

July 2018

## Key messages:

- **Macroeconomic outlook continues to be benign but IFIs see within-EU negative spill-overs, global factors as well as high domestic private debt as a source of downside risk to outlook**
- **EU IFIs warn of lack of ambition in fiscal targets despite favourable cyclical conditions**
- **Demographic changes not only complicate the longer-term outlook but already start to bite in some places**

## Macroeconomic outlook

Growth projections are strong in EU countries with most of them estimated by their IFIs to operate above or close to potential in 2018-2019. Growth prospects are mostly driven by domestic demand in countries such as Malta, Greece, Spain, Cyprus and Sweden. In other cases (Lithuania, Slovakia and the Czech Republic), growth is expected to be more balanced, arising from both domestic and foreign demand.

Many IFIs, however, warn of both domestic and external risks to the favourable outlook (see Figure 1 for a graphical summary of the IFIs' risk-related commentary). The Cyprus Fiscal Council highlights the risks arising from very high private debt and non-performing loans. Developments in the financial sector are a concern in Latvia too. In Denmark, tightening labour markets and rising house prices are seen to threaten the macroeconomic outlook. Tightening labour markets are highlighted by the Slovak and Lithuanian IFIs too. The vulnerabilities arising from high private indebtedness and rapid asset price developments represent a downside risk for Sweden as well. The Hellenic Fiscal Council warns of spill-overs from an eventual turmoil in Italy or Spain, Brexit, political tensions in the Middle East and global trade protectionism. The emergence of new global trade barriers is seen as a key external threat to the benign outlook by the Slovak and Irish IFIs as well. Ireland is particularly exposed to the uncertainty surrounding Brexit and the international tax environment.

## Fiscal outlook

Public debt is projected to fall in 2018 in all countries with the exception of Cyprus, Romania and Greece. Many countries will record a fiscal surplus but the year-on-year change in the structural balance is often close to zero or negative. The structural balance is forecast to deteriorate in Ireland, Romania, Slovenia, the Netherlands, Austria, Denmark and Estonia. Figure 2 shows that while output gap estimates for EU countries are predominantly in the positive territory for both 2018 and 2019, the general tendency is a gradual shift towards a looser stance in 2018 before some tightening, if any, in 2019. IFIs increasingly warn about procyclicality in fiscal stance (see quotes below). Figure 3 also indicates that countries with lower (higher) debt levels plan to loosen fiscal stance more in 2018 (2019).

Demographic change represents a recurring concern among IFIs. Slovakia would need to run a small structural surplus as opposed to a deficit of around 1 percent of GDP to keep public debt under control in the long term while in Denmark, the fiscal effects of aging are forecast to be more moderate. In Lithuania, the adverse demographic trends have very real consequences already today, affecting the economy's growth potential. The Swedish IFI highlights the need to improve the labour market prospects of the non-native population and those with lower education levels.

## Fiscal frameworks

In Sweden, the national fiscal framework will see some changes taking effect in 2019. The surplus target will be reduced, and a debt anchor with a tolerance range will be introduced. The changes have received wide political backing.

Romania's fiscal framework does not seem to be strong enough to prevent rapid fiscal expansion at times of high growth. Repeated warnings by the IFI have been ignored.

*"The fiscal policy will be expansionary both this and next year .... However, given the state of the economy a restrictive stance would be appropriate."* NRR, Czech Republic

*"...the current policy framework is insufficiently equipped to prevent a return to procyclical fiscal policy. Sensible tools such as the Rainy Day Fund and a medium-term debt target set up to help with medium-term budgeting, are only half-formed and need more development if they are to be effective."* IFAC, Ireland

*"The government budgetary balance is not improving, despite the economic boom."* CPB, Netherlands

*"...the fiscal space has not been created during good times to ensure the possibility of counter-cyclical expansion during a downturn in the business cycle"* Fiscal Institution, Lithuania

*"Structural balances are positive but fiscal policy needs to address cyclicity better"*, Bulgarian Fiscal Council

Figure 1: Risks to outlook



Figure 2: Fiscal stance and the economic cycle

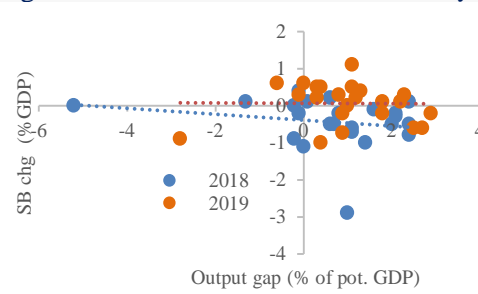


Figure 3: Fiscal space and fiscal stance

