monetary policy is constrained. In times of severe and extended

⁷⁰ See Taylor, J.B., “Reassessing discretionary fiscal policy”, *Journal of Economic Perspectives*, Vol.14, No 3, 2000, pp. 21-36. For a detailed discussion on the role of fiscal stimulus in the economy, including desirable features such as timely, targeted and temporary (TTT), see van Riet, A., op. cit.

⁷¹ Traditional New Keynesian DSGE (Dynamic Stochastic General Equilibrium) models also reflect the dominant view, according to which the key role in terms of macroeconomic stabilisation should be played by monetary policy, while the role of fiscal policy would be limited to the operation of automatic stabilisers. See Brendon, C. and Corsetti, G., “COEURE Survey: Fiscal and Monetary Policies after the Crises”, *CEPR Discussion Papers*, No 11088, 2016. See also the discussion in van Riet, A., op. cit.

⁷² Estimates differ across studies. See, for example, Dolls, M., Fuest, C. and Peichl, A., “Automatic Stabilizers and Economic Crisis: US vs. Europe”, *NBER Working Paper Series*, No 16275, National Bureau of Economic Research, 2010, which finds that automatic stabilisers absorb 38% of a proportional income shock in the EU, compared to 32% in the United States.

⁷³ For a review, see Brendon, C. and Corsetti, G., op. cit. While cautioning that discretionary fiscal policy is normally at a disadvantage compared with monetary policy as a counter-cyclical tool, Taylor (op. cit.) points out that fiscal policy could play a role in situations where monetary policy is constrained at the zero lower bound. In this case, one would need to state explicitly how fiscal policy would be used, such rules being more difficult to specify and enforce in practice than parallel rules for monetary policy. See also the discussion in Box 2.

crisis, the risks of misidentifying the occurrence of a shock and its depth are more limited and the risk of a policy mistake is therefore lower. At the same time, fiscal multipliers may be small (or even negative) when government debt levels are high and concerns about debt sustainability are increasing.⁷⁴

The fiscal stance impacts on both fiscal sustainability and stabilisation, implying a trade-off for expansionary policies. For example, while a fiscal stimulus would tend to raise output in the short run, it would at the same time add to debt and thereby increase sustainability risks. The size of these individual effects depends on the nature of the fiscal stimulus (e.g. whether it is permanent or temporary and the types of instrument applied), the starting fiscal position and the observed financial and macroeconomic conditions, etc.⁷⁵

A fiscal stance is usually assessed as appropriate if it provides a suitable balance between the sustainability and stabilisation objectives of fiscal policy. There is thus usually not just *one* “appropriate” fiscal stance, but rather a range thereof, all of which balance stabilisation and sustainability objectives, but with different weights on each objective. The theoretical and empirical literature does not provide clear guidance on where the optimal balance lies. It does, however, indicate that governments should respond more forcefully to sustainability constraints when their debt levels are high. Indeed, in such regimes, the impact of fiscal adjustment on output stabilisation is mitigated through confidence effects via the interest rate channel. Consequently, any recommendation regarding an “appropriate” fiscal stance requires an operationalisation of the sustainability and stabilisation objectives, which means taking into account the debt level of the country (see Box 3 for an evaluation of the European Commission’s metric to assess the appropriateness of the fiscal stance).

Gauging stabilisation needs is not straightforward. Generally, a government’s decision to increase or reduce support to the economy depends on its assessment of the state of the economy as measured, for example, by the level of the output gap and on the speed at which the government wishes to close it. However, as explained in Box 1, output gap estimates are subject to a high degree of uncertainty and may therefore give wrong signals in real time regarding stabilisation needs.⁷⁶ For this reason, monetary policy has for a long time reduced the emphasis on unobserved indicators, such as the output gap, whose mismeasurement was one of the main driving factors behind the Great Inflation of the 1970s.⁷⁷

There is also no simple indicator for assessing whether a government’s debt is sustainable. Sustainability of government debt means that the accumulated debt

⁷⁴ For a discussion, see the article “Fiscal multipliers and the timing of consolidation”, *Monthly Bulletin*, ECB, April 2014.

⁷⁵ For a discussion on the output and debt effects of fiscal consolidation, see also Warmedinger, T., Checherita-Westphal, C. and Hernández de Cos, P., “Fiscal multipliers and beyond”, *Occasional Paper Series*, No 162, ECB, 2015.

⁷⁶ See Cimadomo, J., “Fiscal policy in real time”, *The Scandinavian Journal of Economics*, Vol. 114, No 2, 2012, pp. 440-465, and Kamps, C. et al., *op. cit.*

⁷⁷ See “The ‘Great Inflation’: lessons for monetary policy”, *Monthly Bulletin*, ECB, May 2010.

can be serviced at any point in time.⁷⁸ At the same time, any sovereign debt sustainability analysis (DSA) is sensitive to the assumptions applied.⁷⁹ A comprehensive DSA framework should generally consider both debt dynamics and the level at which debt stabilises, test the resilience of the debt path under various adverse scenarios and account for other relevant indicators (e.g. a government's gross financing needs, the structure of government debt, the scope for contingent liabilities, the quality of institutions and political risks). In its sustainability assessments under the European governance framework, the European Commission uses three indicators, aimed at summarising short, medium and long-term risks, alongside a more comprehensive DSA framework. Against this background, Box 2 provides a literature overview of how past (estimated) fiscal reaction functions have dealt empirically with the response to the stabilisation and sustainability objectives.

Box 2

Fiscal reaction functions

The literature on fiscal reaction functions can shed some light on the past behaviour of fiscal policies across euro area countries with respect to both sustainability and stabilisation.

While not sufficient to guarantee appropriate policies in the future, past fiscal behaviour can provide useful indications of the extent to which governments have given consideration to sustainability and/or stabilisation objectives. The fiscal reaction framework is commonly used as a weak test for fiscal sustainability following Bohn.⁸⁰ Accordingly, governments are considered to abide by sustainability constraints if they react systematically to increases in the debt-to-GDP ratio by raising their primary surplus ratio.⁸¹ The literature covers related research objectives, including the estimation of “fiscal reactions” following the literature on monetary policy rules (Taylor)⁸² or the work on active and passive fiscal policy regimes (Leeper).⁸³ Most empirical studies on fiscal reaction functions test the sustainability condition by estimating the response of fiscal policy (usually the primary balance, but also the cyclically adjusted primary balance) to the (lagged) debt ratio and controlling for cyclical conditions (current output gap), in addition to other factors. The specification of a fiscal reaction function in terms of both debt and the output gap

⁷⁸ For a review of the theoretical and practical concepts of sustainability, see the article entitled “Analysing government debt sustainability in the euro area”, *Monthly Bulletin*, ECB, April 2012.

⁷⁹ See, for instance, the IMF and the Commission's DSA frameworks in *Staff Guidance Note for public debt sustainability analysis in market-access countries*, IMF, 2013, and *Fiscal Sustainability Report 2015*, European Commission, January 2016.

⁸⁰ See Bohn, H., “The Behavior of U.S. Public Debt and Deficits”, *The Quarterly Journal of Economics*, Vol. 113, No 3, 1998.

⁸¹ As pointed out in several studies, this can be considered only a weak test of sustainability as, inter alia, there is likely to be an upper limit for primary surpluses as a share of GDP. At very high debt ratios, the probability of fiscal fatigue is higher. See Gosh, A.R., Kim, J.I., Mendoza, E.G., Ostry, J.D. and Quereshi, M.S., “Fiscal Fatigue, Fiscal Space and Debt Sustainability in Advanced Economies”, *Economic Journal*, Vol. 123, No 566, February 2013, pp. F4-F30.

⁸² See Taylor, J.B., op. cit. For an application, see Galí, J. and Perotti, R., “Fiscal policy and monetary integration in Europe”, *Economic Policy*, Vol. 18, No 37, October 2003, pp. 533-572.

⁸³ See Leeper, E., “Equilibria under ‘active’ and ‘passive’ monetary and fiscal policies”, *Journal of Monetary Economics*, Vol. 27, No 1, 1991, pp. 129-147. For an application, see Afonso, A. and Toffano, P., “Fiscal regimes in the EU”, *Working Paper Series*, No 1529, ECB, April 2013.

allows an assessment of policymakers' efforts (or the lack thereof) to stabilise both public debt and output.⁸⁴

While a monetary policy rule, such as the Taylor rule, has been considered closely in practice, with good performance over past periods,⁸⁵ the fiscal reaction function literature does not provide “benchmark” reaction coefficients to set a normative behaviour. Instead, a statistically significant, positive reaction coefficient for the lagged debt is taken as a sufficient, but not necessary, condition for sustainability. The larger the coefficient, the stronger is the reaction to increases in debt. Particular caution is warranted when drawing inferences about debt sustainability solely from fiscal reaction function estimates based on past behaviour. As regards the fiscal reaction to the output gap, a statistically significant, positive (negative) coefficient is generally interpreted as evidence of a counter-cyclical (pro-cyclical) fiscal policy.

For the euro area countries, the fiscal reaction function literature generally finds that governments have, on average, given (some) consideration to sustainability constraints. The responsiveness seems to have been much stronger during the recent euro area sovereign debt crisis with its onset in the economic and financial global crisis of 2008.⁸⁶ Overall, there is evidence of non-linearities in the government response to debt, with greater attention paid to the sustainability objective when the debt level is high.⁸⁷ The evidence with respect to responsiveness during the post-Maastricht and euro area periods is more mixed, but some recent studies point to stronger average responsiveness after the Maastricht Treaty, followed, however, by weakening responsiveness during the pre-crisis euro area period.⁸⁸

As regards the stabilisation role of fiscal policy, most evidence points to a significant counter-cyclical role through automatic stabilisers and less through discretionary fiscal policy. For instance, some earlier studies conclude that there was no evidence that the Maastricht Treaty and the SGP prevented automatic stabilisers from doing their job in euro area countries. On the contrary, these countries appear to have strengthened the counter-cyclical nature of fiscal policy (up to 2002).⁸⁹ These and other studies conclude that both the overall fiscal policy and the discretionary component have been responding in a counter-cyclical manner since the adoption of the Maastricht Treaty. However, the evidence for the discretionary fiscal policy, as well as for the responsiveness during the euro area period, is weaker.

⁸⁴ See, inter alia, the discussion in Plödt, M. and Boeing-Reicher, C., “Estimating fiscal policy reaction functions: The role of model specification”, *Journal of Macroeconomics*, Vol. 46, December 2015, pp. 113-128.

⁸⁵ Taylor proposed coefficients for the reaction of real short-term interest rates of 0.5 for both the output and inflation gaps, with “values near this suggestion commonly found in empirical work in the US in the 1980s and 1990s” and also “resulting in good performance in model simulations” (see Taylor, J.B., op. cit.).

⁸⁶ See, inter alia, the fiscal reaction function analysis and overview in *Fiscal Sustainability Report 2015*, op. cit.

⁸⁷ See, for example, De Groot, O., Holm-Hadulla, F. and Leiner-Killinger, N., “Cost of borrowing shocks and fiscal adjustment”, *Journal of International Money and Finance*, Vol. 59, 2015, pp. 23-48 and Plödt, M. and Boeing-Reicher, C., op. cit. At very high debt ratios, the probability of fiscal fatigue increases. See Gosh, A.R. et al., op. cit.

⁸⁸ See, for instance, Bénétrix, A.S. and Lane, P.R., “Fiscal cyclical and EMU”, *Journal of International Money and Finance*, Vol. 34(C), 2013, pp. 164-176; Plödt, M. and Boeing-Reicher, C., op. cit.; Weichenrieder, A. and Zimmer, J., “Euro membership and fiscal reaction functions”, *International Tax and Public Finance*, Vol. 21, No 4, 2014, pp. 598-613. The second study warns, however, that in terms of statistical significance the different response over the euro area period is sensitive to changes in specification, such as an exclusion of Greece from the panel.

⁸⁹ See Galí, J. and Perotti, R., op. cit.

Overall, there is evidence that, on average, governments in the euro area respond to both stabilisation and sustainability objectives. Several studies point to improvements in the conduct of fiscal policy from the perspective of both of these objectives after Maastricht and to a weakening of responsiveness during the early euro area period. The crisis acted as a disciplining device for sustainability, with a stronger reaction than before to the increasing debt levels seen in many euro area countries during the crisis (at least until 2012-13, which is as far as the studies go).

3.2 Specific elements of an appropriate fiscal stance at the euro area level

As at the national level, an appropriate aggregate fiscal stance for the euro area would seek a balance between the sustainability and stabilisation objectives. Notably, macroeconomic stabilisation needs would be gauged with respect to the size of the output gap for the euro area as a whole, while an assessment of debt sustainability risks would start by capturing developments in aggregate public debt.

However, the euro area aggregate fiscal stance is currently a purely mechanical concept, aggregating the fiscal stances at individual country level.

In the absence of a centralised fiscal policy instrument, the euro area fiscal stance merely captures the sum of discretionary national policies. The direction of the euro area fiscal stance may therefore reflect very different developments at individual country level with, for example, fiscal tightening in some countries and fiscal loosening in others. The outcome may not always be optimal.

Inconsistencies between the assessment of the fiscal stance at the euro area and national level may arise for various reasons. Such inconsistencies can be caused by heterogeneous preferences at the central euro area level and the various national levels regarding the relative importance of the two policy objectives, i.e. ensuring fiscal sustainability and providing macroeconomic stabilisation. Therefore, the pursuit of national policies does not necessarily lead to an “optimal” outcome at the euro area level. In addition, problems may arise if previous shortfalls vis-à-vis SGP requirements and related fiscal sustainability concerns require a pro-cyclical fiscal tightening in some euro area countries, while other countries with fiscal room for manoeuvre are enjoying favourable macroeconomic conditions and do not therefore have an incentive to pursue expansionary policies. Indeed, in the context of the reviews of euro area countries’ draft budgetary plans, the Eurogroup has repeatedly stressed that, while the aggregate stance implied by the plans could be viewed as broadly appropriate, its composition across euro area countries was problematic because countries with remaining fiscal imbalances were falling short of SGP commitments, while countries with fiscal room for manoeuvre were not making full use of it.⁹⁰

⁹⁰ See, for example, *Eurogroup Statement on the Draft Budgetary Plans for 2016*, 23 November 2015.

In addition, a mechanical aggregation may not adequately capture the impact of national policies on the euro area economy. This is the case if a fiscal impulse in one euro area country spills over to other countries. Trade links between countries are the main transmission channel for such an impact.⁹¹ For example, if a fiscal expansion is conducted in a euro area country that has sizeable trade links with countries outside the euro area, the increase in domestic and euro area demand will be lower than if the same fiscal impulse were to occur in a euro area country whose trade links were mainly within the euro area. The assessment of the euro area fiscal stance, as a purely mechanical aggregation of national fiscal stances, and its macroeconomic impact on the euro area economy, may vary for a given fiscal impulse, depending on the magnitude of such spillover effects.

Importantly, the euro area aggregate fiscal stance can only be deemed “appropriate” if it safeguards the sustainability needs of all euro area countries. Since fiscal policy in EMU remains a national responsibility, sovereign debt sustainability must be ensured in all euro area countries, as sustainability problems in one country can have adverse implications for others as well as for the conduct of common policies at the euro area level. Sustainability indicators applied to the euro area aggregate debt ratio can thus be used only as a reference or for indicative purposes. In particular, a desired euro area fiscal stance may not necessarily be attainable via the aggregation of national fiscal policies if some countries face severe debt sustainability risks. In other words, the more divergent debt levels across euro area countries are, the greater is the likelihood that the aggregation of national policies will not lead to an appropriate stance for the euro area as a whole.

Box 3

The European Commission’s metric to assess the appropriateness of the fiscal stance

In its 2015 report on public finances in EMU, the European Commission proposed a framework to assess the appropriateness of the euro area fiscal stance.⁹² Based on this approach, the fiscal stance – as measured by the change in the structural primary balance – is assessed against dual criteria: on one hand, the need to address long-term sustainability risks and, on the other hand, the objective of providing macroeconomic stabilisation in the short term.

The sustainability component of the Commission assessment is captured by a variant of the “S1 indicator”. Specifically, the S1 indicator quantifies the cumulative adjustment of the structural primary balance over the next five years that would be needed to reduce government debt to 60% of GDP in 2030, also taking into account implicit liabilities related to ageing. A quarter of this cumulative adjustment is then treated as the frontloaded adjustment effort required in a given year to satisfy the sustainability criterion. By spreading the adjustment effort, the S1 indicator is not in fact a pure sustainability indicator, but implicitly accounts for the stabilisation objective. From a pure

⁹¹ The size of fiscal spillovers depends on various factors, e.g. trade elasticities and possible confidence effects in financial markets that affect sovereign risk premia. For more details, see the box entitled “Fiscal spillover effects in the euro area”, *Monthly Bulletin*, ECB, April 2014.

⁹² See Annex A1 to “Report on Public Finances in EMU – 2015”, *European Economy – Institutional Papers*, No 14, European Commission, December 2015.

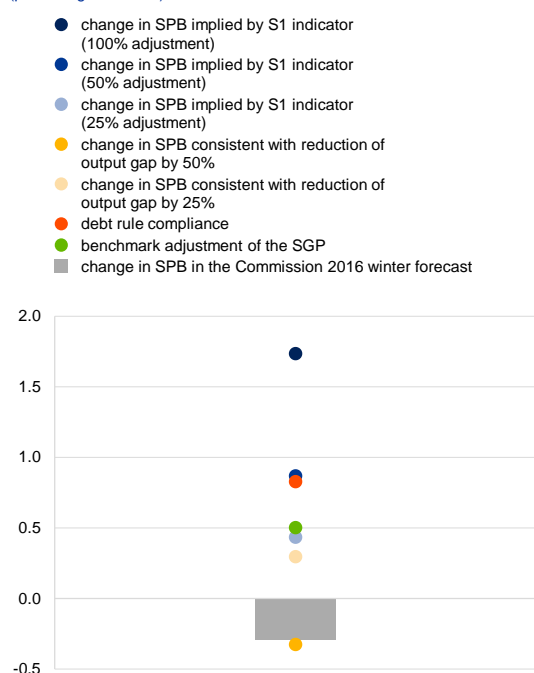
sustainability perspective, it would be preferable to frontload the entire effort to the first year, since this minimises the total adjustment effort.⁹³

The macroeconomic stabilisation criterion of the Commission assessment is captured by the change in the structural primary balance that would be consistent with a closure of the output gap by 25% or 50%, respectively, in a given year.⁹⁴ The sustainability and stabilisation component of the assessment are not linked via relative weights, but are assessed separately. The approach is thus intended to provide a positive rather than a normative analysis of budgetary developments by spanning ranges between the sustainability and stabilisation requirements.⁹⁵

Chart A

Assessment of the 2016 euro area fiscal stance

(percentages of GDP)



Sources: European Commission (AMECO database) and ECB calculations.

Similar to the Commission analysis, Chart A presents an illustrative range for the appropriate fiscal stance using alternative specifications of the sustainability and stabilisation objectives.

At present, the sustainability objective clearly calls for a tightening of the euro area fiscal stance. In its analysis, the Commission assumes that 25% of the total adjustment indicated by the S1 indicator would need to be carried out in 2016 to fulfil the sustainability criterion. Based on the Commission's 2016 winter forecast, such an adjustment for the euro area would amount to around 0.4% of GDP (see light blue circle in Chart A).⁹⁶ This adjustment lies below the benchmark adjustment of 0.5% of GDP implied by the SGP (see green circle in Chart A) and also falls short of the adjustment of around 0.8% of GDP that would be needed to close the gap vis-à-vis the forward-looking debt benchmark of the SGP (see orange circle in Chart A). At the same time, a 0.8% of GDP structural adjustment would reduce the structural deficit of the euro area to around 0.5%

⁹³ See the article "Fiscal multipliers and the timing of consolidation", op. cit., and Warmendinger, T. et al., op. cit.

⁹⁴ The change in structural primary balance that would be mechanically consistent with the considered changes in the output gap is calculated assuming a fiscal multiplier of 0.8.

⁹⁵ For further details on the approach to assessing the appropriateness of the fiscal stance, see Annex 1 ("Assumptions underlying the assessment of fiscal stance") in "Report on Public Finances in EMU – 2015", op. cit.

⁹⁶ Note that the computations for the S1 indicator are based on deterministic debt projections for the period to 2030. These projections are based on the Commission's 2016 winter forecast. Beyond the forecast horizon, the projections assume a closing of the output gap by 2020 and a parallel increase in GDP deflator growth to 2%. Assumptions for potential growth are taken from the T+10 scenario of the Economic Policy Committee's Output Gaps Working Group and extended by the assumptions from the Commission's 2015 Ageing Report. Ageing costs are also taken from the Commission's 2015 Ageing Report.

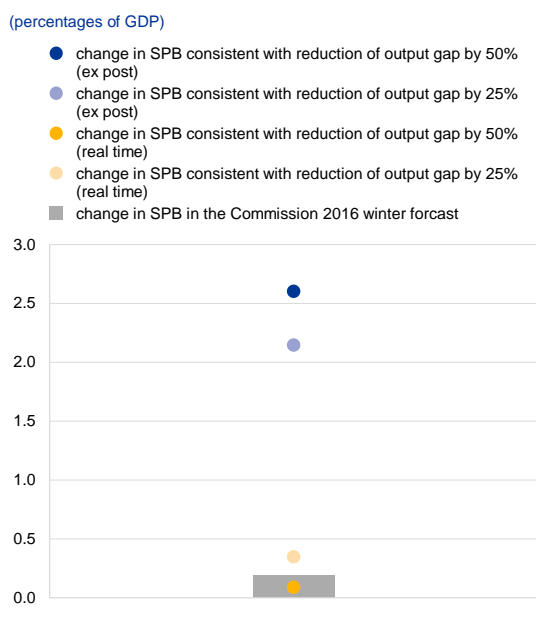
of GDP, in line with the maximum level of the medium-term objective implied by the Fiscal Compact.⁹⁷ This would also roughly correspond to a 50% “frontloading” of the total adjustment effort implied by the S1 indicator (see middle blue circle in Chart A). A full closure of the “sustainability gap” implied by the S1 indicator would require a tightening of the euro area structural primary balance by around 1.7% of GDP in 2016. All in all, this sensitivity analysis suggests that the sustainability objective clearly calls for a tightening of the euro area fiscal stance, with the Commission’s preferred gauge providing a lower bound for the required adjustment.

The stabilisation objective, on the other hand, does not give a clear recommendation of the appropriate euro area fiscal stance at the current juncture. The European Commission’s 2016 winter forecast expects the euro area output gap to decline by around 40% from a gap of -1.8% of GDP in 2015 to -1.1% of GDP in 2016. Therefore, the lower bound of the stabilisation component, which requires a reduction of the output gap by 25% in 2016, is consistent with a tightening of the fiscal stance by around 0.3% of GDP (see light yellow circle in Chart A). On the other hand, a targeted reduction of the output gap by 50% – the upper bound in the Commission analysis – would call for a loosening of the euro area fiscal stance by around 0.3% of GDP in 2016.

Overall, the analysis suggests that the projected loosening of the euro area fiscal stance by 0.3% of GDP in 2016 is heavily tilted towards the stabilisation objective, while deviating significantly from both the sustainability objective and the benchmark requirement under the SGP.

Chart B

Stabilisation objective: real-time versus ex post assessment for 2007



Sources: European Commission (AMECO database) and ECB calculations.

The assessment of the stabilisation objective based on output gap developments may suffer from a real-time bias.

As explained above, a comparison of output gap estimates for the euro area with the respective estimates contained in real-time forecast vintages suggests a tendency to mismeasure output gaps in real time. This real-time bias may result in very different assessments of the appropriateness of the fiscal stance against the stabilisation criterion based on ex post and real-time data. Chart B provides an illustrative example for the year 2007. The European Commission’s spring 2007 forecast estimated a negative output gap of 0.4% of GDP for the euro area in 2007. Compared to 2006, this implied a closure of the gap by around 50%, implying that a broadly neutral fiscal stance would have been assessed as appropriate vis-à-vis the upper bound of the stabilisation component (see dark yellow circle in Chart B). A closure of the output gap by 25% would have been consistent with a

⁹⁷ The Fiscal Compact of the Treaty on Stability, Coordination and Governance in the Economic and Monetary Union requires contracting parties to reach budgetary positions in balance or in surplus. This fiscal rule is deemed to be respected if a structural deficit limit of 0.5% of GDP is not exceeded.

slight tightening of the fiscal stance by around 0.3% of GDP. At the same time, the sustainability criterion would not have been a constraint since the debt ratio in the euro area stood at around 65% of GDP. Therefore, judged against the European Commission's metric and based on real-time data, the slight tightening of the fiscal stance by 0.2% of GDP (see grey bar in Chart B) would have been assessed as broadly appropriate. However, the estimate contained in the European Commission's 2016 winter forecast suggests that the euro area output gap in 2007 was not somewhat negative but strongly positive (+2.6% of GDP).⁹⁸ Based on ex post data, a closing of the output gap from positive territory by 25% and 50%, respectively, would have been consistent with a strong tightening of the structural primary balance (see blue circles in Chart B). In hindsight, a stronger fiscal tightening in economic good times before the crisis would have seemed more appropriate. This exemplifies the great uncertainty involved in a reliance on output gaps in the real-time assessment of the fiscal stance.

4 Limits of the current fiscal framework on the setting of the euro area fiscal stance

The EU's current institutional framework entails no provisions or instruments to directly manage the aggregate euro area fiscal stance, which is a key difference between the euro area and federations such as the United States. In fact, fiscal policies are conducted in 19 euro area countries on the basis of national budgets and within different national fiscal frameworks. While the EU budget has common resources used, in particular, to promote economic and social cohesion among Member States, it is rather small in size (around 1% of the EU's aggregate GDP), not specific to the euro area and not focused on macroeconomic stabilisation. At the euro area level, the institutional framework has been complemented by the European Stability Mechanism (ESM), a crisis management tool providing financial assistance to euro area countries experiencing or threatened by financing difficulties. Overall, however, the lack of common fiscal instruments at the centre stands in stark contrast to other federations such as the United States, where important policy instruments such as the setting of tax policies and important spending functions, e.g. defence and social and health insurance, operate at the federal level.

Notably, the SGP affects the aggregate fiscal stance indirectly rather than steering it directly. The euro area countries' decentralised fiscal policies are coordinated by the SGP, which takes the economic cycle into account. As indicated in Box 4, the SGP contains a multitude of provisions for countries under both its preventive and corrective arms that modulate the required structural effort according to economic conditions and, to a lesser extent, the government debt ratio. Consequently, the SGP affects the aggregate euro area fiscal stance indirectly.

In addition, the SGP does not entail obligations for countries that have fiscal room for manoeuvre to contribute to a desirable aggregate fiscal stance. As

⁹⁸ The same holds true for 2006, where the output gap was estimated at -0.8% of GDP in real time, while the latest Commission forecast suggests that it stood at +1.4% of GDP.

indicated in Chart 1 above, the euro area aggregate fiscal stance is expected to be mildly expansionary in 2016. At the same time, while a number of euro area countries were assessed as being at risk of non-compliance with the SGP and therefore required additional fiscal tightening measures,⁹⁹ others still have fiscal room for manoeuvre under the SGP rules. This notwithstanding, the SGP does not contain any provisions that incentivise these countries to use their existing fiscal room for manoeuvre to provide support to the euro area economy. The logic of the SGP is that it sets minimum requirements rather than targets for national fiscal policies, leaving it up to individual Member States to set themselves targets going beyond minimum requirements.

Recent legislative developments tend towards stronger coordination of the euro area fiscal stance. In particular, Regulation (EU) No 473/2013, which entered into force on 30 May 2013, includes common provisions for monitoring and assessing draft budgetary plans. Moreover, it requests the Council to issue policy recommendations for the euro area as a whole, including advice regarding the euro area aggregate fiscal stance. For example, to strengthen the scope of this advice, within the 2016 European Semester, i.e. the annual cycle of policy coordination and surveillance, the release of these recommendations for the euro area was frontloaded to November 2015.¹⁰⁰ Member States should take these recommendations into account when defining their policy strategy. Thus, instead of actively steering the aggregate euro area fiscal stance, this frontloading enables the Commission and the Council to assess the draft budgetary plans of the individual euro area countries for the forthcoming year in the light of the recommended aggregate fiscal stance for the euro area as a whole.

Box 4

Provisions for accommodating the state of the economy in the SGP

The provisions of the SGP take into account the state of the economy. The 2005 reform of the SGP introduced the concept of the structural balance, which caters for cyclical impacts on the government budget balance. To this end, it enshrined the medium-term budgetary objective (MTO), which sets country-specific structural balance targets over the medium term. These are designed, inter alia, to ensure sustainable government debt ratios by also taking into account the budgetary

⁹⁹ See the Eurogroup statement on the follow-up to the review of draft budgetary plans for 2016, available at <http://www.consilium.europa.eu/en/press/press-releases/2016/03/07-eurogroup-statement-draft-budgetary-plans-2016>

¹⁰⁰ See also Recommendation for a Council Recommendation on the economic policy of the euro area (COM(2015) 692 final), available at http://ec.europa.eu/europe2020/pdf/2016/ags2016_euro_area_recommendations.pdf

costs of ageing. At the same time, MTOs are aimed at ensuring sufficient fiscal room for manoeuvre to deal with cyclical downturns and preserve public investment.¹⁰¹

The SGP foresees a significant role for the operation of automatic fiscal stabilisers. Such fiscal stabilisers are built into existing tax-transfer systems and operate automatically over the cycle and thus around the countries' paths of structural adjustment. At the same time, countries that have reached their MTOs can let their automatic stabilisers operate freely, thereby helping to smooth the business cycle.

In addition, under its preventive arm, the SGP foresees a modulation of fiscal adjustment requirements according to the cyclical position and other factors. On 12 February 2016, the ECOFIN Council endorsed a commonly agreed position on how to take the economic cycle, structural reforms and investment into account within the existing rules of the SGP. Within a matrix, different states of the economy are defined and related to structural adjustment needs. Specifically, it distinguishes "economic good times" and divides economic developments that are worse than in "normal times" into "bad", "very bad" and "exceptionally bad" economic times. The matrix modulates the structural adjustment requirements needed in order to move towards the MTO according to the size of the output gap, economic growth and the debt ratio. These adjustment requirements can be reduced if a country implements structural reforms or undertakes public investment, with the possible cumulative reduction being capped at 0.75% of GDP. Consequently, in an unfavourable economic environment, even countries with high debt-to-GDP ratios could be allowed to let their structural balance deteriorate without falling foul of the EU's fiscal rules.

Under the SGP's corrective arm, excessive deficit procedure (EDP) deadlines can be set over horizons of several years and can be further extended. This allows a spreading of the required amount of structural adjustment over the medium term, thereby taking stabilisation considerations into account. Furthermore, various relevant factors, such as low inflation, are taken into account in the assessment of compliance with the requirements under the debt rule.¹⁰²

The SGP also contains a general escape clause, introduced with the "six-pack" reforms¹⁰³ in 2011, which can bring about broad-based reductions in structural effort requirements. This clause can be triggered for all or for individual euro area countries whenever an unusual event outside the control of Member States occurs that has a major impact on the financial position of the general government or in periods of severe economic downturn for the euro area or the Union as a whole.¹⁰⁴ In the event of such developments, it is possible to depart from the adjustment requirements under the preventive arm. Similarly, the fiscal effort requirements under EDPs can be

¹⁰¹ MTOs are set by Member States according to country-specific circumstances. They must respect minimum values and are designed to serve three goals: (i) Member States maintain a safety margin that prevents them from breaching the 3% deficit reference value during cyclical downturns; (ii) Member States' debts are sustainable taking into consideration the economic and budgetary impact of ageing populations (i.e. by in part frontloading projected ageing-related increases in government spending, while ensuring long-run convergence of the debt ratio to 60%); and (iii) Member States have room for budgetary manoeuvre, in particular when it comes to preserving public investment. For more details, see the box entitled "The effectiveness of the medium-term budgetary objective as an anchor of fiscal policies", *Economic Bulletin*, Issue 4, ECB, 2015.

¹⁰² See the article entitled "Debt reduction strategies in the euro area", *Economic Bulletin*, Issue 3, ECB, May 2016.

¹⁰³ For more information on the "six pack", see the box entitled "The EU's new framework for economic governance", *Monthly Bulletin*, ECB, July 2012.

¹⁰⁴ A severe economic downturn is defined as a protracted period of negative growth and/or large negative output gaps.

adjusted and EDP deadlines can be extended. However, under the corrective arm, an annual structural improvement of 0.5% of GDP should in principle apply. In any case, the general escape clause can only be triggered if it does not endanger the fiscal sustainability of the Member State concerned in the medium term. The exact conditions for the application of this clause (including the metric for sustainability) are not explicitly defined.¹⁰⁵

5 Institutional considerations surrounding the future setting of the euro area fiscal stance

5.1 The European Fiscal Board

The newly created European Fiscal Board will advise the European Commission on the appropriateness of the fiscal stance at both national and euro area level within the rules of the SGP. As a follow-up to the Five Presidents' Report, Commission Decision (EU) 2015/1937¹⁰⁶ established a European Fiscal Board which – once fully operational – will provide an evaluation of the implementation of the provisions of the SGP and of the implications of budgetary policies at national level for the aggregate euro area fiscal stance.

The European Fiscal Board will not be equipped with policy tools to actively influence the setting of fiscal policies. It will rather contribute in an advisory capacity to multilateral surveillance in the euro area. However, the Commission Decision does not specify how the Board will perform its advisory function. In particular, it remains unclear how it would be involved in the procedures of the European Semester, the EU's annual cycle of economic and fiscal policy coordination.

Given the envisaged institutional set-up, it is unclear how effectively the European Fiscal Board will be able to carry out its role. The fact that, according to the Commission Decision, the European Fiscal Board will operate within the European Commission's institutional structure and not have a strong public voice is likely to undermine its credibility as an independent policy advisory institution.¹⁰⁷

From an operational point of view, the European Fiscal Board will need to develop a sound methodological framework on which to base its assessment of the fiscal stance. The Commission Decision also remains vague on how the Board shall perform its tasks in practice. While the assessment of Member States' compliance with the provisions of the EU fiscal framework can build on well-

¹⁰⁵ According to the European Commission, this exceptional provision is expected to be used only in the most unusual of circumstances. See "Vade mecum on the Stability and Growth Pact", *European Economy – Occasional Papers*, No 151, European Commission, May 2013.

¹⁰⁶ Commission Decision (EU) 2015/1937 of 21 October 2015 establishing an independent advisory European Fiscal Board.

¹⁰⁷ See the box entitled "The creation of a European Fiscal Board", *Economic Bulletin*, Issue 7, ECB, 2015.

established methodological foundations, this is not the case for the assessment of the appropriateness of the fiscal stance, in particular at the euro area level. Given the European Fiscal Board's mandate to provide its assessments within the rules of the SGP, it will be important to ensure that SGP compliance in all Member States and debt sustainability risks form key elements of the assessment of the fiscal stance.

5.2 Options for a better setting of fiscal policies at the euro area level

In the context of a far-reaching overhaul of the institutional architecture of EMU, the Five Presidents' Report proposes two fiscal instruments at the euro area level – a macroeconomic stabilisation function and a euro area treasury.

The experience of the crisis has shown that, without monetary policy instruments at the national level, fiscal policies can become overwhelmed if country-specific shocks are very large and not well catered for by the shock-absorbing capacity of the economy and the financial sector. At the same time, as discussed in Section 4, the pursuit of national policies does not necessarily result in an appropriate stance at the euro area level. Central fiscal policy tools may therefore be useful to address idiosyncratic shocks more effectively and/or better steer the aggregate fiscal stance where appropriate.

A macroeconomic stabilisation function at the euro area level could complement automatic stabilisers at national level under certain conditions.

While the ultimate design of a euro area macroeconomic stabilisation function would depend on political preferences, certain design principles should be adhered to in order to preserve incentives for sound fiscal policymaking and for addressing structural weaknesses at the national level. As emphasised in the Five Presidents' Report, a euro area macroeconomic stabilisation function should neither be aimed at income equalisation nor lead to permanent transfers between Member States. It should take the form of automatic stabilisation and not aim at fiscal fine-tuning of the economic cycle. The stabilisation function would therefore not be a tool to actively steer the euro area fiscal stance, but rather reduce the need for euro area countries to address large country-specific shocks by using discretionary policies.

Mutual insurance against asymmetric shocks through a stabilisation function will require convergence in other policy areas. In this context, the Five Presidents' Report emphasises that any move towards risk sharing needs to be preceded by a new convergence process towards more resilient economic structures in euro area countries.

In the longer term, a euro area treasury could be created and equipped with fiscal instruments to contribute to the setting of the aggregate euro area fiscal stance. The creation of such a central treasury would be the only way to effectively steer the euro area aggregate stance. However, to be effective, the budgetary capacity of this treasury needs to be sufficiently large to be able to react to economic shocks in the euro area. It is clear that the creation of such a central treasury function would require far-reaching institutional reform – in particular, a shift of

sovereignty to the euro area level via an amendment to the Treaty on the Functioning of the European Union. A future euro area treasury would need to be democratically legitimised and accountable in order to carry out fiscal policy functions at the central level.

6 Conclusions

Recent institutional reforms have gone in the direction of strengthening the aggregate euro area perspective when assessing fiscal policies in the euro area. Following the “two-pack” reforms in 2013,¹⁰⁸ the Council – based on the Commission’s assessment of euro area countries’ draft budgetary plans – now issues policy recommendations for the euro area as a whole, including advice regarding the appropriateness of the euro area aggregate fiscal stance. Member States should take into account this advice when defining their policy strategy in the context of the annual stability programme updates. At the same time, once operational, the newly established European Fiscal Board will advise the Commission on the appropriateness of the fiscal stance at both the national and euro area level within the rules of the SGP. The SGP, however, does not contain any requirement to contribute to the euro area-wide fiscal stance.

The assessment of the appropriateness of the euro area fiscal stance is not straightforward. Such an assessment needs to balance various objectives, notably with regard to sustainability and stabilisation, and to account for severe measurement problems, notably with respect to the output gap. While the European Commission’s approach to assessing the fiscal stance at the national and euro area level provides a useful basis for discussion, further work needs to be done to develop a sound methodological framework that is sufficiently robust to draw policy conclusions. Compliance with the provisions of the SGP and the timely correction of debt sustainability risks need to be key elements of the assessment of the fiscal stance.

The Stability and Growth Pact provides flexibility for Member States’ budgetary policies to react to cyclical fluctuations while ensuring adequate progress towards sound and sustainable fiscal positions. The full and consistent implementation of the SGP is crucial to ensure that markets trust the capability of the EU governance framework to effectively coordinate fiscal policies in EMU. At the same time, compliance with the SGP rules will enable Member States to rebuild fiscal buffers and increase their capacity to cushion future economic shocks effectively.

The decentralised fiscal framework, however, does not necessarily result in an appropriate stance at the euro area level. Two additional features for the future institutional architecture of EMU therefore appear desirable. First, the creation of a euro area macroeconomic stabilisation function to cushion large country-specific

¹⁰⁸ See the box entitled “The ‘two-pack’ regulations to strengthen economic governance in the euro area”, *Monthly Bulletin*, ECB, April 2013.

shocks, which can overwhelm national stabilisation capacities as experienced in the recent crisis. The aim of such a central macroeconomic stabilisation function would not be to actively steer the euro area fiscal stance but to provide an additional layer of automatic stabilisation, which would mitigate the need for discretionary policies at national level. A central stabilisation function would need to be well designed to preserve incentives for sound fiscal policymaking and for addressing structural weaknesses at the national level. At the same time, access to a prospective macroeconomic stabilisation function would need to be made conditional on significant progress on economic convergence in the euro area to achieve similarly resilient economic structures, ensuring that the stabilisation function does not imply permanent transfers between Member States. Increased risk sharing in the euro area would also have to be accompanied by more joint economic policy decision-making. Second, in the longer term, a euro area treasury could be equipped with fiscal policy tools to contribute directly to the setting of the euro area fiscal stance. This would require a shift of sovereignty to the euro area level via a Treaty amendment. Strong democratic legitimacy and accountability are crucial prerequisites for a euro area treasury that would carry out fiscal policy functions.