



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

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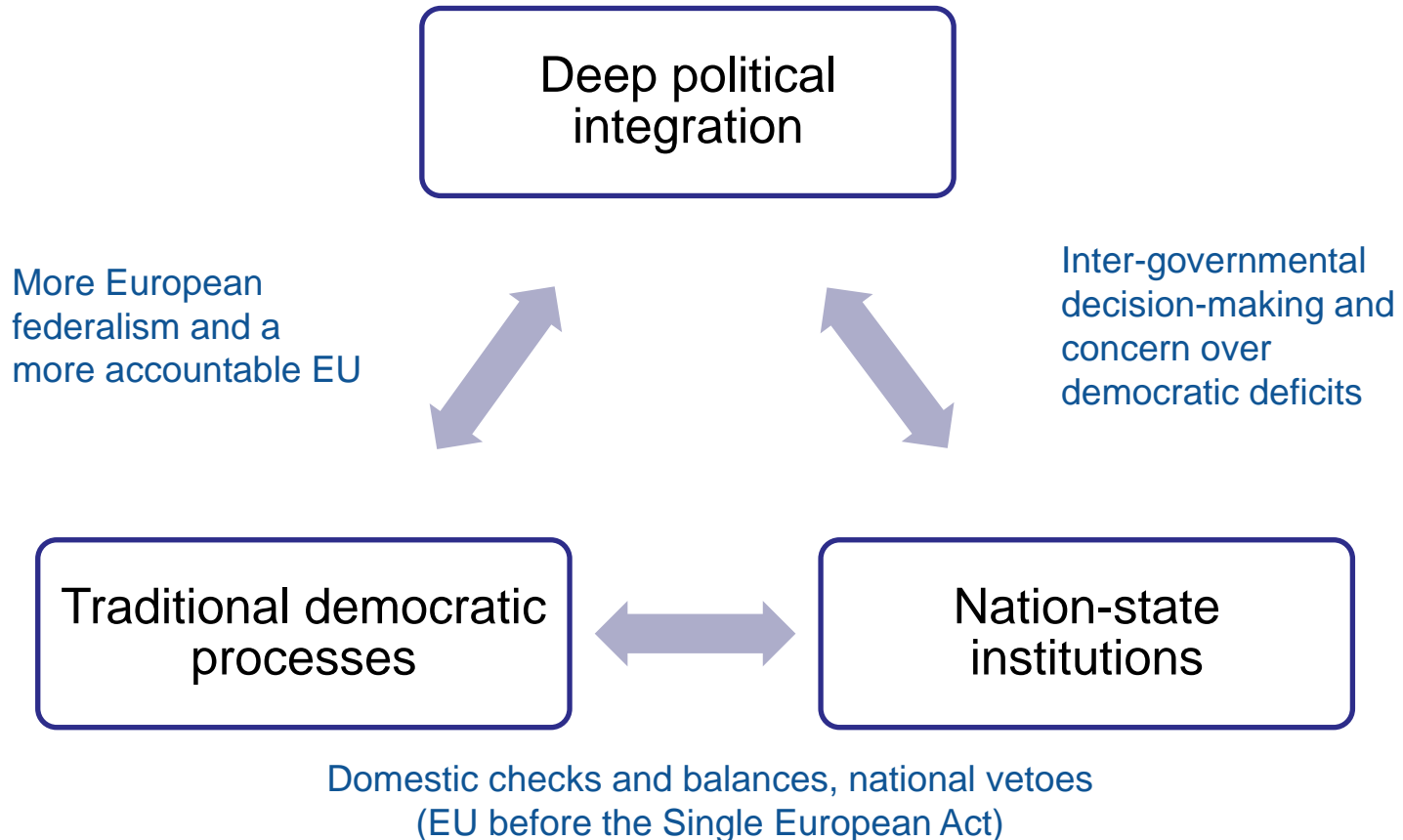
Brown University, 31 October 2016

Outline

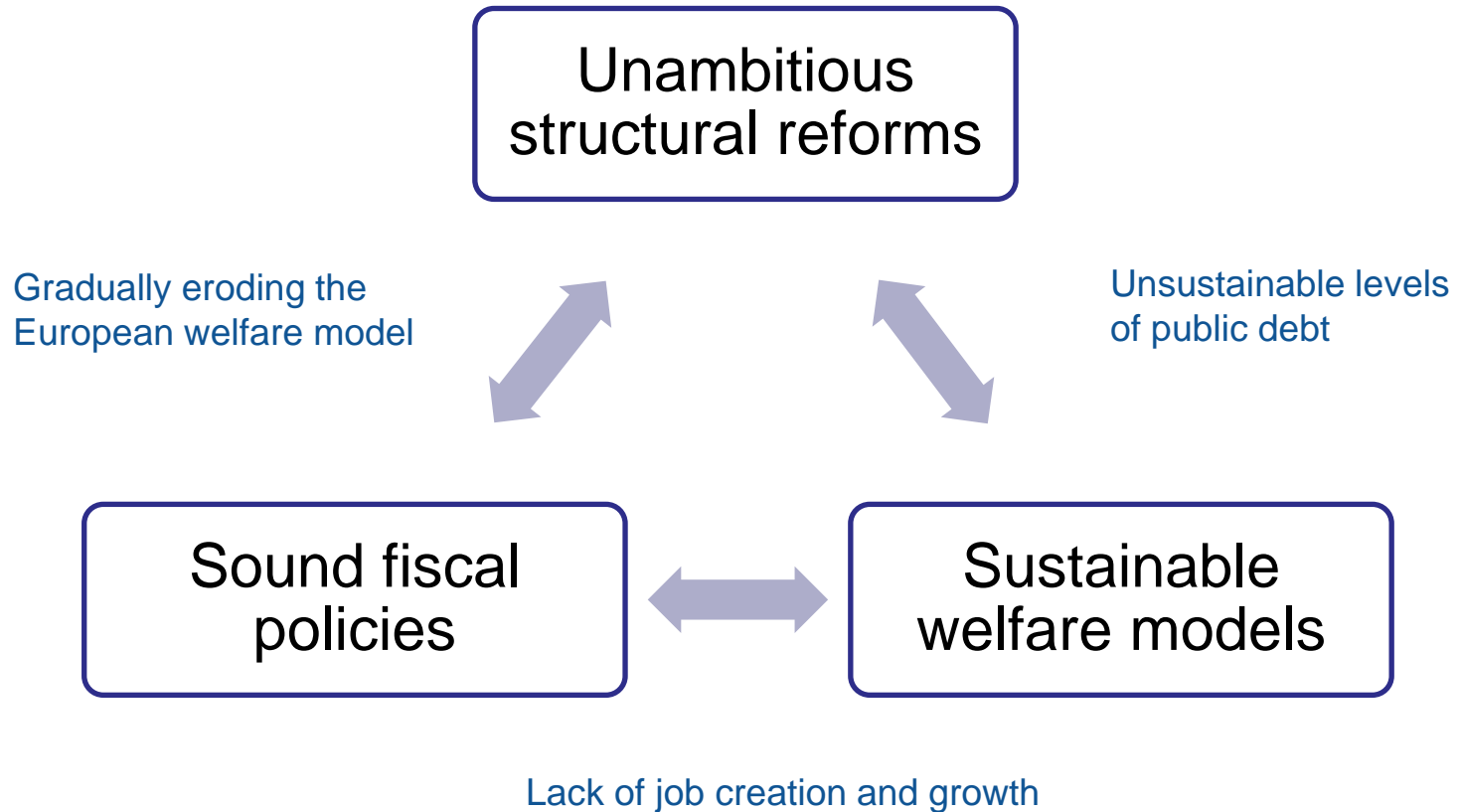
1. *Overcoming Europe's Policy Trilemmas*
2. *A more balanced policy mix: fiscal policy*
3. *The role of structural reforms*
4. *Strengthening EMU governance*

1. OVERCOMING EUROPE'S POLICY TRILEMMAS

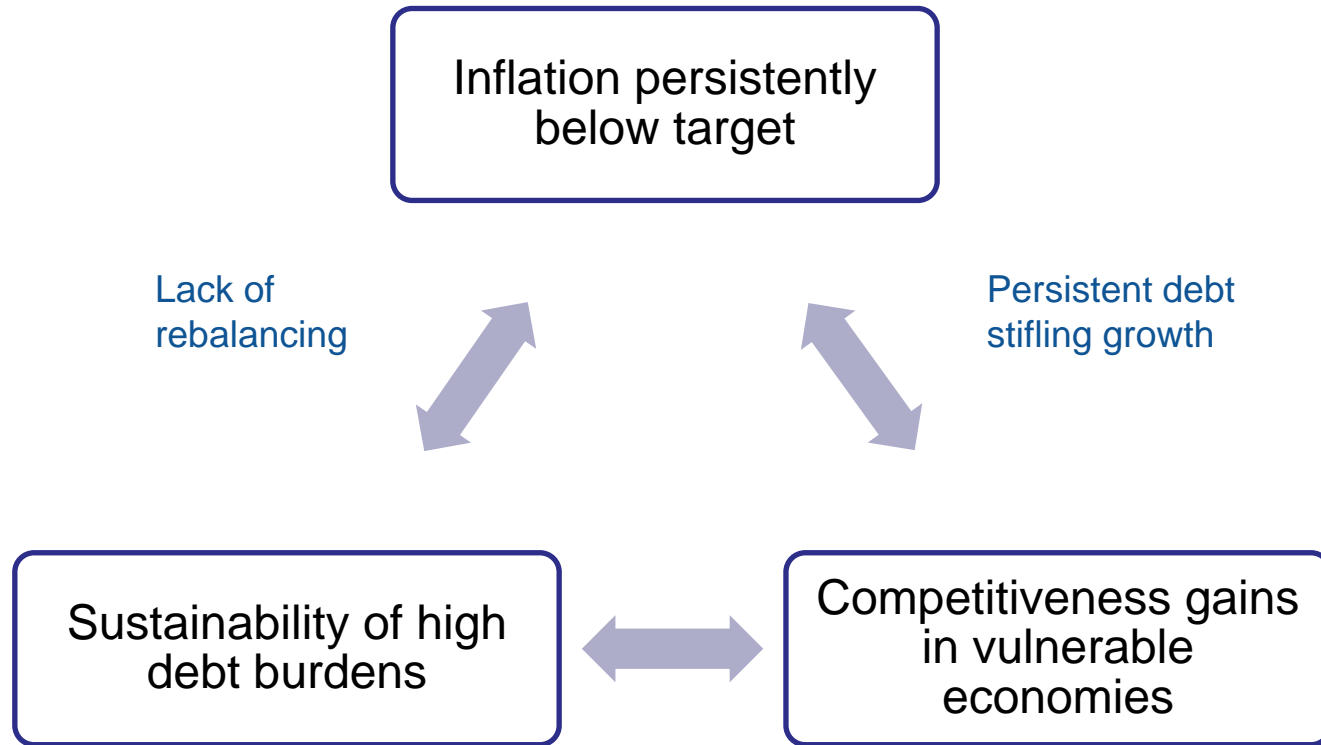
First inconsistent trinity: political integration



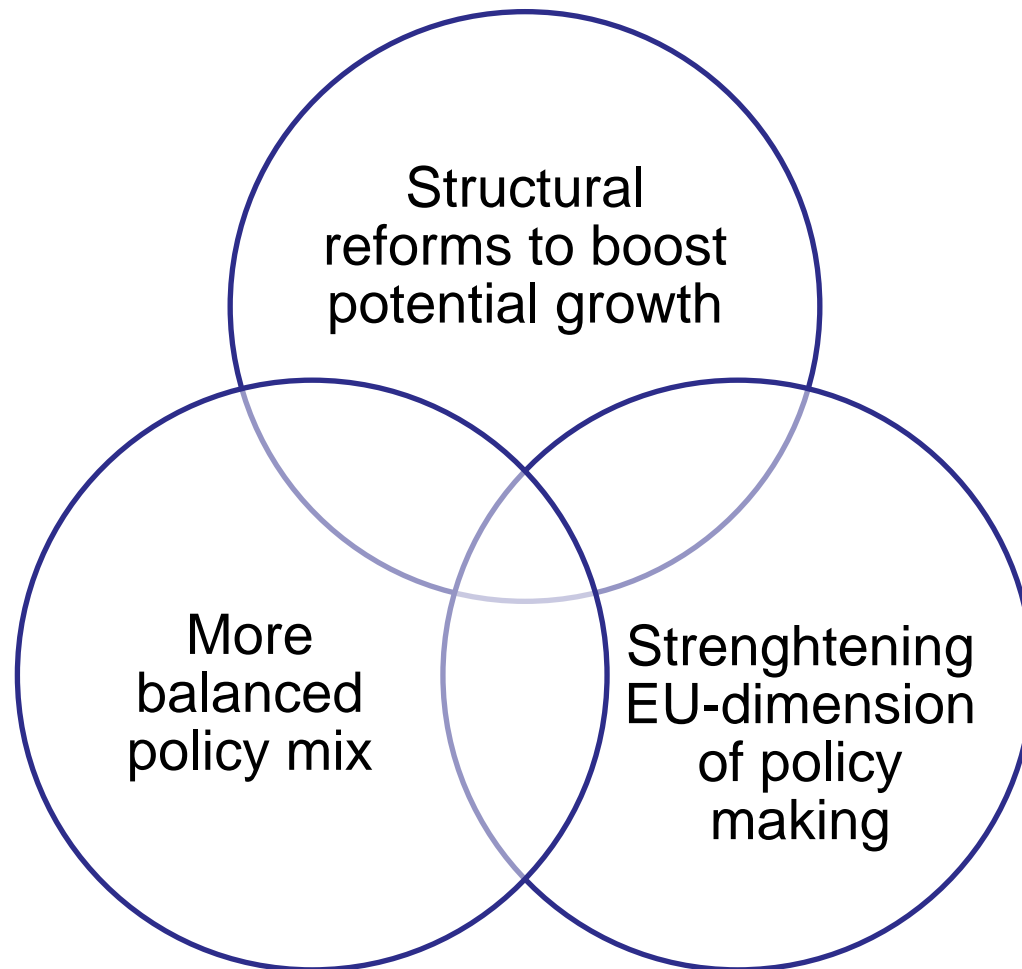
Second inconsistent trinity: economic and social viability



Third inconsistent trinity: Adjustment objectives in the Eurozone

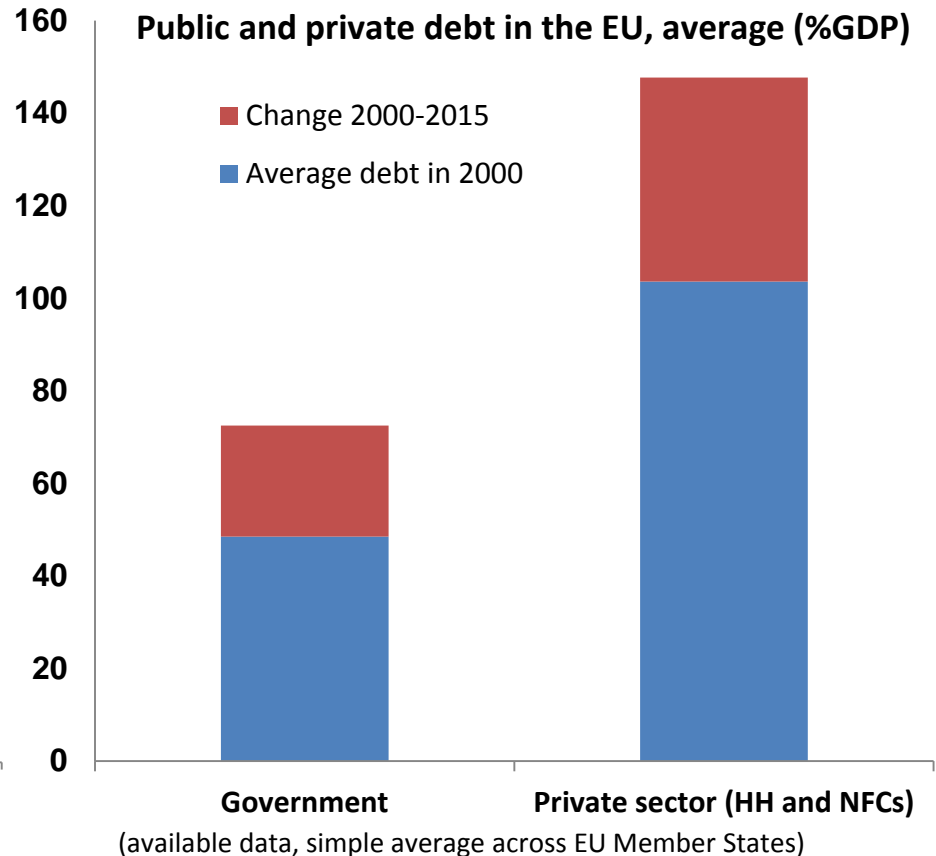
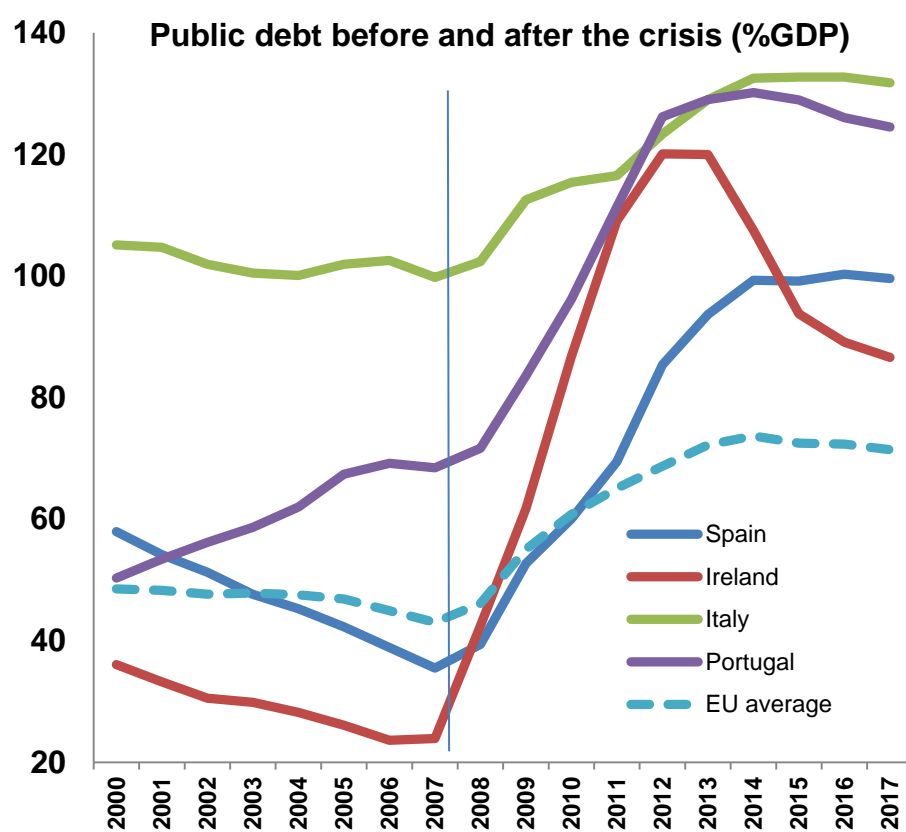


A new political synthesis



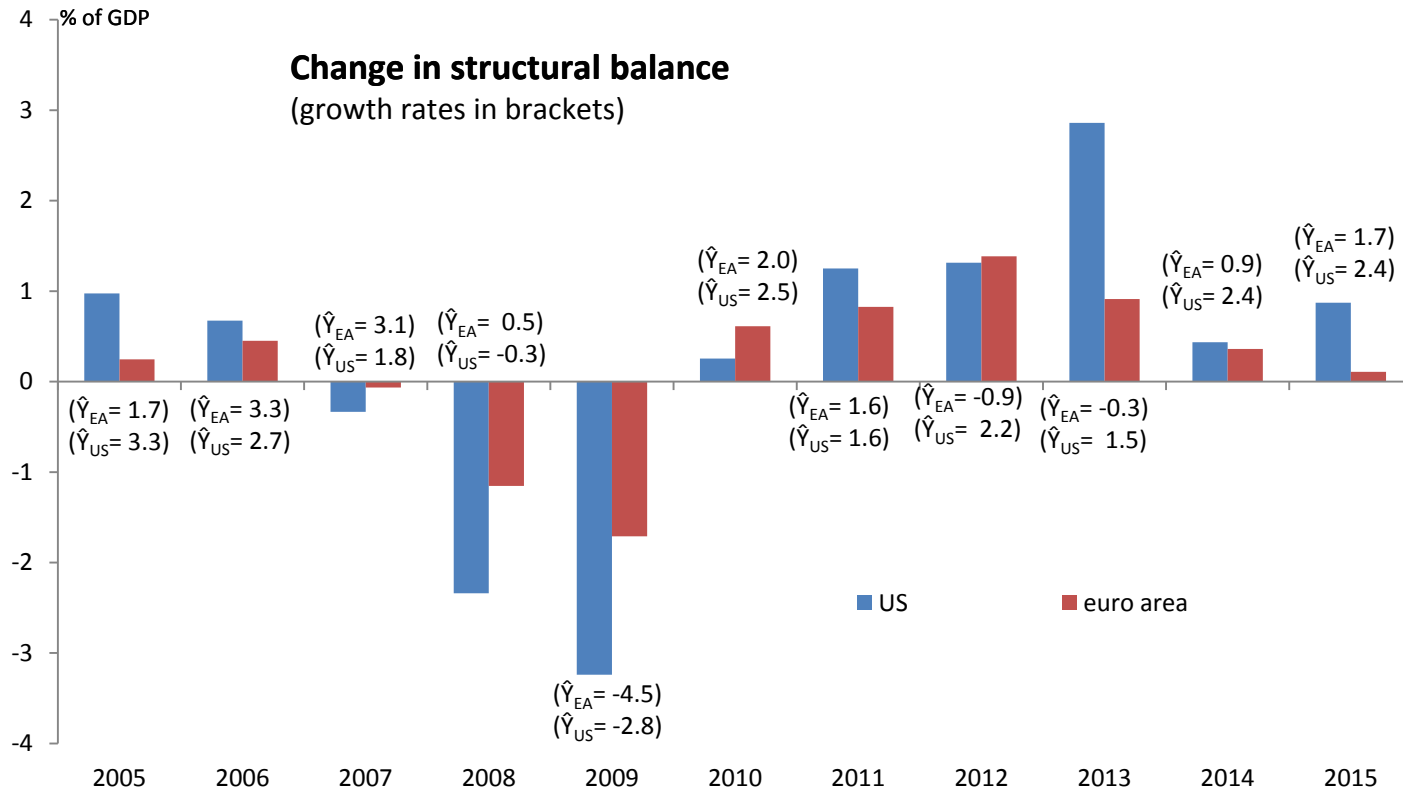
2. A MORE BALANCED POLICY MIX: FISCAL POLICY

The legacy of debt



Source: AMECO and ECFIN calculations.

Fiscal Policy: EA vs. US



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 fiscal 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

3. THE ROLE OF STRUCTURAL REFORMS

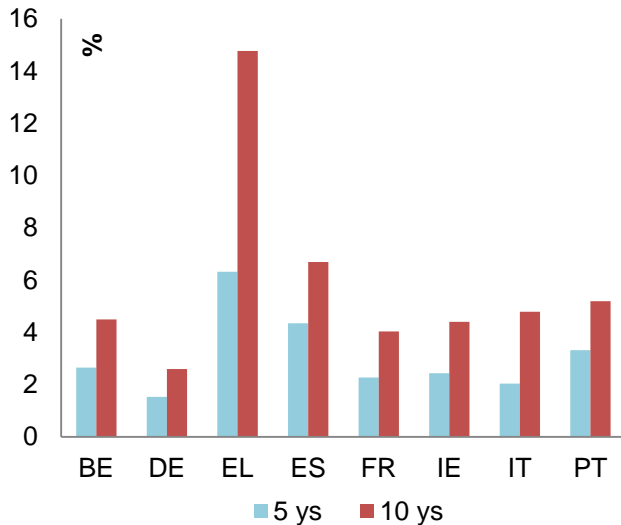
What are structural reforms?

- 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

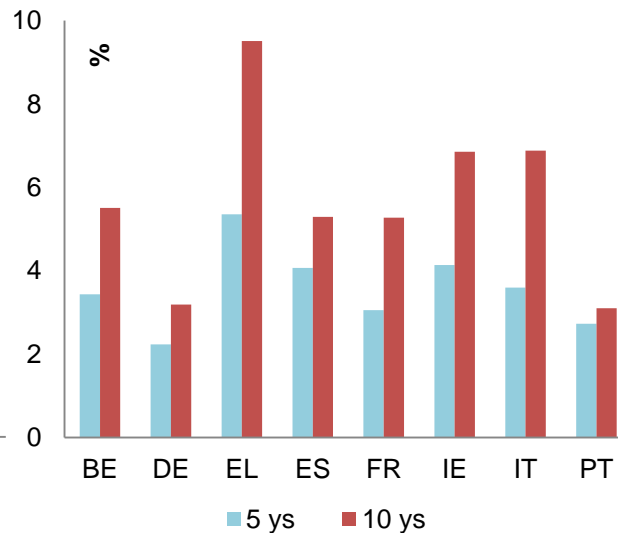
The impact of structural reforms on economies

Model simulations of narrowing the gap with best performers by half

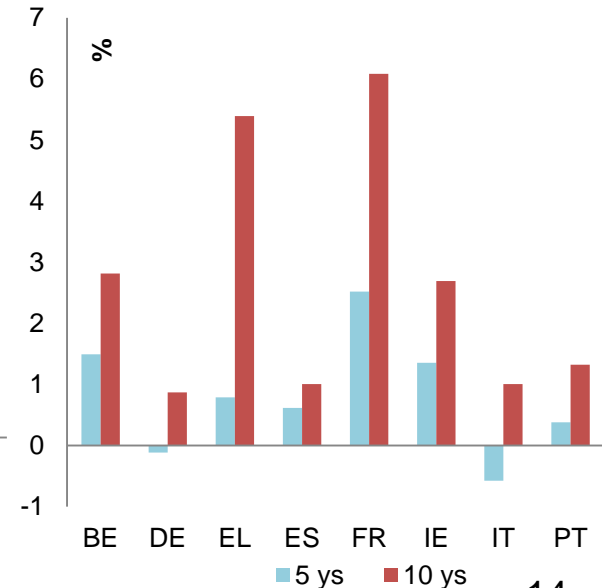
GDP
(% difference)



Employment
(% difference)



Government balance
(% difference)



Source: European Commission

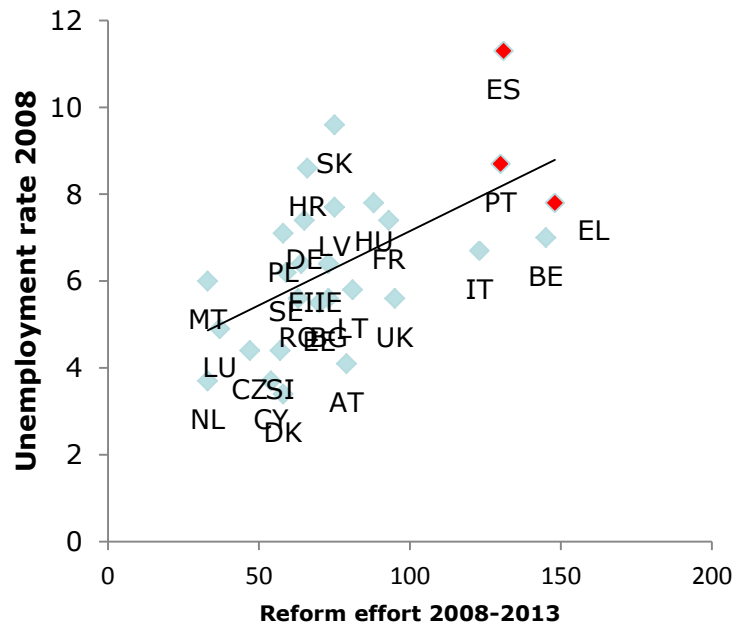
The Keynesian view vs. the political economy point of view of structural reforms

- 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

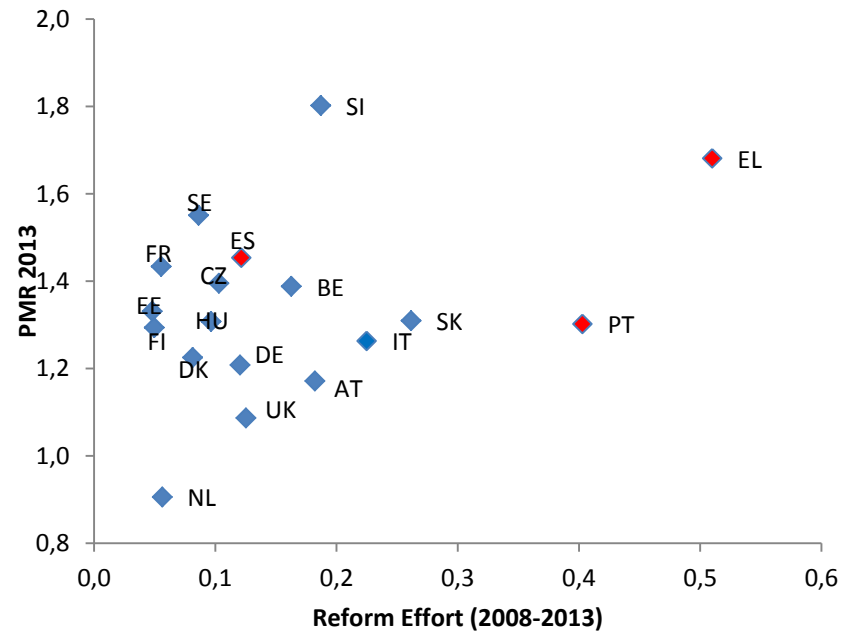
Reform effort (2008-13) and unemployment rate (2008)



Source: European Commission

Product market reforms

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

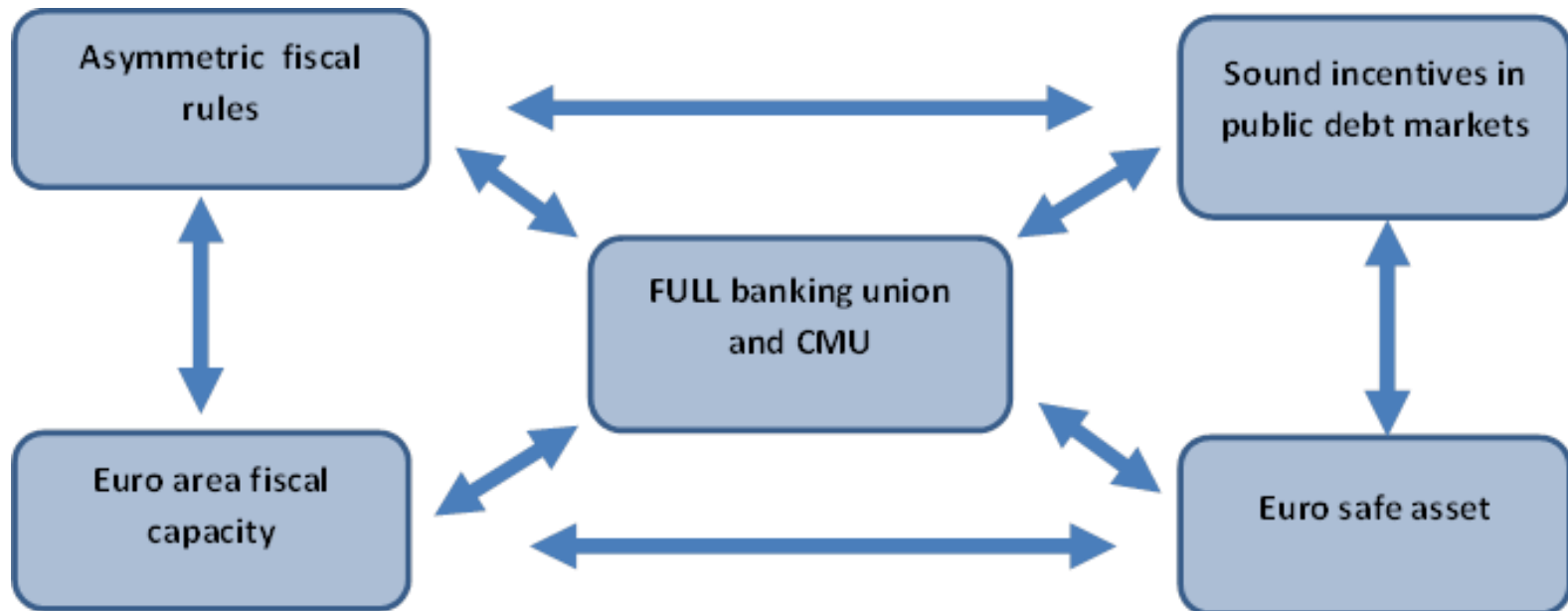


Source: OECD (PMR)



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