



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

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Outline

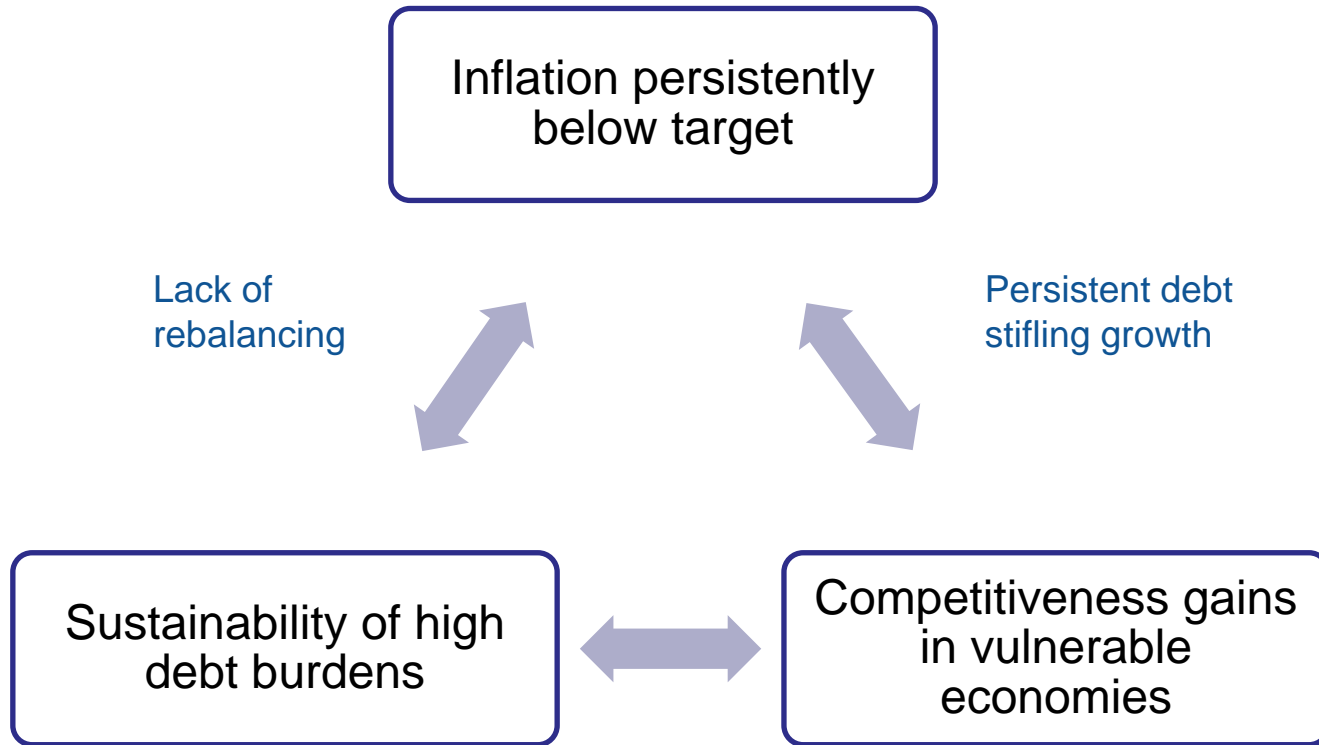
1. *Towards a more balanced policy mix*
2. *The role of fiscal policy*
3. *The role of structural reforms*
4. *Conclusion*

1. A MORE BALANCED POLICY MIX

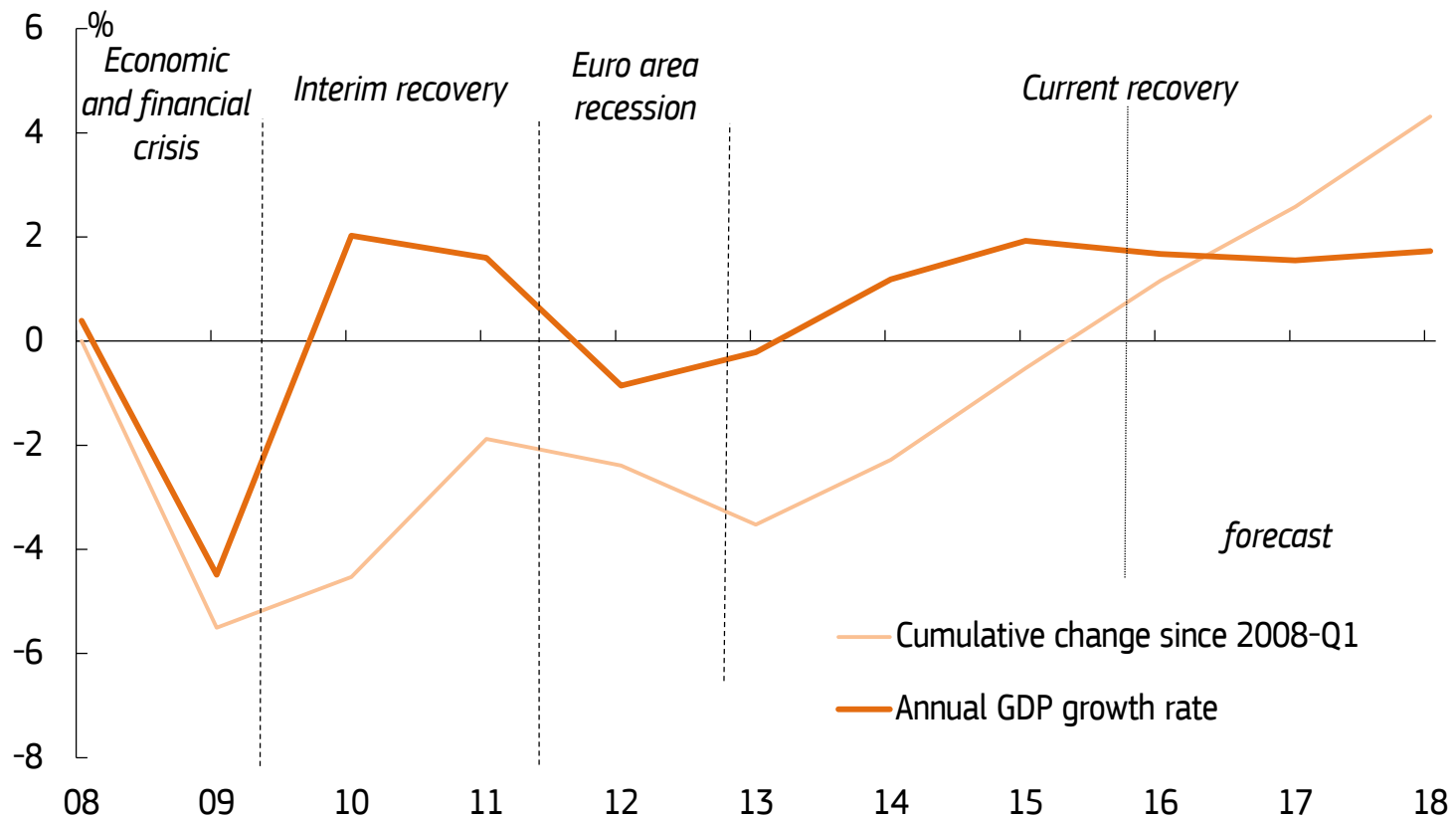
"Our growth must be shored up by well-designed and coordinated policies. We are determined to use all policy tools - monetary, fiscal and structural - individually and collectively to achieve our goal of strong, sustainable, balanced and inclusive growth. Monetary policy will continue to support economic 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

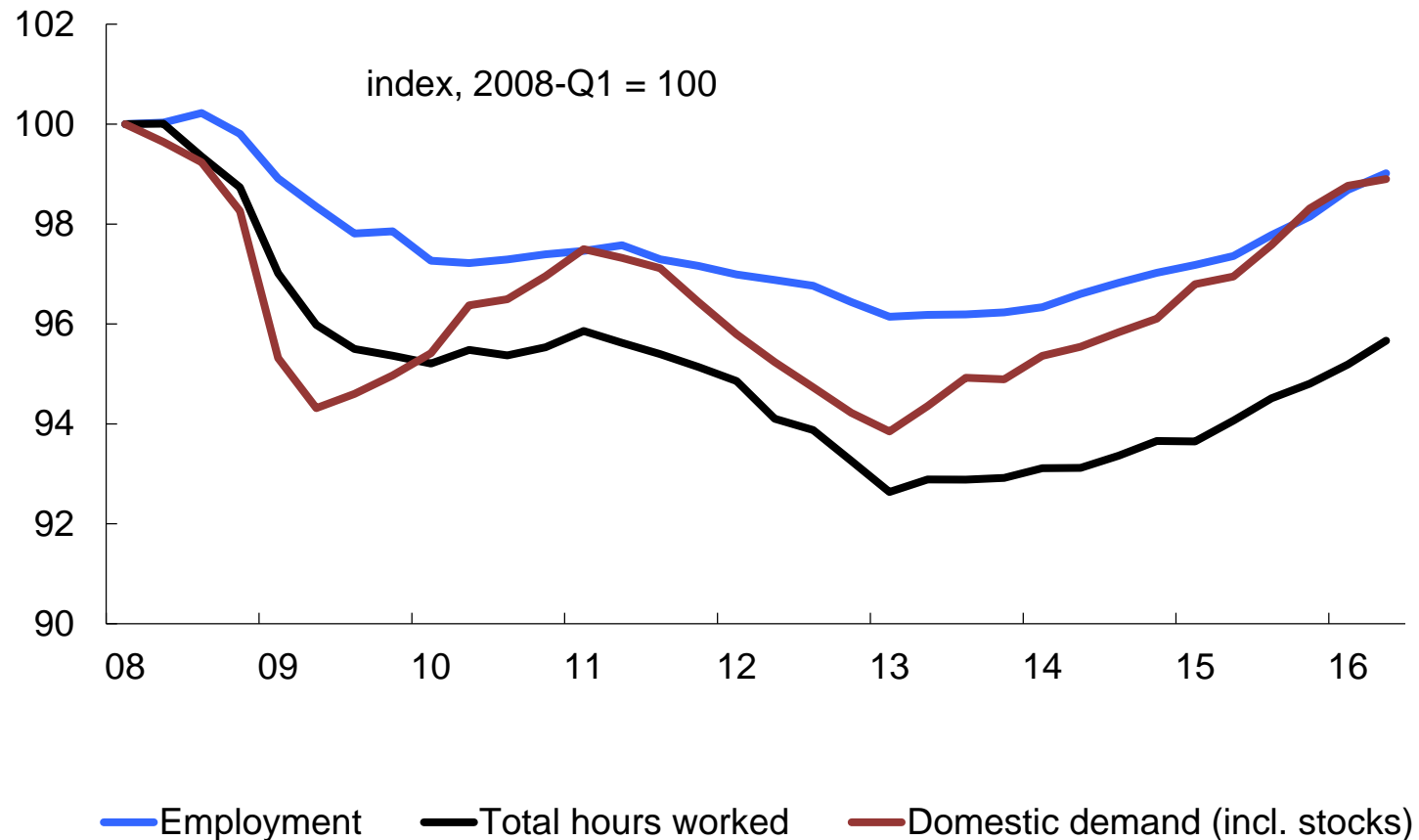


Modest growth in challenging times

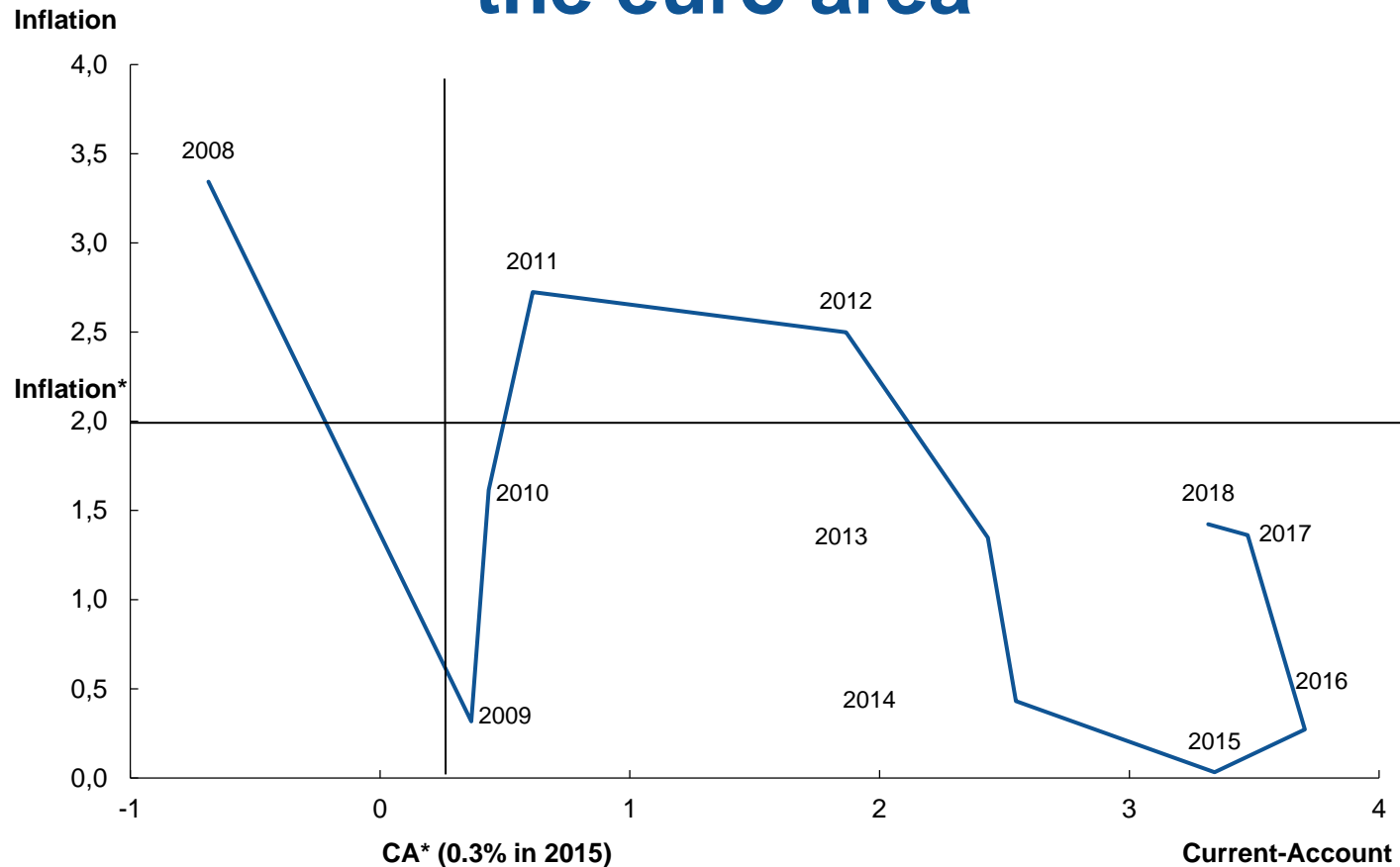


Euro area GDP: annual growth rate and cumulative change, 2008-18,

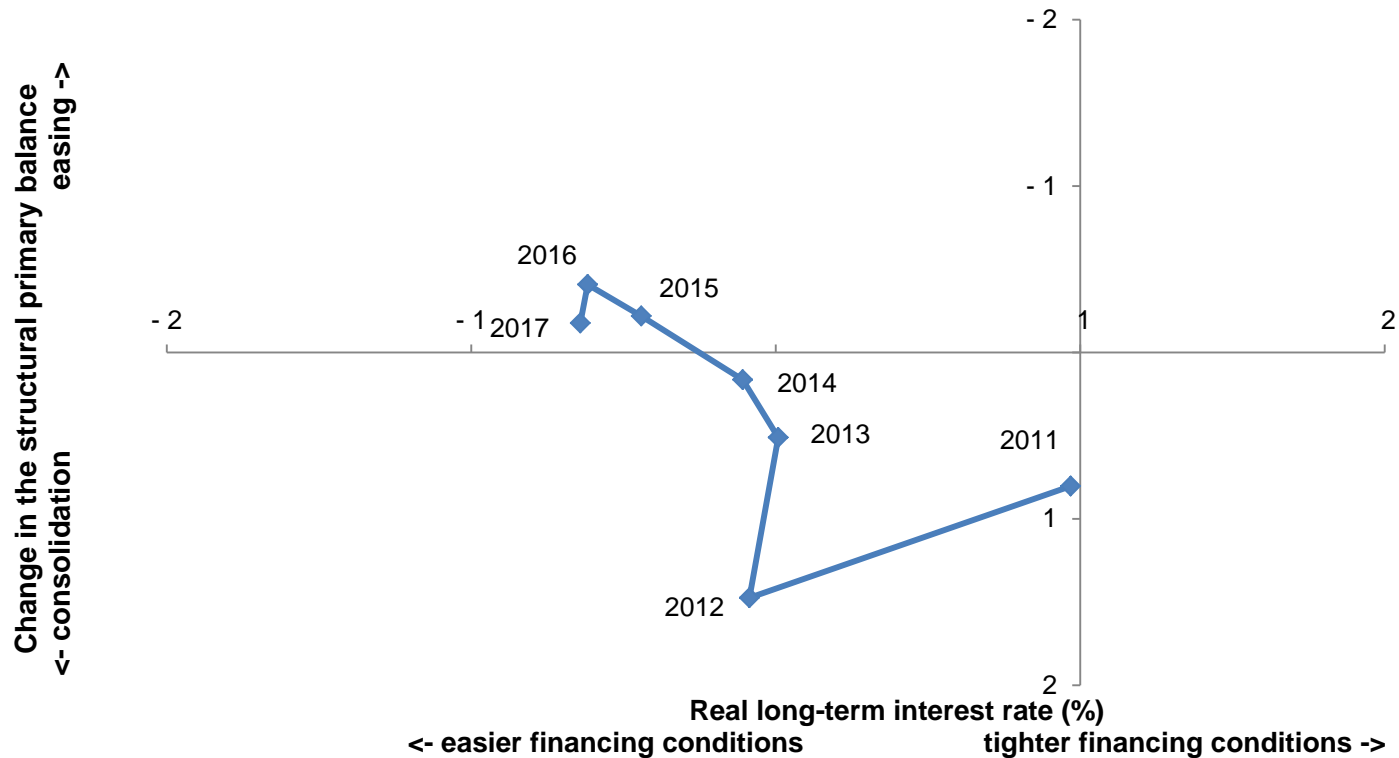
Substantial economic slack remaining



Inflation vs. current-account balance in the euro area

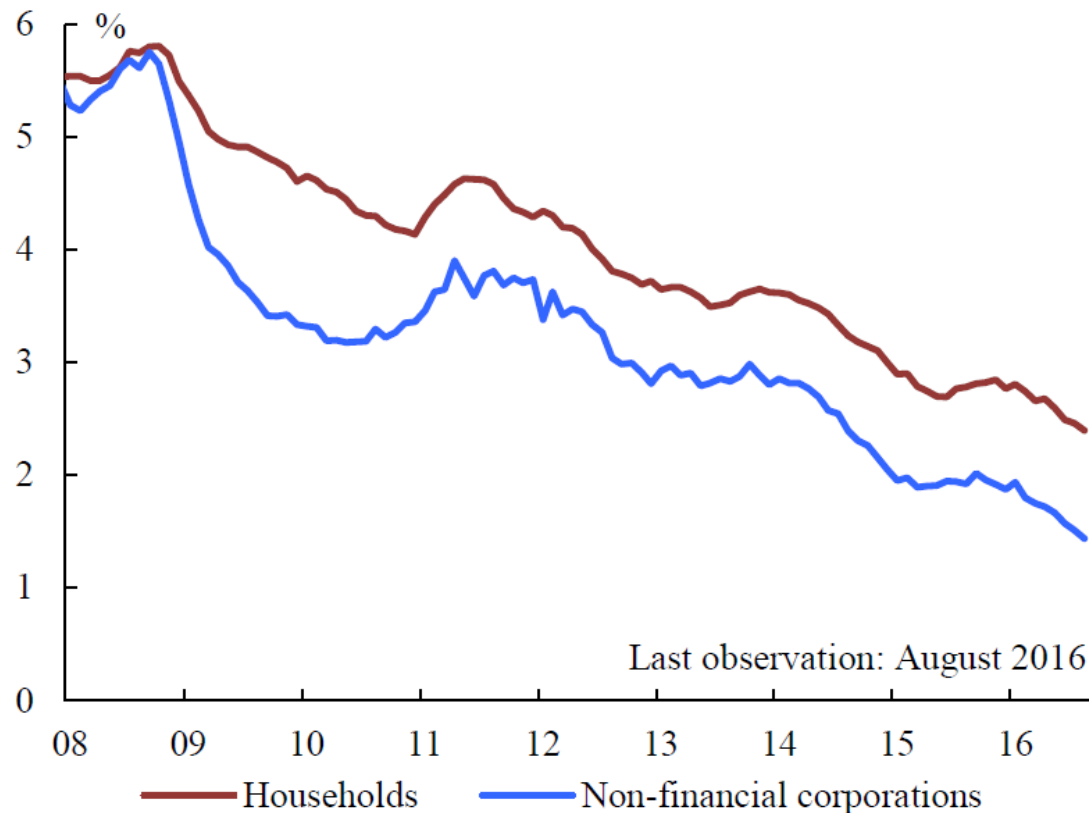


Finding the right policy mix



Horizontal axis centered at +1, which is broadly in line with potential growth over the forecast horizon.

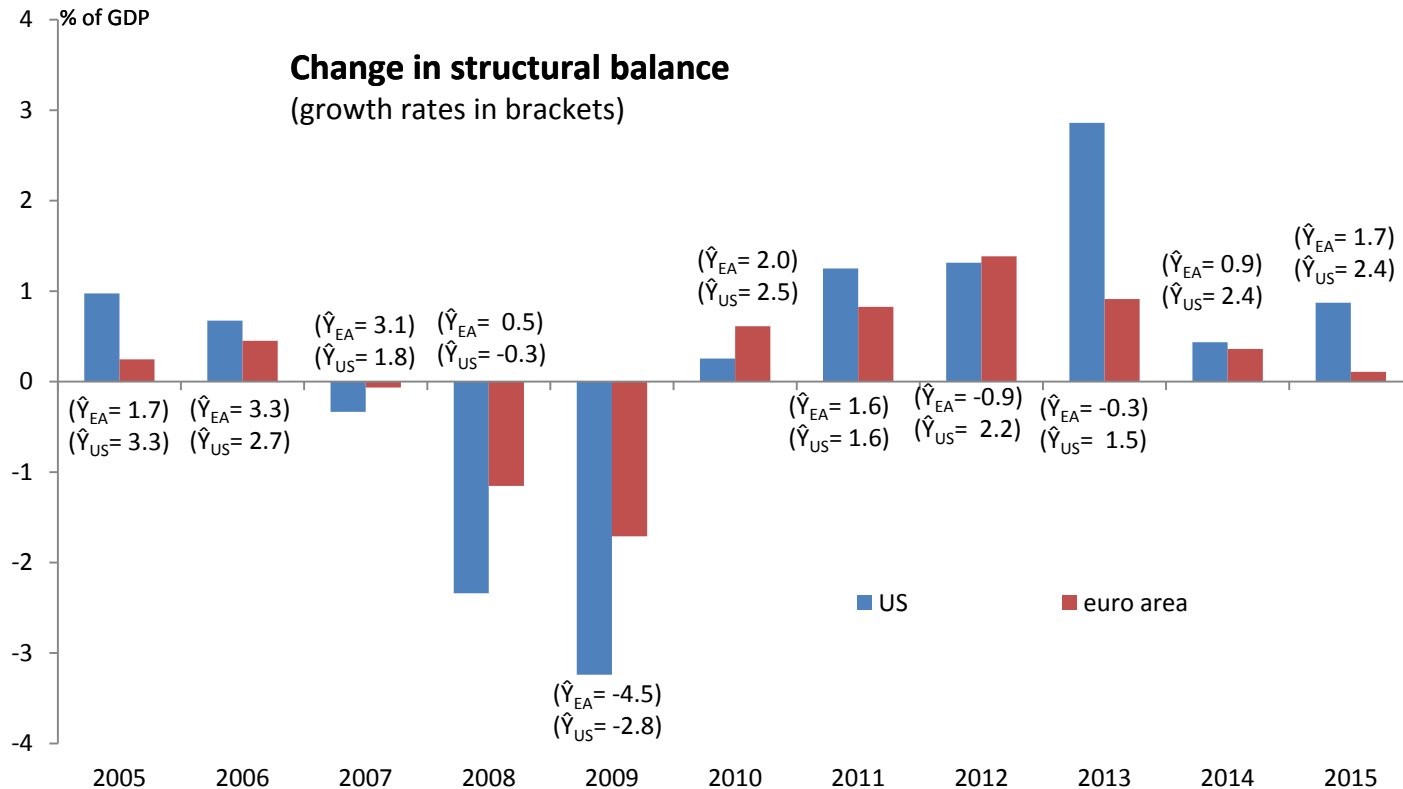
Euro area composite credit cost indicators show marked decline



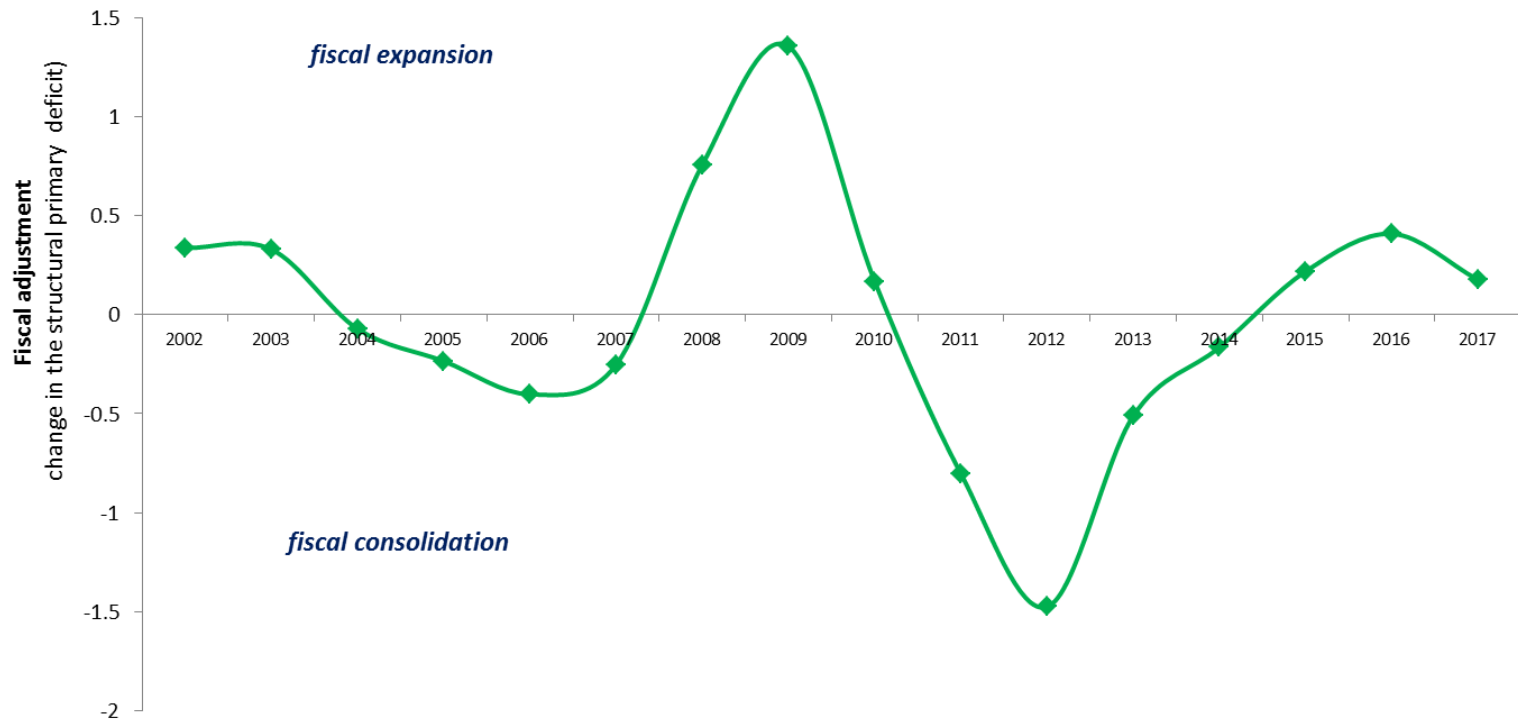
Sources: ECB, Bloomberg, own calculations

2. THE ROLE OF FISCAL POLICY

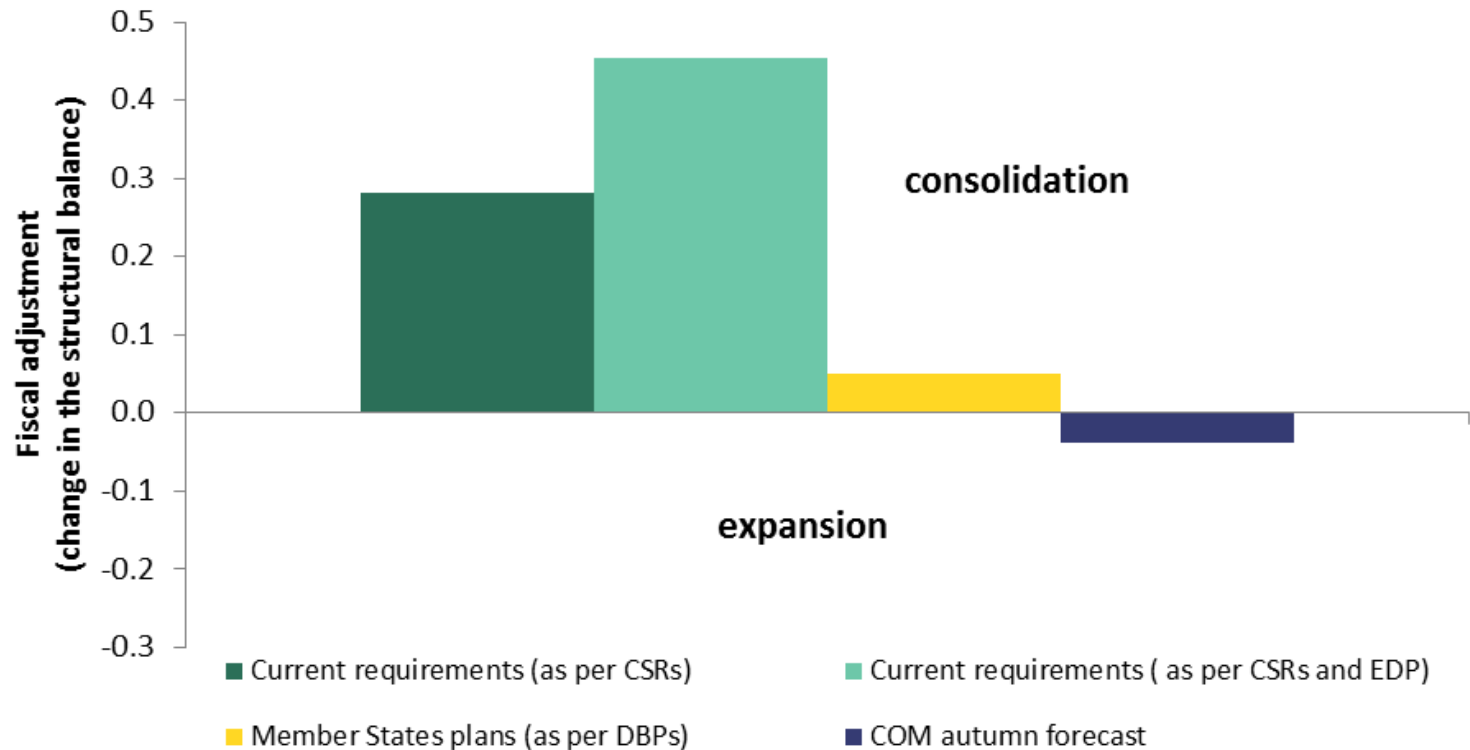
Fiscal Policy: EA vs. US



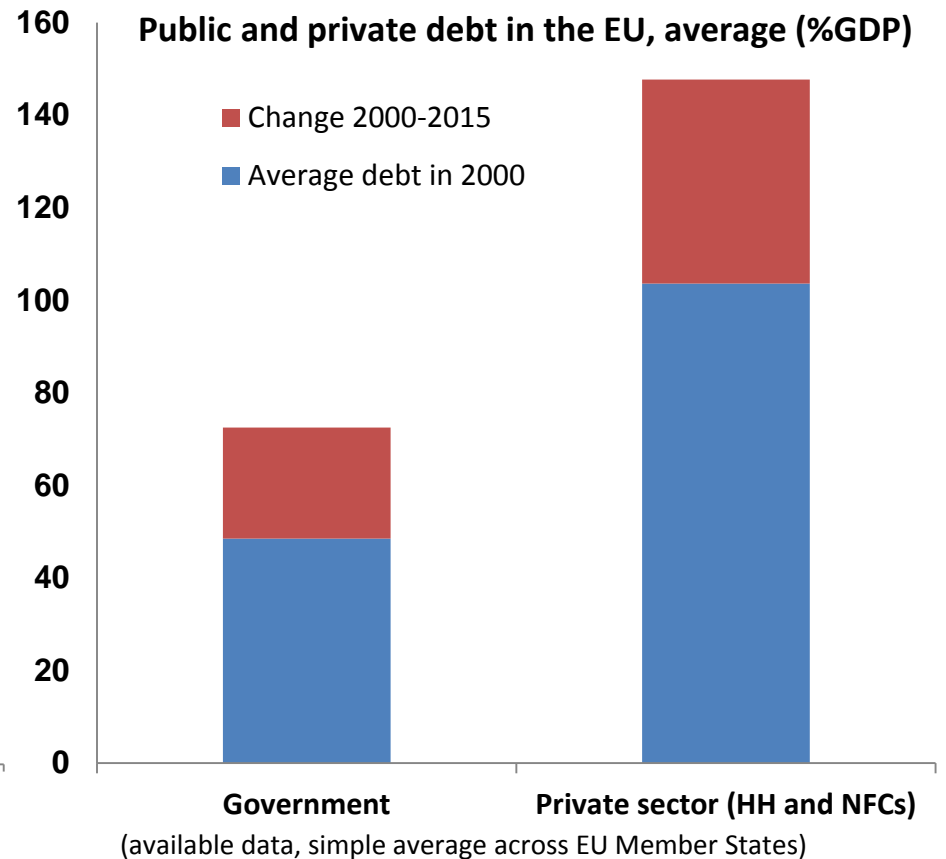
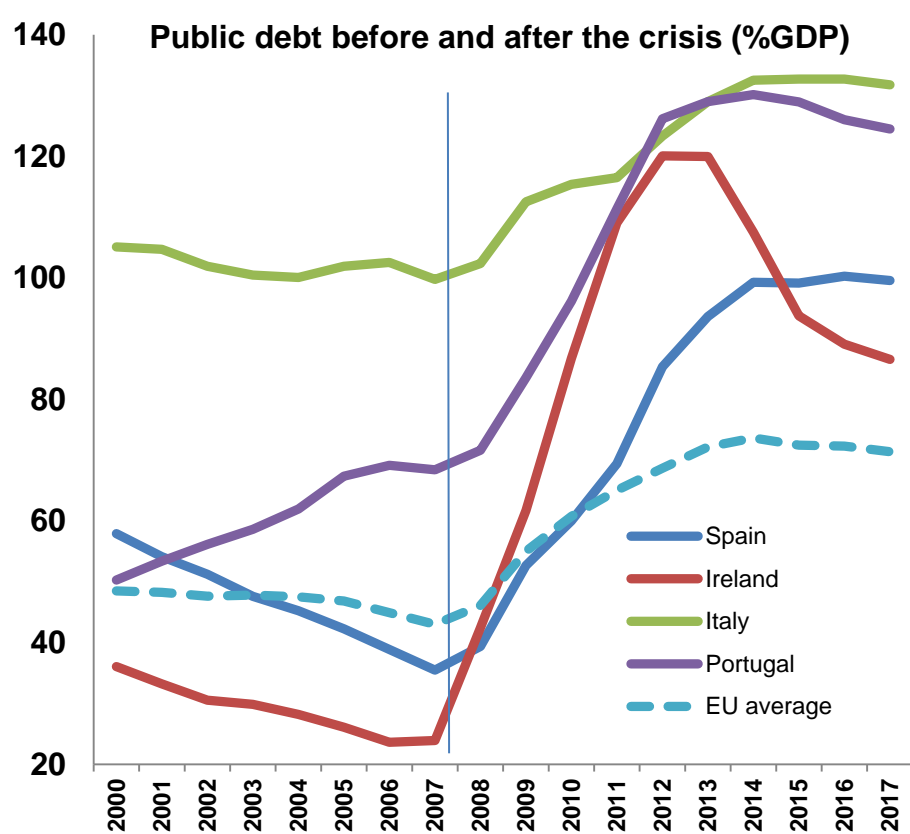
The EA fiscal stance



The EA fiscal stance in 2017: what SGP prescribes



The legacy of debt



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

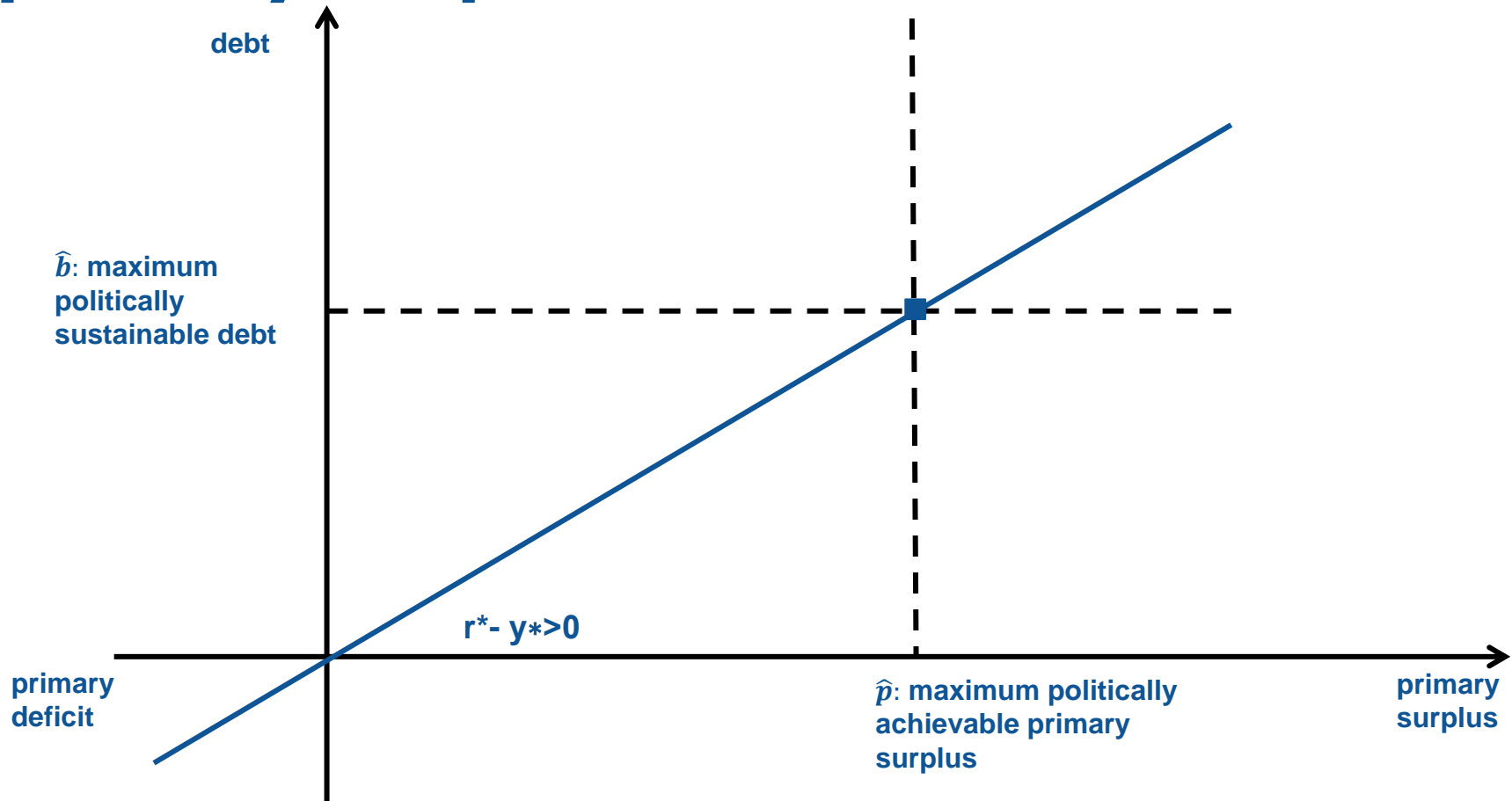
\hat{p} : maximum politically achievable primary surplus

r^* : normal interest rate

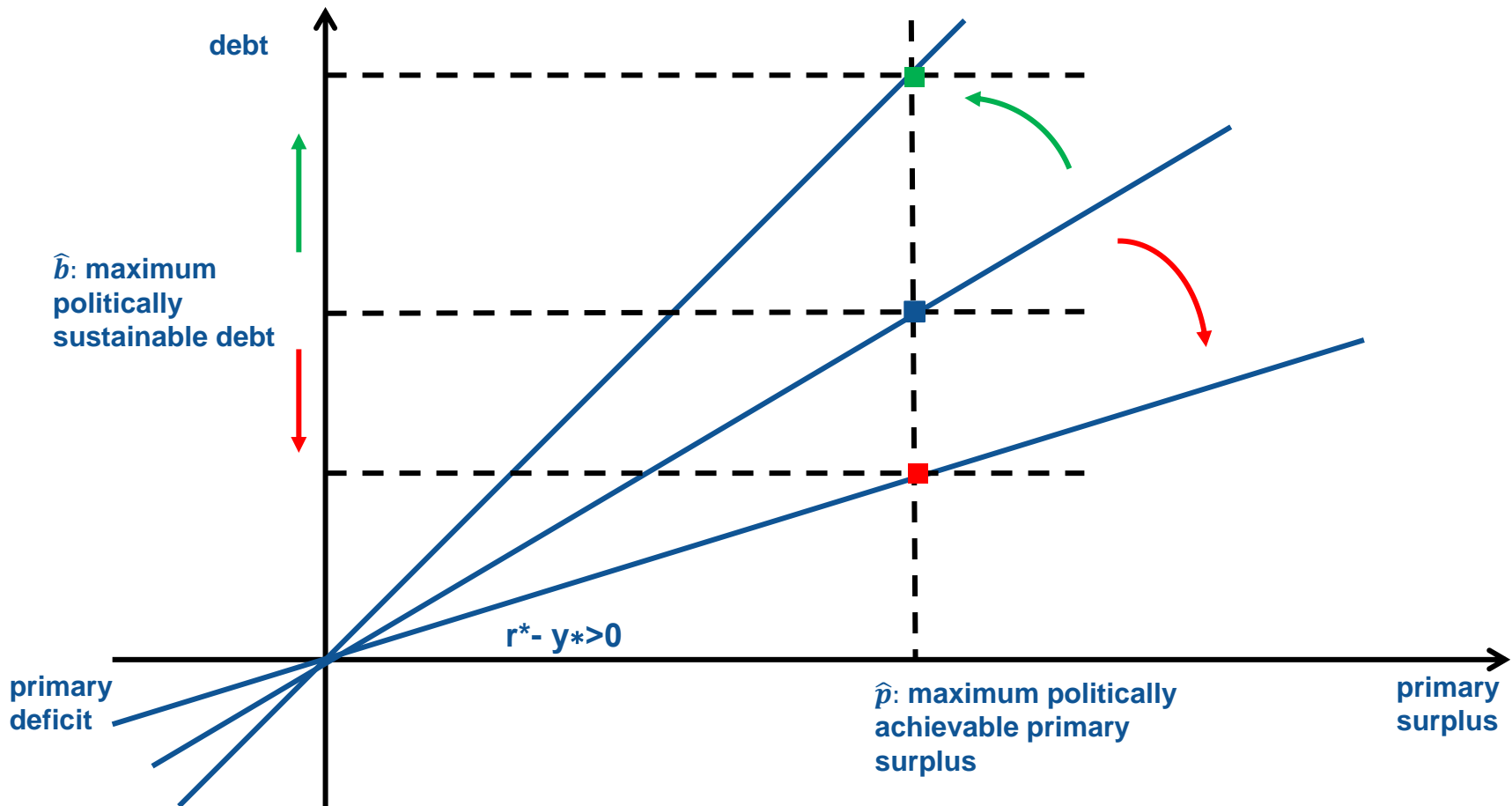
y^* : potential growth rate

- 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

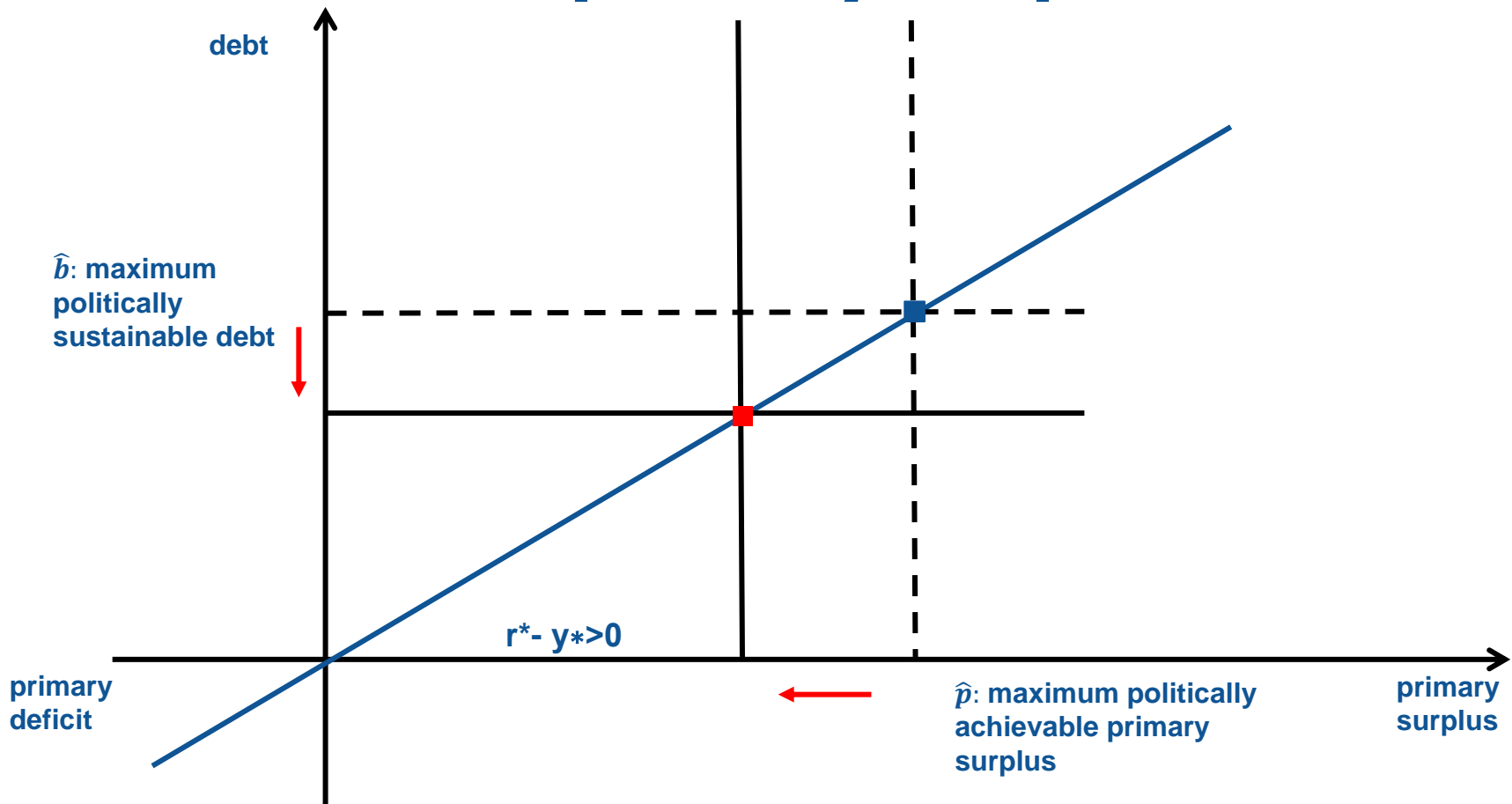
Fiscal space: the interplay between primary surpluses and overall debt levels



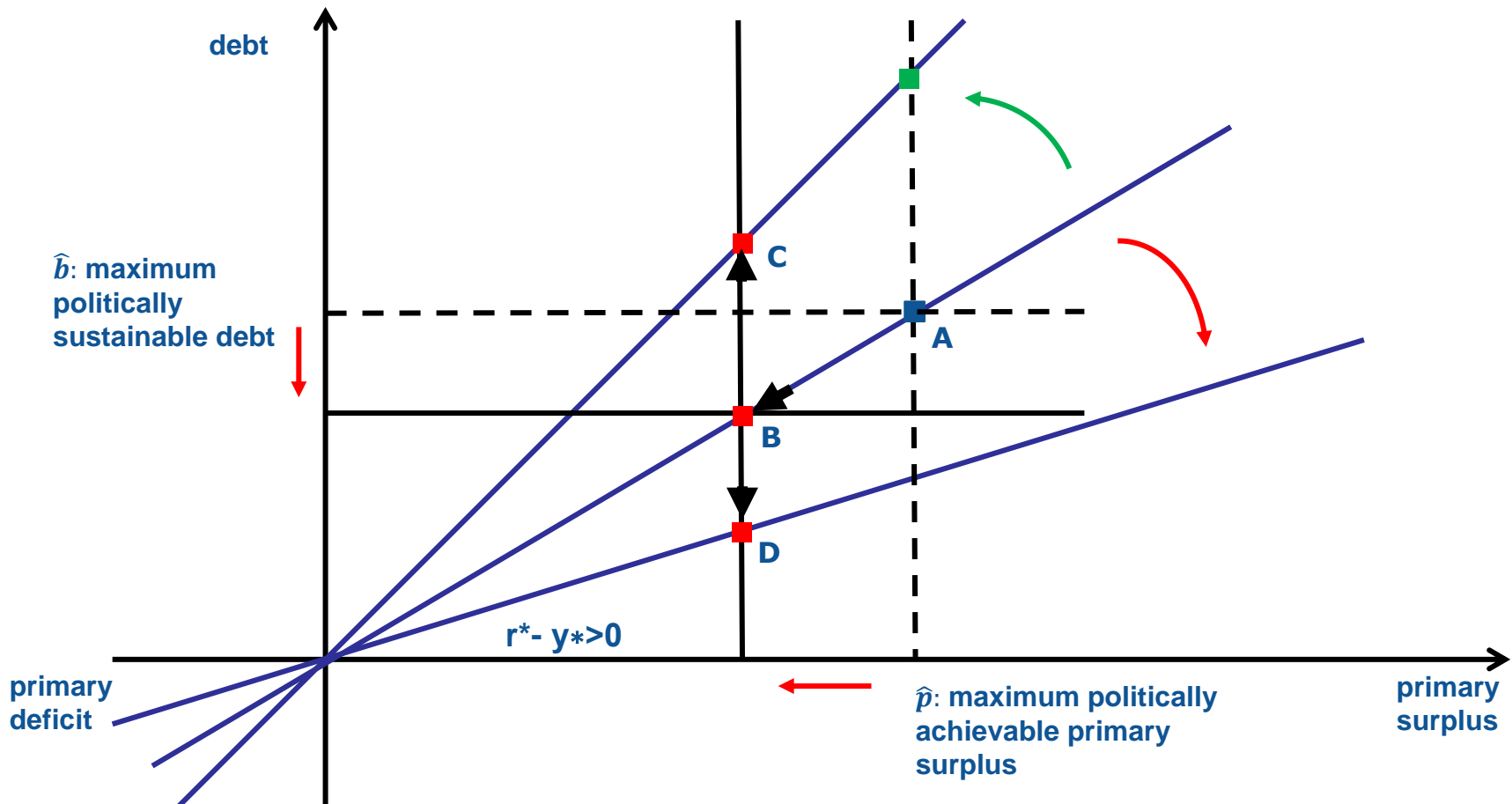
Fiscal space: change in $r^* - y^*$



Fiscal space: lower sustainable primary surplus



Fiscal space: higher or lower in the future



3. THE ROLE OF STRUCTURAL REFORMS

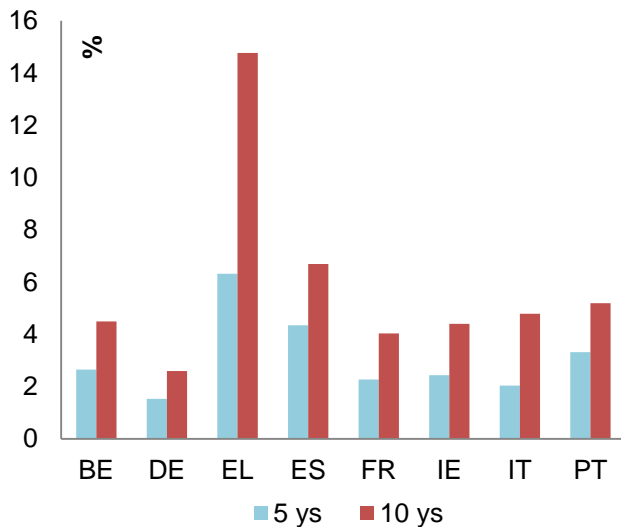
What are structural reforms?

- 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**)

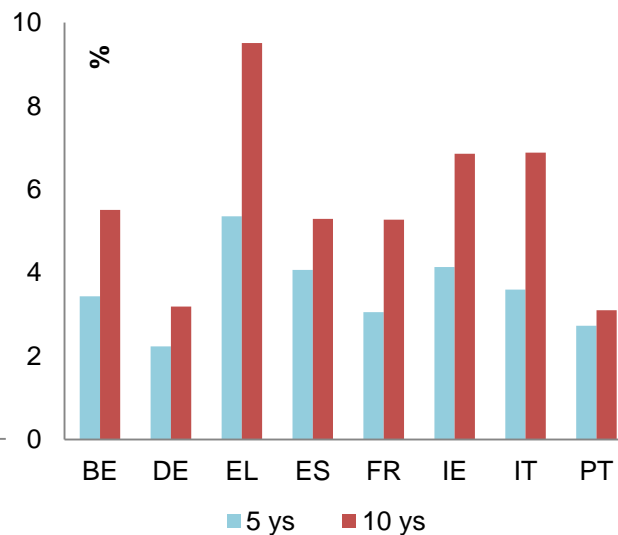
The impact of structural reforms

Model simulations of narrowing the gap with best performers by half

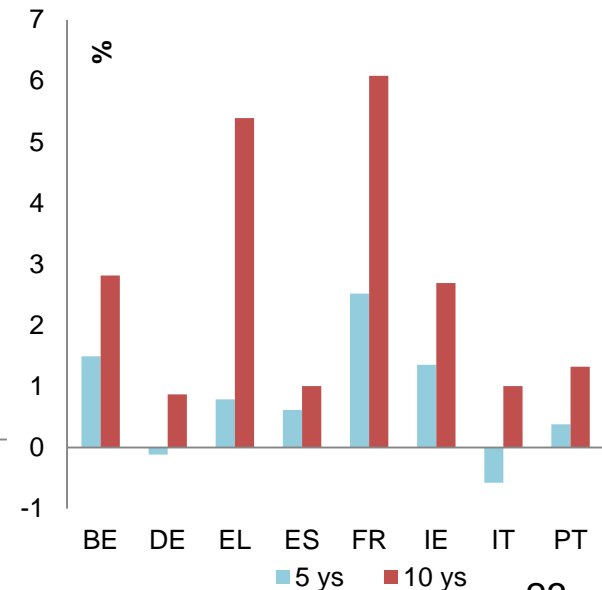
GDP
(% difference)



Employment
(% difference)



Government balance
(% difference)



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?**