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Prospects for National Stability and Convergence Programmes

Rafael Doménech
Chief Economist for Spain and Europe

The European Union's Economic Governance:
Prospects for Recovery, Reform and Europe 2020
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Main messages

- Huge increase of government deficits in European countries in 2009 as a consequence of discretionary fiscal policies and, more important, a structural deterioration of budget balances.
- A negative spillover from the increase in sovereign risk in Europe
- Are the current Stability and Convergence Programmes optimal with both short-run and long-run growth requirements?
- Very recently Olivier Blanchard and Carlo Cottarelli have proposed “Ten Commandments for Fiscal Adjustment in Advanced Economies”.
- We evaluate Stability and Convergence Programmes according to these requisites.
- Main conclusion: Stability and Convergence Programmes go in the right direction but more can be done, at least in the following areas:
    - Contingency programmes, and pension and health reforms.
    - Reforms to boost potential growth.
    - Improvement of fiscal institutions.
    - Coordination of monetary and fiscal policy, and coordination at the European level.

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Negative spillover arising from the increase in sovereign risk in Europe

Risks for the EMU

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3 **Faster than expected fiscal adjustment**

Difference in growth vs. US

Difference in interest rates vs. US

Supports for the EMU

2 **A new institutional framework**

Adequate and powerful incentives

A more depreciated exchange rate

Positive impact on exports

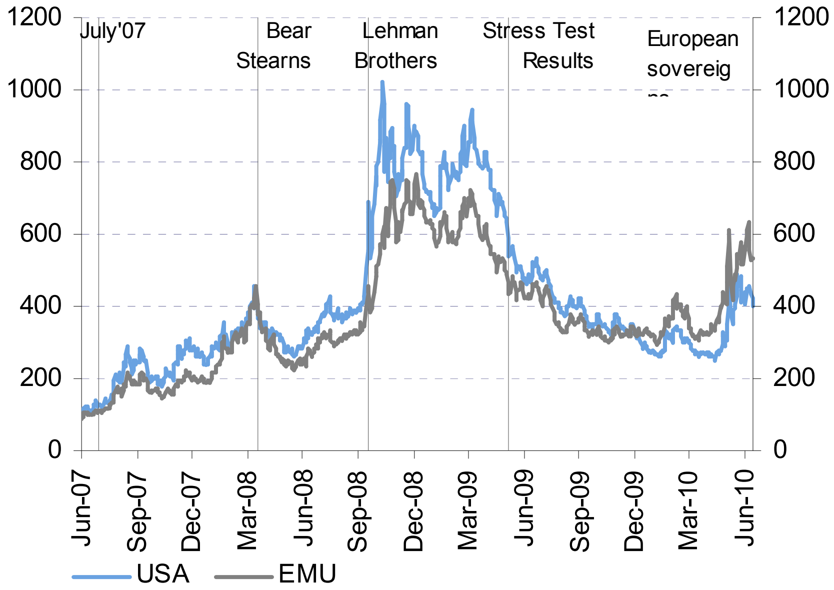
Section I
Empirical evidence on Stability and Convergence Programmes

1. Increase in risk premia

Negative spillover arising from the increase in risk premia in Europe

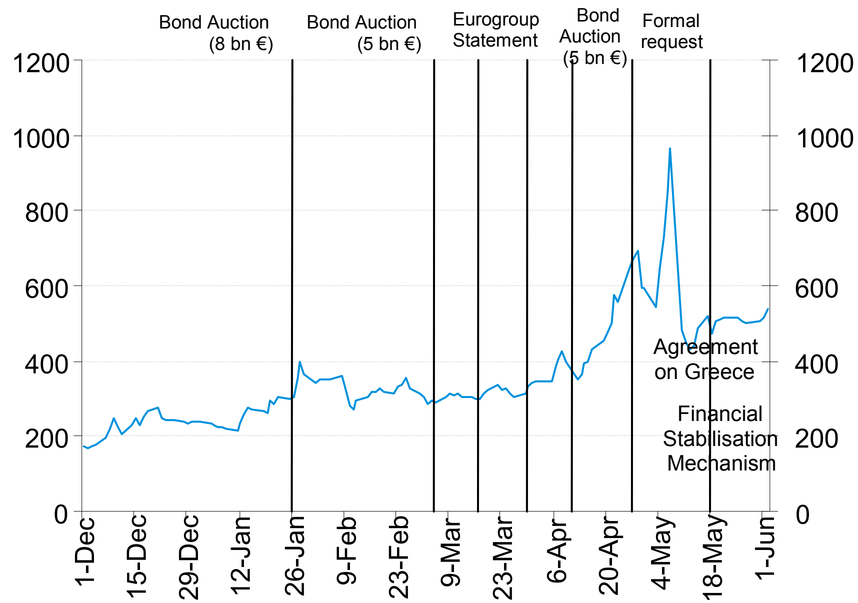
Financial Tensions Indicator 100 = January-07

First normalized principal component of the following series: OIS spread, implicit volatility, and banking and corporate CDS spread
Source: BBVA Research



Greece: 10-yr Sovereign spread (bps)

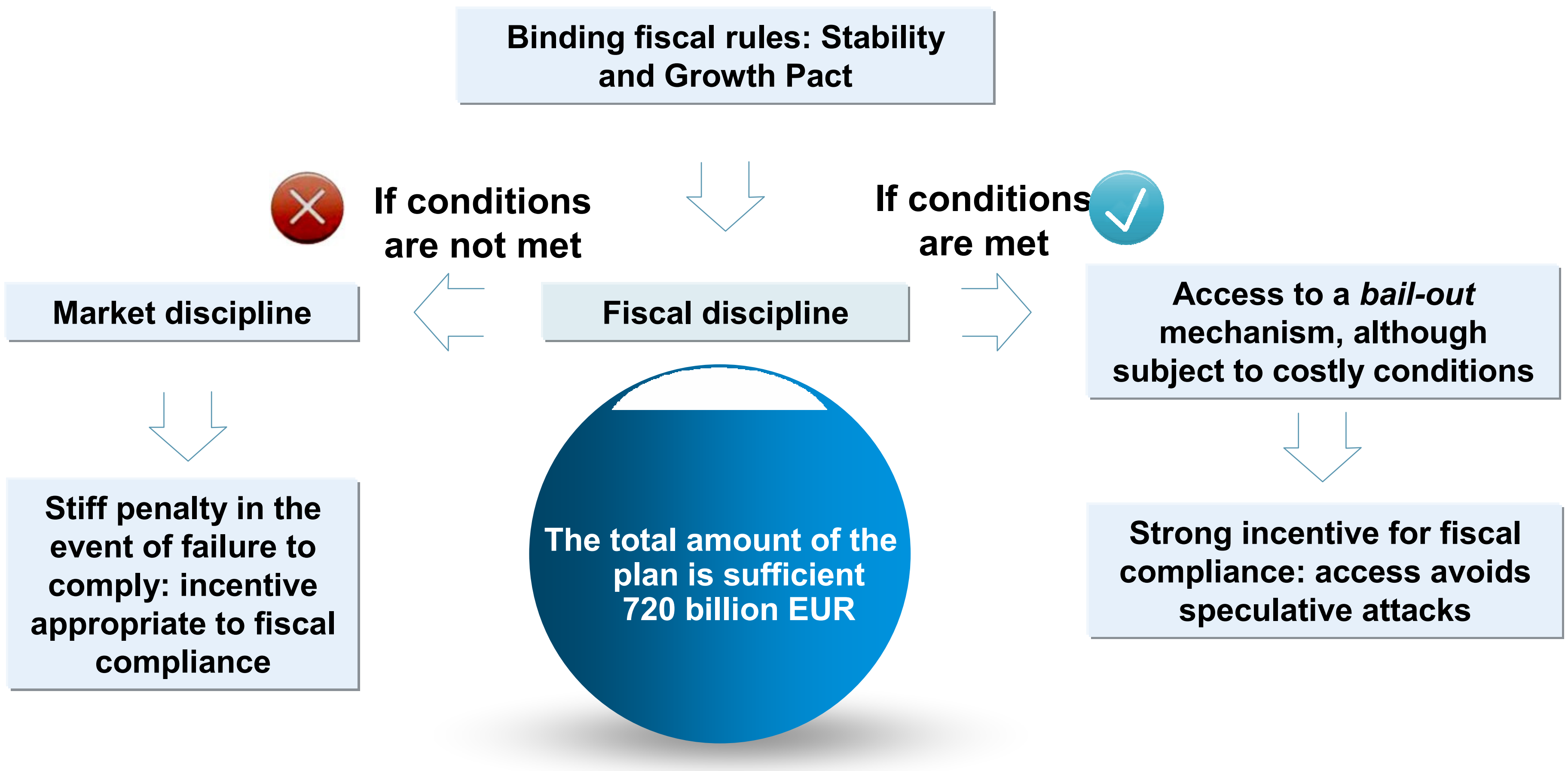
Source: Bloomberg and BBVA Research



2. New institutional framework

The European Stabilization Mechanism, together with the ECB's measures, should reduce uncertainty, at least in the short term

It seeks to harmonize market discipline mechanisms and those resulting from fiscal rules, as it makes access to the stabilization fund conditional on the implementation of a credible fiscal consolidation plan. Market discipline is reinforced with **European budget stability rules**.



Section I
Empirical evidence on Stability and Convergence Programmes

3. Faster fiscal adjustment

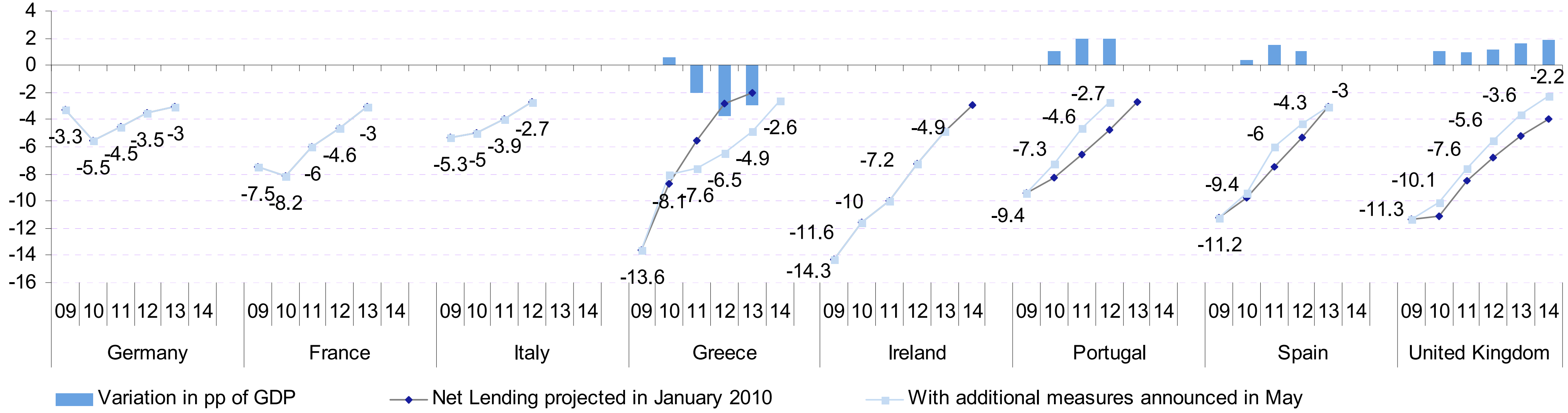
The fiscal adjustments revealed recently follow the consolidation plans announced at the beginning of 2010.

The UK, Portugal and Spain speed up their plans.

The necessary adjustment is large and its effect on activity will be limited, but it will be gradual over time.

Projected deficit plans

Source: National Government to EC January 2010, announcement in May and June, note that UK figures refers to Treaty deficit



Germany, France and Italy have detailed austerity plans for 2011

Spain and Portugal have disclosed measures for 2010 with regard to the actions contained in the stability plans. Greece's adjustment is being slower

UK announced its new budget on June 22

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Optimal discretionary fiscal policies

The short-run trade-off between fiscal consolidation and growth requires an optimal design of fiscal policies

- The design of the **exit strategies** would have been optimal when expansionary fiscal policies were implemented.
- Several authors (Corsetti et al, 2010) have shown that expansionary fiscal policies accompanied with anticipated **spending reversal** are more effective in boosting activity (larger fiscal multiplier).
- However the experience has shown that most countries (if not all) implemented in 2008 and 2009 expansionary fiscal policies with **no announcements about the details of exit strategies**.
- At that moment, the consensus was that discretionary fiscal policies should be timely, targeted and temporary (the three Ts). However, only the first two requirements received attention from policy makers whereas the duration of such policies were not discussed.
- The **sovereign debt crisis** has shown that most governments had no plans about how to dismantle **discretionary fiscal policies well in advance** and, more importantly, about how to reduce **structural deficits** effectively.
- An important lesson (prevention is better than cure): discretionary fiscal policies would have been more effective if they were announced simultaneously with exit strategies and plans to reduce structural budget deficits. **Uncertainty would have been smaller** and we would have avoided the increase of risk premia in Europe.

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Optimal discretionary fiscal policies

The question is **how to implement effective exit strategies for fiscal policy now.**

Are the current Stability and Convergence Programmes optimal with both short-run and long-run growth requirements?

Very recently **Olivier Blanchard and Carlo Cottarelli** have proposed "**Ten Commandments for Fiscal Adjustment in Advanced Economies**".

We evaluate Stability and Convergence Programmes according to these requisites.

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1. **A credible medium-term fiscal plan with a visible anchor (in terms of either an average pace of adjustment, or of a fiscal target to be achieved within four–five years)**

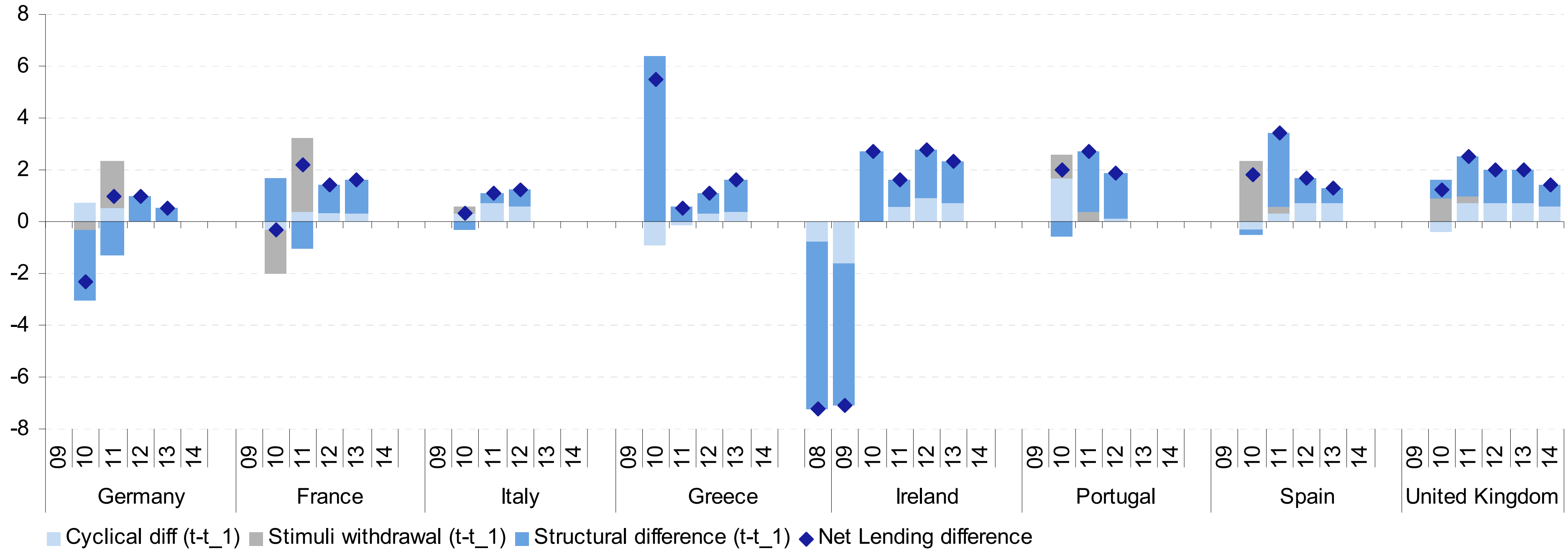
All countries have a medium-term fiscal plan (2013 or 2014), and

countries are reducing their deficits at a different speeds.

There are some doubts about its credibility, particularly in the case of Greece, Italy and France, and about the recovery of revenues.

Size and composition of consolidation **year on year difference**

Source: BBVA research

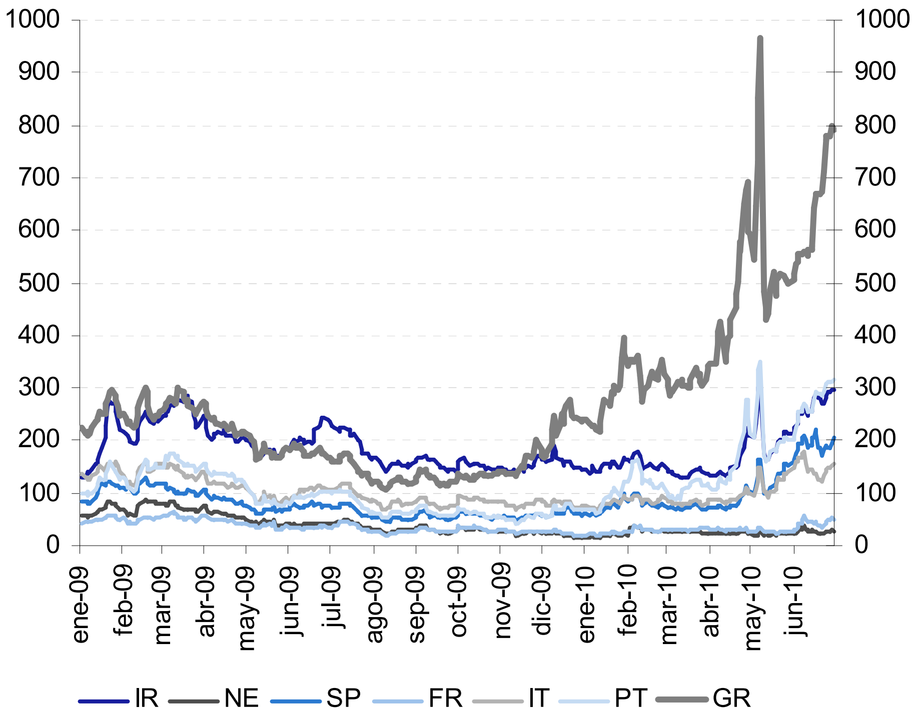


2. You shall not front-load your fiscal adjustment, unless financing needs require it.

- Countries which are accelerating their fiscal adjustment are those with more restrictions in financial markets.
- Procyclical fiscal policies in Greece, Portugal or Spain.
- Countercyclical fiscal policy in Germany, Italy and France.

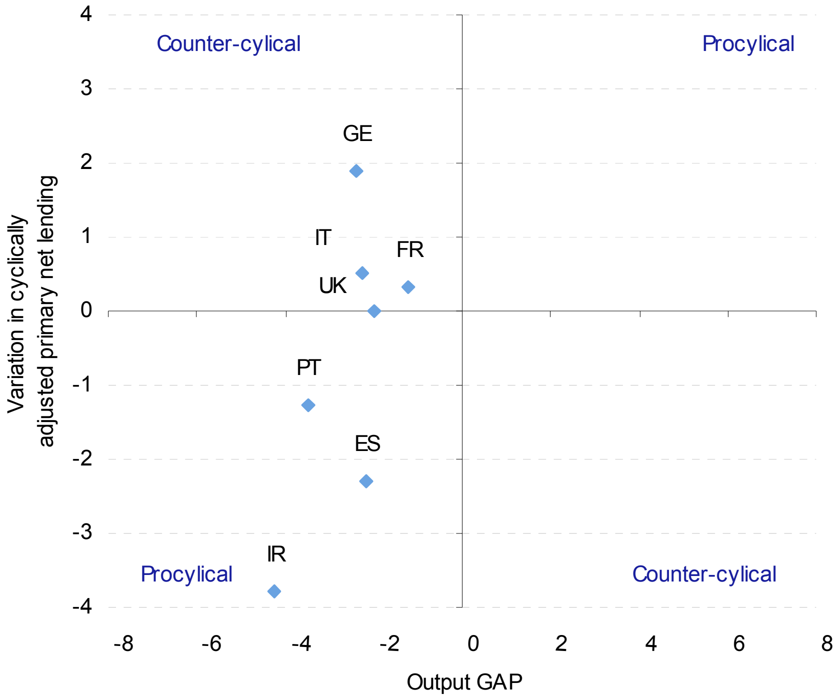
Sovereign spreads: 10yr bond (bps)

Source: BBVA Research



Sign of discretionary Policy in 2010

Source: Eurostat and National Governments SP (Jan 10)



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3. **You shall target a long-term decline in the public debt-to-GDP ratio, not just its stabilization at post-crisis levels.**

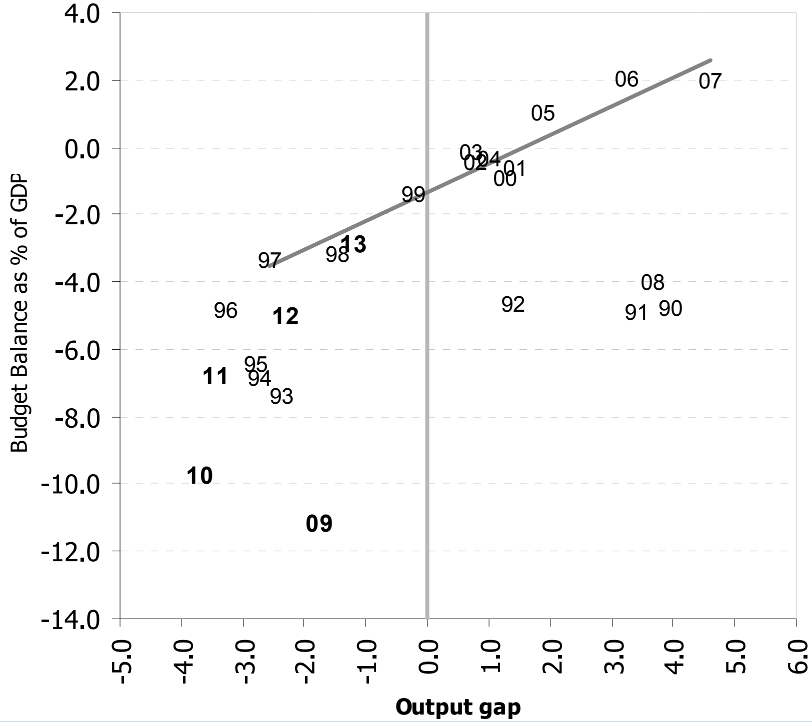
In some countries, a fiscal deficit of 3% in 2013 will be equivalent to a lower structural deficit since the output gap will be still negative.

Therefore debt-to-GDP ratios will decline slowly in the long run.

Example: D/GDP=(def/GDP)*(1/g)=0.015/0.04=0.375, as before the crisis.

Spain: Budget balance vs Output gap

Source: BBVA Research



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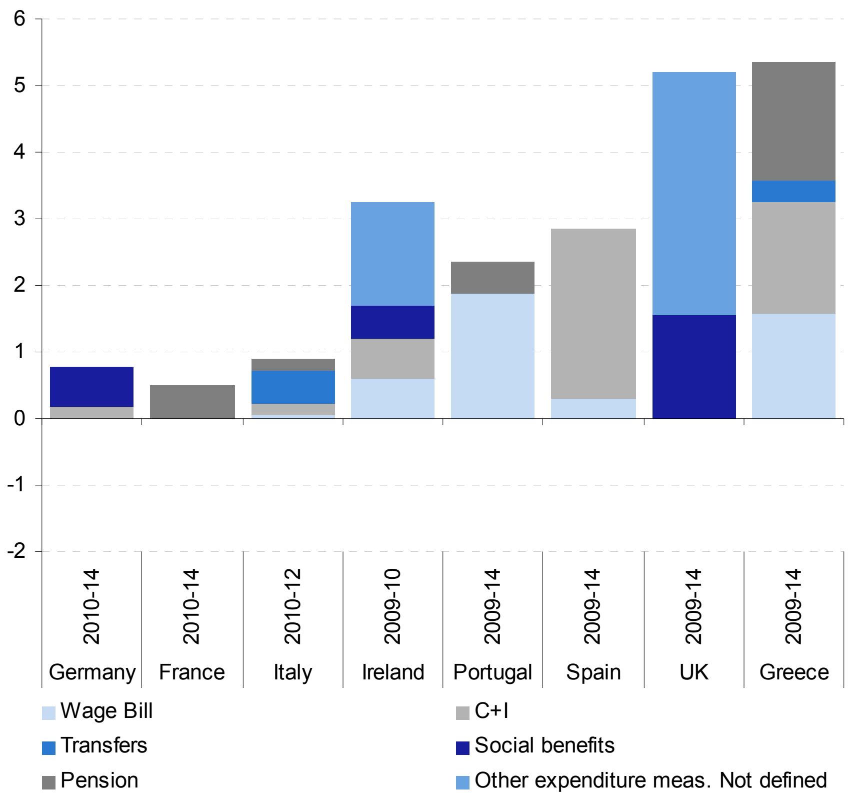
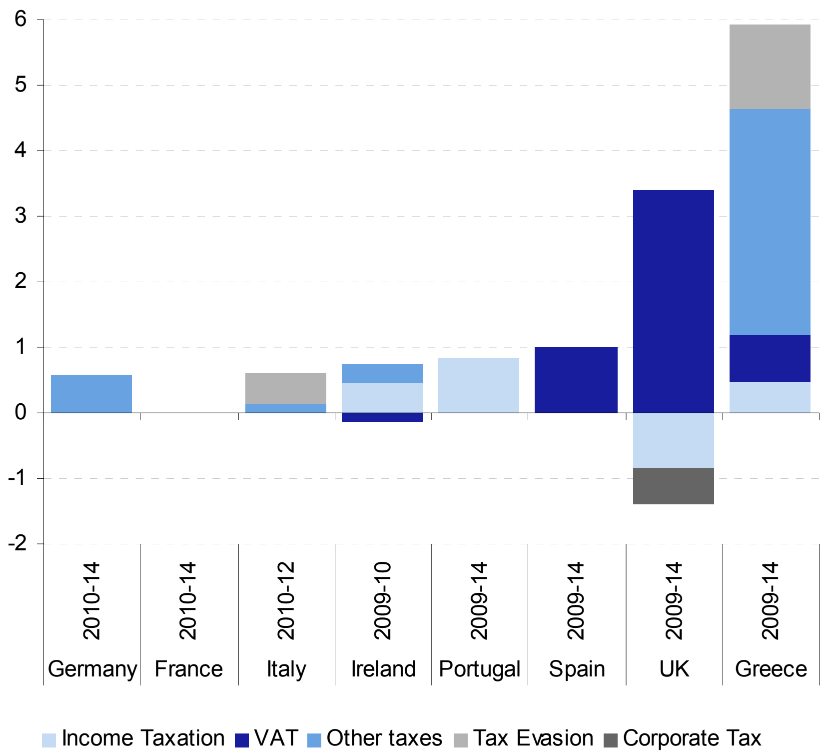
4. **You shall focus on fiscal consolidation tools that are conducive to strong potential growth.**

This require a bias towards (current) spending cuts, in order to avoid highly distortionary taxes, which are currently high in some European countries.

All detailed expenditure measures as % of GDP
Source: BBVA Research



All detailed revenue measures as % of GDP
Source: BBVA Research



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5. **You shall pass early pension and health care reforms as current trends are unsustainable.**

Significant differences across European countries. Countries like Germany, Portugal and Italy will suffer a moderate increase of health and pension expenditures.

Countries like Greece, Spain and Ireland will face a significant increase in these expenditures. Recent reforms approved (Greece) or under way (France or Spain).

Increase in total social protection expenditures (% of GDP)

(expenditure period T-expenditure 2010)

	2015	2020	2030	2040	2050	2060
Greece	0,8	1,9	6,4	11,5	15,1	16,0
Spain	0,4	0,7	2,4	5,2	8,3	8,2
Ireland	0,3	0,7	2,1	3,3	5,8	7,2
Germany	-0,1	0,2	1,9	3,5	4,3	5,1
EU27	0,1	0,4	1,8	3,3	4,3	4,9
Portugal	0,2	0,4	0,7	1,0	2,5	2,9
Italy	0,2	0,3	1,3	2,8	2,7	1,7

Source: 2009 Ageing Report, European Commission and BBVA Research

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6. **You shall be fair. To be sustainable over time, the fiscal adjustment should be equitable.**

Inequality is low in most European countries.

Progressivity of income taxes is high

Balance between direct and indirect taxes.

	Expenditure measures						Revenue measures				
	Gw	Gc, Gi	Social Benefits	Pensions		Other	Taxation				
				Gp	Reform		Td	Tc	Allow & exempt	Tk	Tax evasion
France					✓						
Germany	✓	✓	✓	✓					✓		
Italy	✓	✓		✓	✓	✓			✓		✓
Spain	✓			✓	✓		✓	✓	✓		✓
Greece	✓	✓		✓	✓		✓	✓	✓		✓
Ireland	✓						✓				
Portugal	✓	✓	✓	✓			✓				
UK	✓		✓		✓	✓	✓	✓		✓	

Source: BBVA Research

7. **You shall implement wide reforms to boost potential growth.**

Lower potential growth in Europe, but mainly explained by small population and capital growth

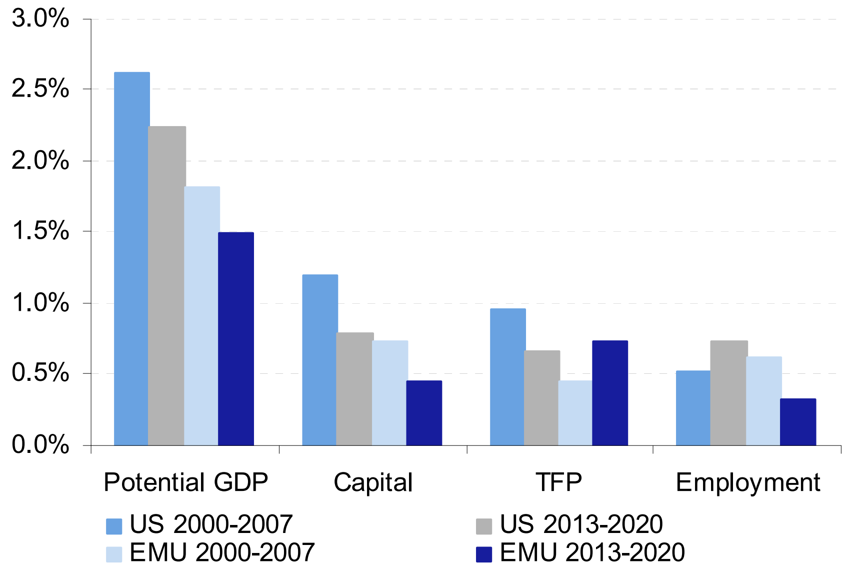
Significant differences with the USA in GDP/adult, not in terms of GDP per hour.

Significant differences among European countries in GDP per capita.

Strategy 2020 needed.

US and EMU: Potential GDP

Source: BBVA Research



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8. **You shall strengthen your fiscal institutions.**

   The Stability and Growth Pact did not avoid large fiscal imbalances.

   The role of the European Commission should become stronger. Expectations about the task force on economic governance.

9. **You shall properly coordinate monetary and fiscal policy.**

   Until now there has been not a perfect coordination between fiscal and monetary policy.

   Better fiscal rules and European fiscal procedures (European semester) will favour monetary and fiscal coordination.

   Some people do not share the need of more coordination.

10. **You shall coordinate your policies with other countries.**

    Low level of coordination among European countries, both when fiscal policies were expansionary and now when they are contractionary.

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Conclusions

In the right direction, but more can be done ...

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2. You shall not front-load your fiscal adjustment, unless financing needs require it.
3. You shall target a long-term decline in the public debt-to-GDP ratio, not just its stabilization at post-crisis levels.
4. You shall focus on fiscal consolidation tools that are conducive to strong potential growth
5. You shall pass early pension and health care reforms as current trends are unsustainable.
6. You shall be fair. To be sustainable over time, the fiscal adjustment should be equitable.
7. You shall implement wide reforms to boost potential growth.
8. You shall strengthen your fiscal institutions
9. You shall properly coordinate monetary and fiscal policy
10. You shall coordinate your policies with other countries

Main messages

- Huge increase of government deficits in European countries in 2009 as a consequence of discretionary fiscal policies and, more important, a structural deterioration of budget balances.
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