"Achieving the optimal policy mix in the Eurozone: macroeconomic and structural policies to support growth"

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Outline

1. Towards a more balanced policy mix
2. The role of fiscal policy
3. The role of structural reforms
4. Conclusion
1. A MORE BALANCED POLICY MIX
"Our growth must be shored up by well-designed and coordinated policies. We are determined to use all policy tools - monetary, fiscal and structural - individually and collectively to achieve our goal of strong, sustainable, balanced and inclusive growth. Monetary policy will continue to support economic activity and ensure price stability, consistent with central banks’ mandates, but monetary policy alone cannot lead to balanced growth."

(G20 leaders' communique, 4/5 September 2016 Summit in Hangzhou)
Adjustment objectives in the Eurozone

- Inflation persistently below target
- Lack of rebalancing
- Persistent debt stifling growth
- Sustainability of high debt burdens
- Competitiveness gains in vulnerable economies
Modest growth in challenging times

Euro area GDP: annual growth rate and cumulative change, 2008-18,
Substantial economic slack remaining

index, 2008-Q1 = 100

- Employment
- Total hours worked
- Domestic demand (incl. stocks)
Inflation vs. current-account balance in the euro area

Inflation vs. current-account balance in the euro area
Finding the right policy mix

Horizontal axis centered at +1, which is broadly in line with potential growth over the forecast horizon.
Euro area composite credit cost indicators show marked decline.

Sources: ECB, Bloomberg, own calculations.
2. THE ROLE OF FISCAL POLICY
Fiscal Policy: EA vs. US

Change in structural balance
(growth rates in brackets)

Source: OECD April 2016
The EA fiscal stance

- Fiscal expansion
- Fiscal consolidation
The EA fiscal stance in 2017: what SGP prescribes
The legacy of debt

Public debt before and after the crisis (%GDP)

Public and private debt in the EU, average (%GDP)

Source: AMECO and ECFIN calculations.
How much fiscal space? A Blanchard-inspired framework

\[ \hat{b} = \frac{\hat{p}}{r^* - y^*} \]

- \( \hat{b} \): maximum politically sustainable debt
- \( \hat{p} \): maximum politically achievable primary surplus
- \( r^* \): normal interest rate
- \( y^* \): potential growth rate

- The normal interest rate \( (r^*) \) has been falling potential growth rates \( (y^*) \) have also dropped
- Implications of Blanchard's model:
  - Lower \( r^* \) increases the fiscal space
  - Lower \( y^* \) reduces the fiscal space
  - \( \hat{p} \) will probably decrease in the future

Fiscal space: the interplay between primary surpluses and overall debt levels

\[ \hat{b}: \text{maximum politically sustainable debt} \]

\[ \hat{p}: \text{maximum politically achievable primary surplus} \]

\[ r^*- y^* > 0 \]
Fiscal space: change in $r^*-y^*$

- $\hat{b}$: maximum politically sustainable debt
- $\hat{p}$: maximum politically achievable primary surplus

$r^*-y^*>0$
Fiscal space: lower sustainable primary surplus

\[ \hat{b}: \text{maximum politically sustainable debt} \]

\[ r^* - y^* > 0 \]

\[ \hat{p}: \text{maximum politically achievable primary surplus} \]
Fiscal space: higher or lower in the future

\[ b^*: \text{maximum politically sustainable debt} \]

\[ r^*-y^*>0 \]

\[ \hat{p}: \text{maximum politically achievable primary surplus} \]
3. THE ROLE OF STRUCTURAL REFORMS
What are structural reforms?

- Reforms tackle fundamental bottlenecks to economic growth and help economies to adjust to shocks by making them more flexible and reactive.

- First years of the crisis: focus on competition-enhancing aspects (e.g. labour market flexibility) and resilience (e.g. pension reforms).

- Moving forward: Second generation of reforms focus on enhancing human capital and tackling rent-seeking.

→ Structural reforms and income distribution: need for a fresh approach (structural reforms 2.0)
The impact of structural reforms

Model simulations of narrowing the gap with best performers by half

Source: European Commission
The Political economy of structural reforms: the Keynesian view vs. the moral hazard view

• **Keynesian view**: reforms can be painful in the short-term: undertake reforms in periods of high growth so as to compensate losers

• **Moral hazard view**: governments undertake difficult reforms only when they are with their back against the wall

• **Who is right?**
  
  • government horizon is key
  • opposite prescription on fiscal and monetary policy
  • TINA in the crisis
Defying the "Juncker's curse"

- Reforms and re-election
- Empirical evidence
- Key role of financial markets and welfare systems
4. CONCLUSION
Conclusion

• The **G20 three-pronged strategy** is the way forward

• A more balanced policy mix is consistent with **lower global imbalances and better global governance**

• More **supportive fiscal policies** reduce the pressure on monetary policy: the ECB may more quickly return to orthodoxy

• Addressing the tensions between national and EA fiscal stances: a **EA fiscal capacity**?