"Overcoming Europe’s Policy Trilemmas: Economics, Politics and Governance in a Union Under Stress"

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Outline

1. Overcoming Europe’s Policy Trilemmas
2. A more balanced policy mix: fiscal policy
3. The role of structural reforms
4. Strengthening EMU governance
1. OVERCOMING EUROPE’S POLICY TRILEMMAS
First inconsistent trinity: political integration

Deep political integration

More European federalism and a more accountable EU

Inter-governmental decision-making and concern over democratic deficits

Traditional democratic processes

Nation-state institutions

Domestic checks and balances, national vetoes (EU before the Single European Act)
Second inconsistent trinity: economic and social viability

- Unambitious structural reforms
  - Gradually eroding the European welfare model
  - Unsustainable levels of public debt

- Sound fiscal policies
  - Sustainable welfare models

Lack of job creation and growth
Third inconsistent trinity: Adjustment objectives in the Eurozone

- Inflation persistently below target
- Lack of rebalancing
- Sustainability of high debt burdens
- Competitiveness gains in vulnerable economies
- Persistent debt stifling growth
A new political synthesis

- Structural reforms to boost potential growth
- More balanced policy mix
- Strengthening EU-dimension of policy making
2. A MORE BALANCED POLICY MIX: FISCAL POLICY
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.
Fiscal Policy: EA vs. US

Change in structural balance
(growth rates in brackets)

Source: OECD April 2016
How much fiscal space?
A Blanchard-inspired framework

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

- 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.

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

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**, on adjustment (e.g. labour market flexibility)
- Moving forward: second generation of reforms (**structural reforms 2.0**) focus on enhancing human capital and tackling rent-seeking
- Structural reforms and **income distribution**: need for a fresh approach
The impact of structural reforms on economies

Model simulations of narrowing the gap with best performers by half

Source: European Commission
The Keynesian view vs. the political economy point of view of structural reforms

- Reforms can be **painful in the short-term**: in periods of high growth so as to **compensate losers**
- **TINA**: governments undertake difficult reforms only when they are with their back against the wall
- **Who is right?**
- The "**Juncker curse**" empirically founded?
Large reform efforts in countries under pressure

Labour market reforms
Reform effort (2008-13) and unemployment rate (2008)

Product market reforms
Reform effort (2008-13) and level of regulation - PMR (2013)

Source: European Commission
Source: OECD (PMR)
4. STRENGTHENING EMU GOVERNANCE
The way forward: towards a more complete EMU
The way forward: Parallel progress on risk sharing and risk reduction

- Enforcement of fiscal rules at national level can be more efficient and more legitimate if completed with a central risk sharing tool
- More private risk sharing via Banking Union and Capital Market Union allows less fiscal risk sharing
- More fiscal risk sharing prevents overburdening the ECB