

Prot. 829/ns.

May 3, 2017

Dear Vice President, Dear Commissioner,

As the economic outlook shows that the recovery, albeit still modest, is picking up, it is the appropriate time for the economies of the EU to focus on their trajectories towards the MTOs. Notably, the Communication from the Commission of January 2015, and the following common agreed position formally endorsed by the February 2016 Ecofin, provide for differentiated fiscal efforts depending on the position in the economic cycle, with lower efforts in bad times and higher efforts to be taken in normal/good times, i.e. when the output gap is closing and/or growth is above potential. This corresponds to a symmetrical approach to fiscal policy over the cycle, fostering an enhanced budgetary discipline in periods of recovery to create the necessary room to accommodate for economic downturns, thereby contributing to the long-term sustainability of public finances.

While we confirm our support for this principle, we also highlight the unusual nature of current juncture where the legacy of the last crisis is still visible. In some countries, the negative consequences of a very protracted period of extraordinary low inflation, low growth, high unemployment and the resulting hysteresis effect, amplified by significant policy uncertainties at global level including risks of increased protectionism, could lead to detrimental and long term effect on potential growth if not tackled decisively. In this context, authorities should use all economic policy instruments at their disposal to ensure that economic growth and employment return to sustainable levels.

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With respect to fiscal policy, guidance remains based on unobservable indicators for which methodological discussions are underway. In particular, there are substantial uncertainties regarding the estimates used in fiscal surveillance, notably the potential growth, the output gap and the speed at which it is closing. Besides not being observable, these indicators are often subject to substantial revisions and are very sensitive to the length of the forecast period considered. These concerns have also been supported by the implementation of the so called “plausibility tool”, developed by the Commission, that indicates that for a number of countries the output gap estimates obtained according to the commonly agreed methodology are characterized by uncertainties and not negative enough. However, the plausibility tool is a very limited instrument and can only signal the implausibility of point-in time estimates. Furthermore, quite surprisingly, it doesn’t flag a number of countries where the output gap estimates could be seen as counterintuitive looking at macroeconomic fundamentals.

From a general perspective, the uncertainty surrounding the current estimates of the potential output is to be attributed to the length and persistence of the economic and financial crisis which has made the current recovery unusual and the pre-existing models to interpret the economic reality fragile and potentially misleading.

As attempts to improve the common methodology at EU level regarding potential growth estimation in a reasonable timespan have not been particularly successful, - policy makers have been pushed to developing alternative models of estimation of potential output, which could help provide for results that seem more in line with the economic fundamentals and the relative performance of countries in the EU.


For example, the model should try to better capture the impact, especially on structural unemployment, of the significant reforms enacted resulting in improvements in competitiveness and macroeconomic conditions; in addition other elements should be explicitly considered, as for instance, the ability to predict inflation or considering a variable of labour hoarding that better captures the behaviour of firms in the aftermath of the crisis. The alternative models that have been or could be developed, - still within the remit of the commonly agreed methodology - can lead to different outcomes in term of compliance with the fiscal framework. This casts concerns at the current juncture on the appropriateness and predictability of annual requirements, especially for countries in the preventive arm, where the surveillance is centered around the structural balance.


Against this backdrop, it appears necessary to consider the economic conditions stemming from a prolonged period of low inflation, low growth, high unemployment and develop significant changes in the common methodology on potential growth and output gap estimation, as well as on fiscal rules’ predictability and simplicity. Further work in this direction should be timely performed by the Commission.

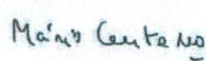
Indeed, an enhanced approach taking into account all the above described concerns would make the commitments towards the requirements clearer, more credible and predictable, thus increasing the ownership of fiscal recommendations.

We are confident that, while Member States agree on a definitive solution regarding the above mentioned methodological issues, the Commission will be able to factor in all the above elements in its work plan for the coming months and to take into account the current economic juncture and the methodological limits raised in this letter in its regular assessment of Member States' fiscal policies in the Stability Programmes and in the country specific policy guidance within the European semester framework, starting from the forthcoming country specific policy guidance on the basis of the 2017 Stability Programmes. We believe that such an approach would bring a positive contribution to the growth perspectives of the Union and enhance the overall credibility of the common framework of rules.

Yours sincerely,

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