Contents Page

Figures (continued)

Tables

I. Overview

1. Background work for the Article IV consultations with France, Germany, Italy, and Spain has been pooled and focused on two topics: fiscal policy frameworks and the job-intensity of growth. The topics are highly relevant to macroeconomic performance and policy making in all four countries. Fiscal frameworks take on added importance in a monetary union and need to address ongoing tensions between long-term consolidation goals and short-term policy objectives. Such tensions are currently quite prominent as the economic slowdown puts budget deficit targets under pressure. And adequate job creation has been one of Europe's long-standing economic problems: understanding the factors behind the seemingly better employment performance of the last few years will provide pointers for making further progress in reducing still-high unemployment. The main analysis and conclusions are presented here. Some further information can be found in the Supplementary Information paper.

2. The work on fiscal frameworks (Chapter II) explores the benefits of rules-based approaches to policy making in the four countries. Fiscal rules attempt to constrain policy by committing the authorities to targets for deficits, debt, or public expenditure. In principle, rules can help to counteract the deficit or spending bias that may be inherent in a discretionary policy framework, given the structure and incentives that typically reside within political systems. At the same time, rules need not constrain the room for counter-cyclical fiscal policy—a potential advantage of a discretionary framework, albeit one that is frequently not realized.

3. Chapter II argues that the four countries should place more emphasis on spending rules within the boundaries set by the Stability and Growth Pact. At present, fiscal frameworks are geared to achieving balances around zero in the medium term. En route, annual deficits are meant to follow declining paths as articulated in each country's Stability Program. This chapter suggests that countries should maintain medium-term targets for the budget balance—or, alternatively, the stock of public debt—geared to long-term policy objectives. But it points out that rigid adherence to annual deficit targets can impart a pro-cyclical bias to fiscal policy through contractionary measures to buttress revenues in a downswing and a temptation to spend windfall tax receipts in an upswing. A binding spending rule that was consistent with the medium-term deficit or debt target and with tax policy objectives would allow cyclical revenue fluctuations to be reflected in annual outcomes for the budget balance. But it would not sacrifice—and perhaps it would even enhance—policy credibility. Nonetheless, designing an effective spending rule is not straightforward: should spending rules be real or nominal? how comprehensive should the definition of spending be? what safeguards can be put in place to ensure that the rules are credible? how can they be made to work in a decentralized system where regions/states enjoy considerable autonomy? Chapter II reviews the implementation issues and provides some practical answers to these and other questions.

4. Chapter III examines the factors behind the improved job-creating records of the four countries in the second half of the 1990s. Economic growth in the two cycles prior to the current downturn was unusually "job rich". That is, employment responded more buoyantly