Prospects and challenges for the Euro Area economy

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Think Tank Europe
Copenhagen, 28 April 2017
1. **Economic outlook:** Brightening growth prospects, propelled by improving fundamentals and supportive policy mix

2. **Challenges:** Addressing long-standing structural weaknesses and crisis legacies

3. **Future of Europe:** How could a sustainable institutional architecture for EMU look like?
Sluggish post-crisis recovery

Real GDP, Euro Area
(index, Y-7 = 100)

Real GDP, advanced economies
(index 2008 = 100)
Key drivers of the recovery

- **Waning initial favourable tailwinds**
- **Improving fundamentals**
  - Job-rich recovery, fuelling private consumption
  - Switch from *balance sheet* to *macro* deleveraging in the private sector
  - Safer and sounder banking sector
  - Improved competitiveness
- **Continued supportive policy mix**
Highly accommodative monetary policy

Policy rates set by the ECB and US Fed (in %)

ECB MRO rate
ECB deposit facility rate
US Fed target rate (upper bound)

ECB and Fed balance sheet expansion (in % of annual nominal GDP)

Diverging views on the role of fiscal policy

- **Discretionary fiscal policy is fraught with problems**
  - It should be limited to exceptional circumstances
  - Fiscal policies in EMU should focus on prudent medium-term positions in each and every country

- **The macroeconomic role of fiscal policies is essential in EMU**
  - At country level, as individual Member States have lost the channel of monetary policy
  - Aggregate fiscal stance important too, complements monetary policy (at least in some circumstances)
What fiscal stance for the euro area?
Differentiated fiscal space

*Fiscal space and adjustment needs at country level*

![Bar chart showing fiscal space and adjustment needs for various countries.](image)
# Challenges

## Pre-crisis structural impediments to growth
- Population ageing
- Slow productivity growth
- High unemployment
- Rigid product and labour markets

## Crisis legacy
- Investment gap
- Low potential growth
- Persistently low inflation
- High debt (private/public)
- Weak banks (high NPL, low profitability, high costs)
- Asymmetric rebalancing
- Halt/reversal convergence process
- Rising inequality
- Citizens' declining systemic trust
Sluggish recovery of investment

**Gross fixed capital formation**
(in local currency, index 2008 = 100)

**Gross fixed capital formation breakdown, EA-19**
(in % GDP)

*Note: Crisis countries include Cyprus, Greece, Ireland, Portugal, Spain. Data for construction and equipment only available until 2015.*

*Source: European Commission winter forecast 2017.*
Economic structures less resilient

Product market regulation

Employment protection legislation

Note: The graph shows OECD indicators measuring the degree of product and labour market regulation (the latter refers to individual and collective dismissals). Indicators range on a scale from 0 (least restrictions) to 6 (most restrictions). Latest data available 2013.

Source: OECD.
Structural reforms fatigue

Implementation record of COM country-specific recommendations (CSRs)

Note: Implementation record is measured by a COM composite indicator ranging from 0 (no implementation) to 100 (full implementation). The country-specific recommendations (CSRs) list key reform needs of Member States as part of the European Semester.
Secular decline in potential growth

Contributions to potential growth
(in ppt., unless otherwise indicated)

High public and private debt

**Gross debt general government**
*(in % of GDP)*

**Private sector debt**
*(NFC and HH; in % of GDP)*

**Note:** General government debt in line with Maastricht definition. Red line shows the Maastricht reference value.

**Source:** European Commission winter forecast 2017.

**Note:** The private sector debt is the stock of liabilities in the form of loans and securities other than shares excluding financial derivatives held by the sectors non-financial corporations and households and non-profit institutions serving households. Transactions within sectors are eliminated (consolidation).

**Source:** Commission services.
Limited fiscal buffers to cope with shocks

Fiscal adjustment required to reach a 60% public debt-to-GDP ratio by 2031
(in % of GDP)

Note: COM baseline scenario comes from the winter forecast 2017, 2016 Stability and Convergence Programmes (SCP). Dotted line indicates COM assessment of high/medium risk (above the dotted line/between the dotted and zero line/below the zero line).
Source: Commission services.
High non-performing loans (NPL)

The evolution of the NPL ratio and real GDP growth, EU and EA (2000 - 2015)

Note: Data based on Worldbank, ECB, DG ECFIN calculations.

NPL per Member State (in % of GDP)

Note: ECB and DG ECFIN calculations.
Sizeable heterogeneity in the Euro Area

**Real GDP**
(in %)

**Unemployment rate**
(in %)

Note: Dark blue line shows the weighted EA-19 average; dotted line shows the simple un-weighted EA-12 average. Light blue area defines the whole range of observed values (from maximum to minimum), while the darker blue area defines the area between the first and second quartile based on un-weighted data for EA-19. Green line shows Denmark.

EMU today: an unsustainable equilibrium?

Incomplete Banking Union and no CMU

Asymmetric surveillance mechanisms

No common stabilisation function

- Insufficient private and public risk-sharing
- Impossible to achieve simultaneously:
  - an appropriate fiscal stance for the euro area as a whole
  - an optimal distribution of the fiscal effort
- Leads to the overburdening of monetary policy
- Risk of renewed financial instability
- Weak/challenged democratic accountability
Two competing models for EMU

"Back-to-Maastricht"

- Stronger enforcement of EU fiscal rules to rein debt and deficits
- MIP focused on competitiveness of lagging countries
- Banking Union does not need common deposit insurance
- End to the risk-free status for sovereign debt and establish sovereign debt restructuring mechanism
- More market discipline

Fast forward to an integrated EMU

- Distribution of fiscal efforts to achieve an appropriate aggregate fiscal stance
- Symmetric adjustment to help weak countries and reduce Euro area current account surplus
- Full Banking Union to ensure financial stability and private risk sharing
- Fiscal capacity for public risk sharing and eventually sovereign debt mutualisation
- Euro area Treasury
Minimum governance requirements for a viable EMU

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<thead>
<tr>
<th>Monetary</th>
<th>Banking</th>
<th>Fiscal</th>
<th>Economic</th>
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</thead>
<tbody>
<tr>
<td>• ECB as a lender of last resort</td>
<td>• Establish a common European Deposit Insurance Scheme</td>
<td>• Establish a sovereign debt restructuring mechanism</td>
<td>• Foster convergence towards similarly resilient economic structure</td>
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<td>• Implement a common backstop to the SRF</td>
<td>• Improve the effectiveness of direct bank recapitalisation in the ESM</td>
<td>• Create a centralised fiscal capacity</td>
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<td>• Create a European safe asset</td>
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<td>• Establish a debt redemption fund</td>
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**Included in the Blueprint**

**Included in 5PR?**

**Possible w/o Treaty change?**

*Note: This assessment only serves for indicative purposes. Inspired by Baldwin and Giavazzi (2016): How to fix the Eurozone: Views of leading economists, 12 February 2016, VoxEU.*
# European policy priorities

| **More balanced policy mix** | • Unburdening the ECB  
• Fiscal capacity and fiscal rules  
• Private and public risk sharing |
|-------------------------------|------------------------------------------------------------------------------------------------------------------|
| **Structural Reforms 2.0**   | • Productivity / TFP  
• Human capital  
• New welfare and financial systems |
| **Rethinking EMU architecture** | • New European public goods  
• Rebuilding trust to complete EMU  
• Vertical budget coherence |