The euro area fiscal stance and the policy mix: challenges and trade-offs

EUI, Florence, 2 March 2017

Marco BUTI

DG ECFIN - European Commission

OUTLINE

1. Current recovery in perspective
2. The policy mix: excessive reliance on monetary policy
3. The fiscal stance from a euro area perspective
4. Fiscal space
5. Impact of an expansionary fiscal policy
6. Policy orientations

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1. **Current recovery in perspective**
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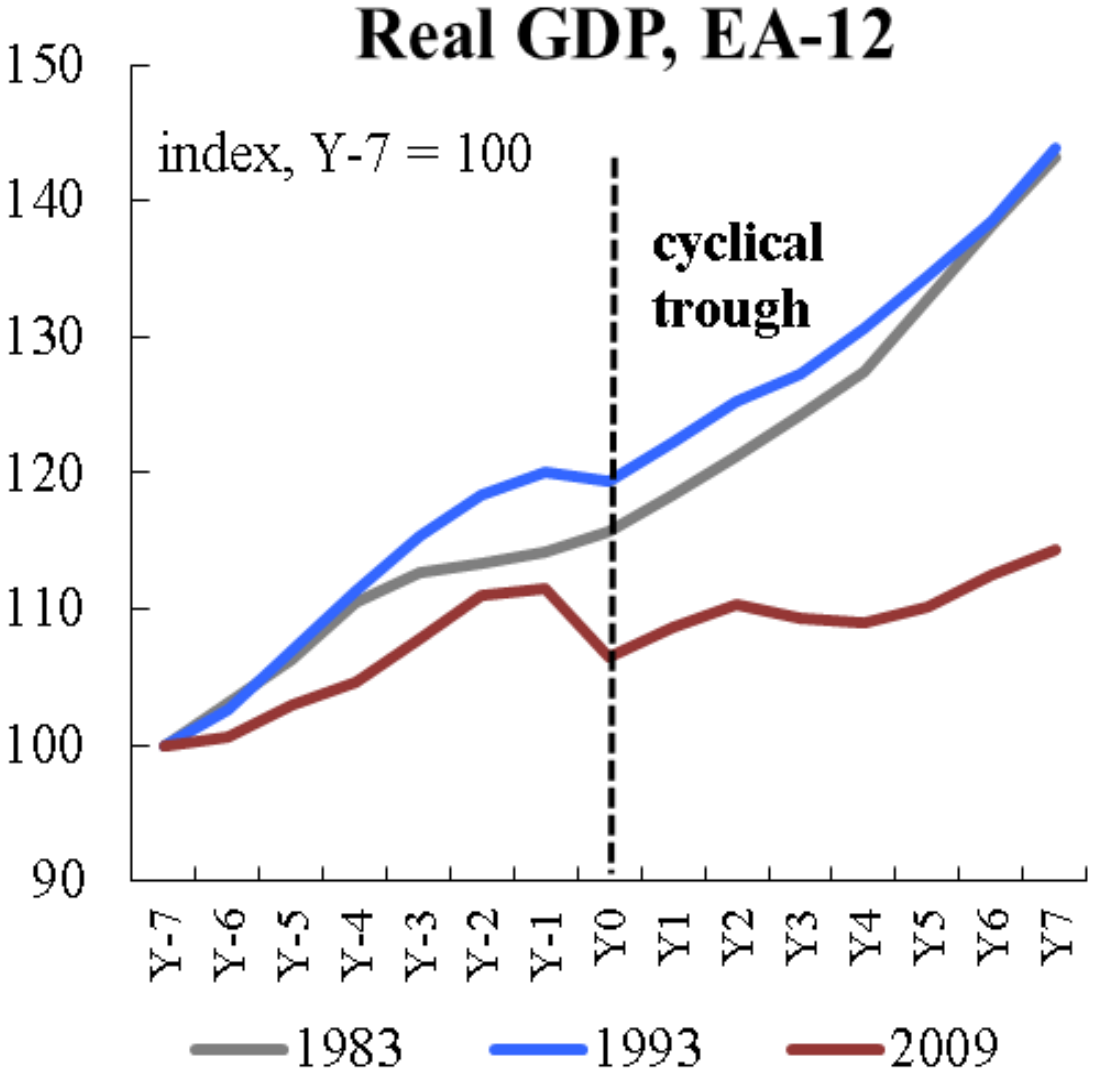
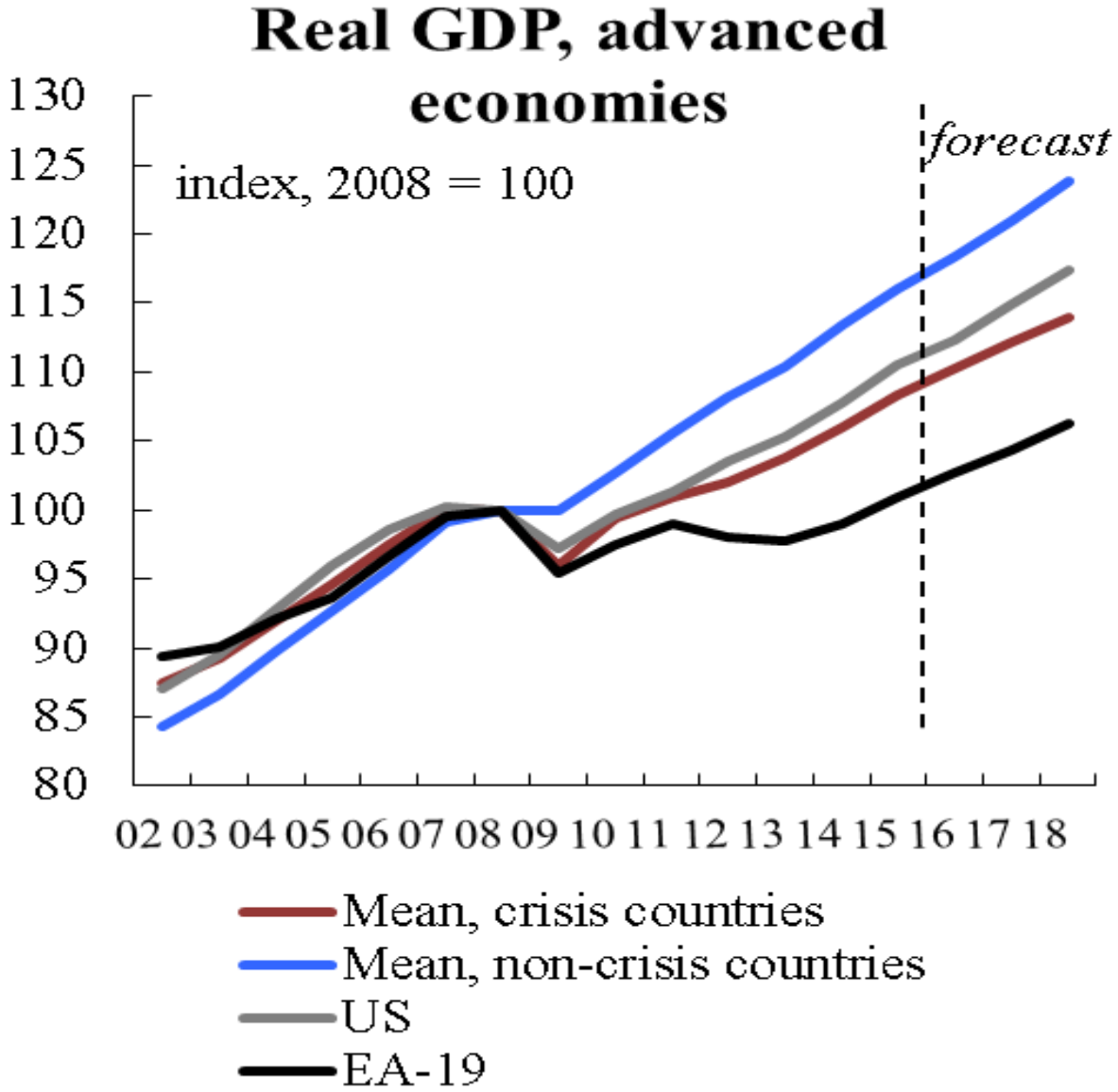
1. The current recovery in perspective

The recovery in the euro area has been particularly slow, when compared to the past



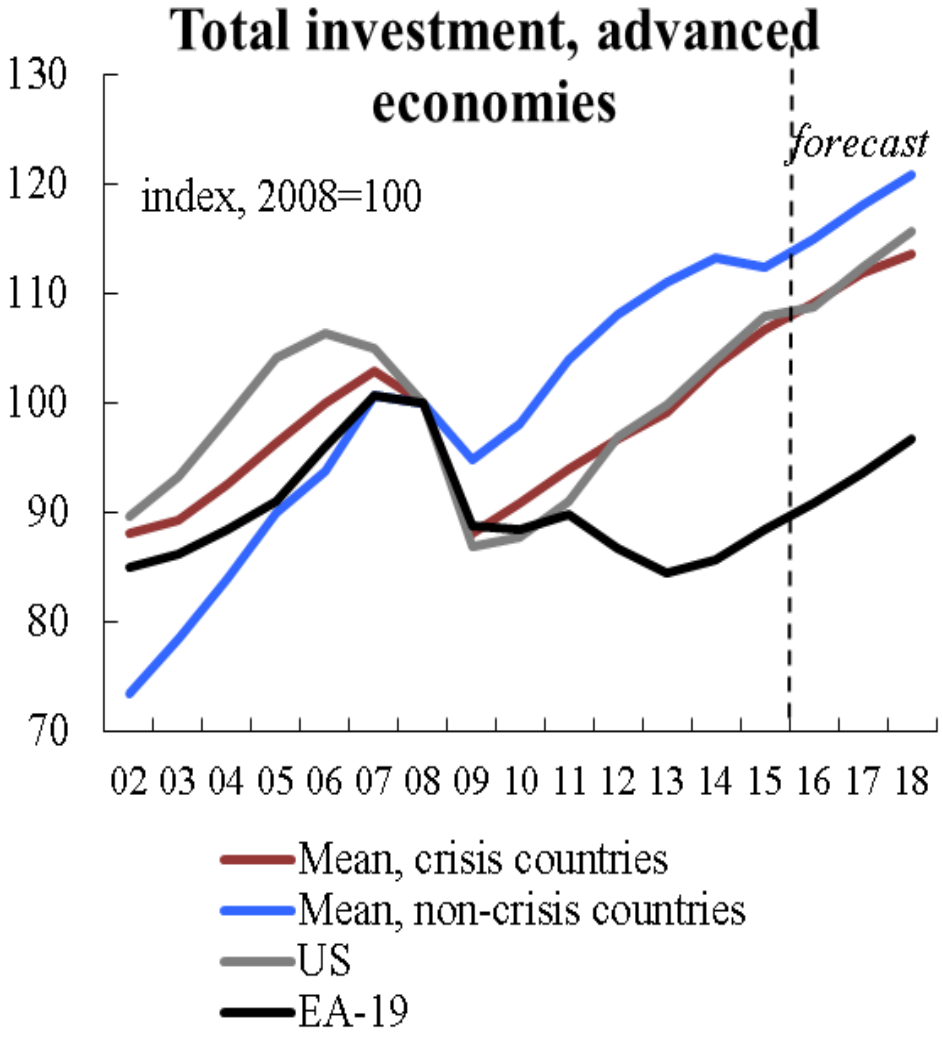
1. The current recovery in perspective

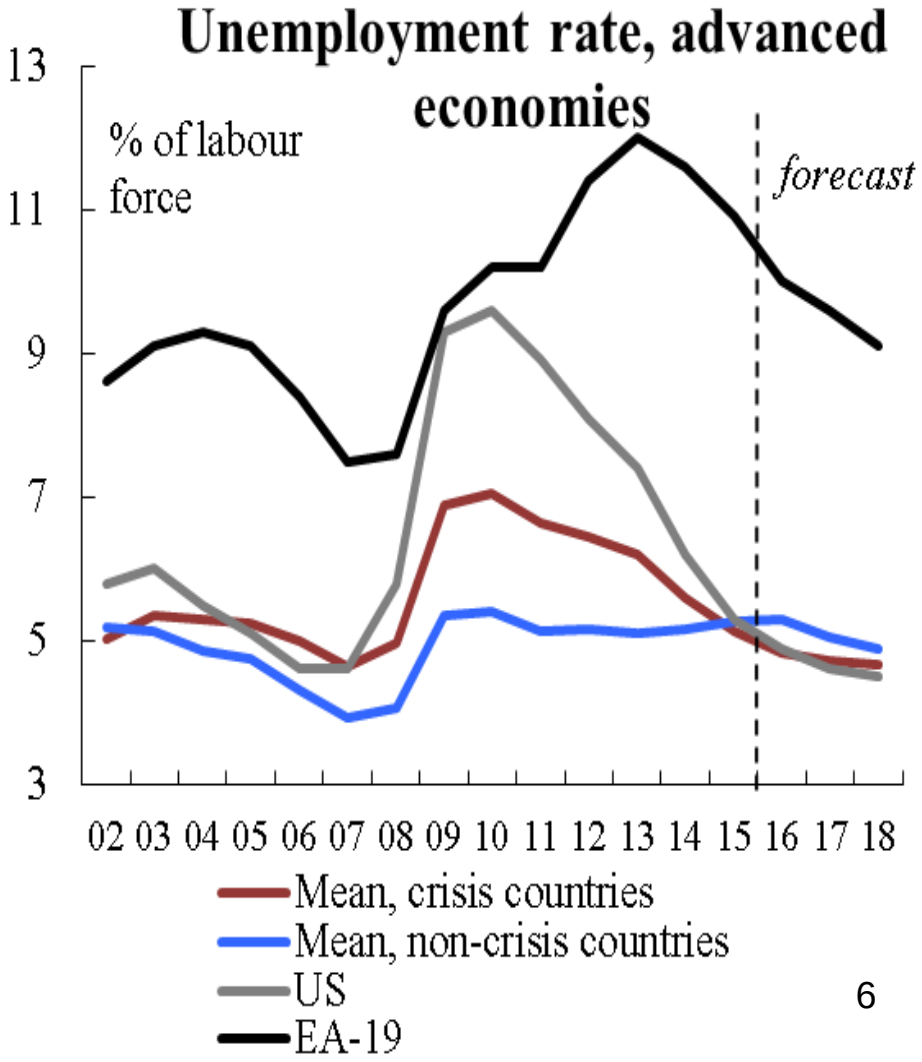
And also when compared to other economies



1. The current recovery in perspective

The recovery is not yet complete





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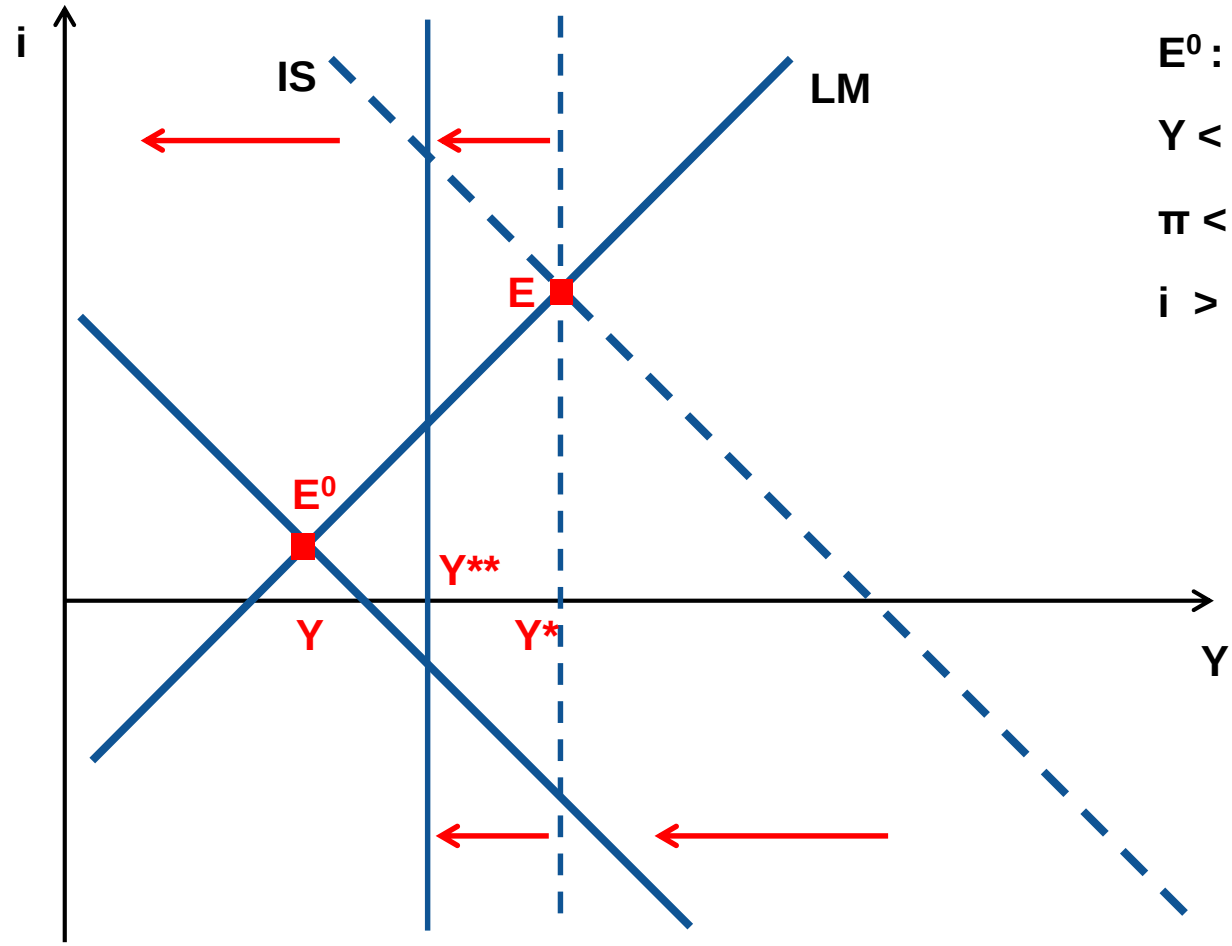
2. The policy-mix: excessive reliance on MP

"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)

2. The policy-mix: excessive reliance on MP

Pre-crisis equilibrium (E) and first shock (E0): demand and supply shock



E^0 : first crisis shock

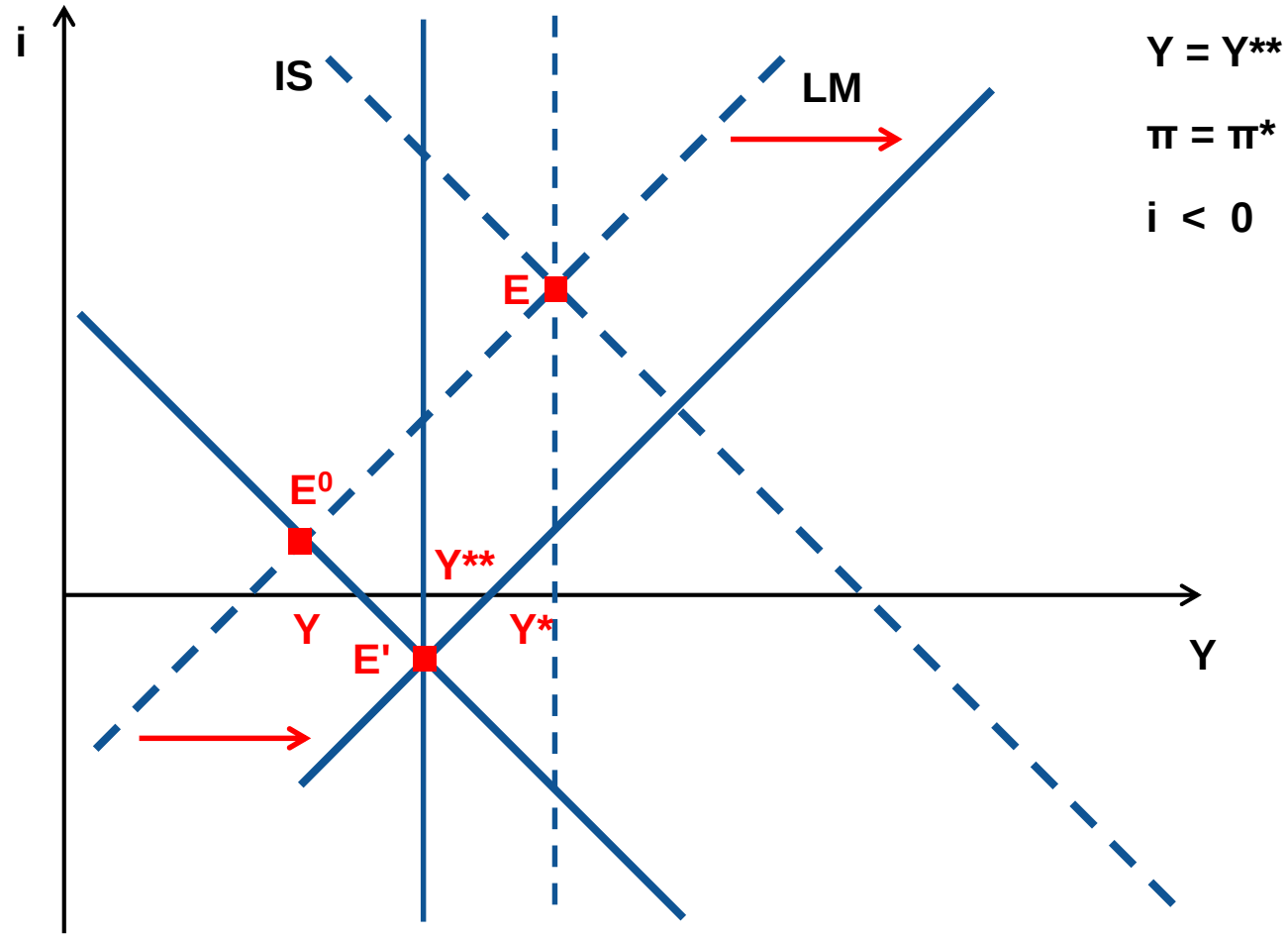
$Y < Y^{**} < Y^*$

$\pi < \pi^*$

$i > 0$

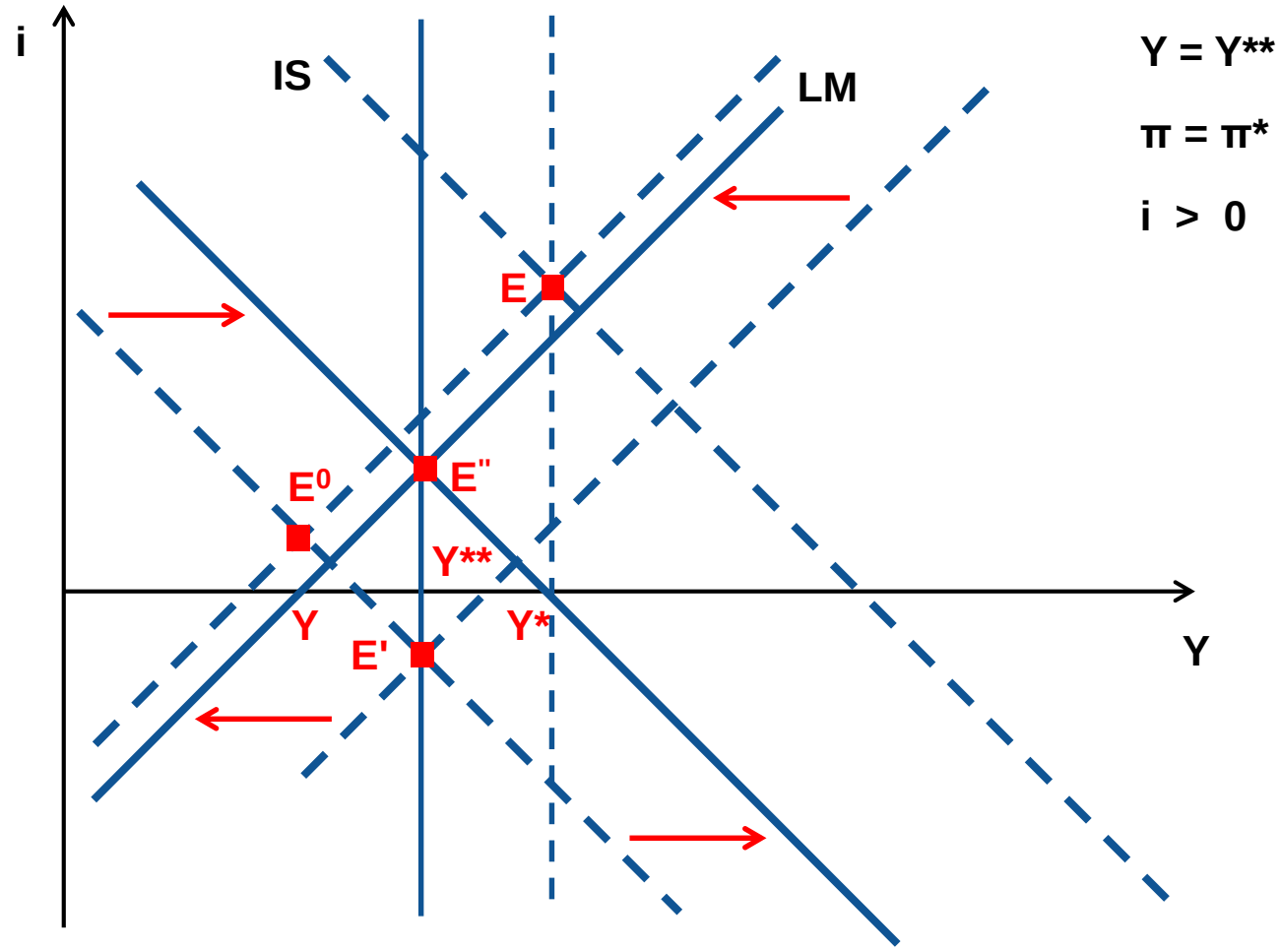
2. The policy-mix: excessive reliance on MP

Central bank left alone (E')



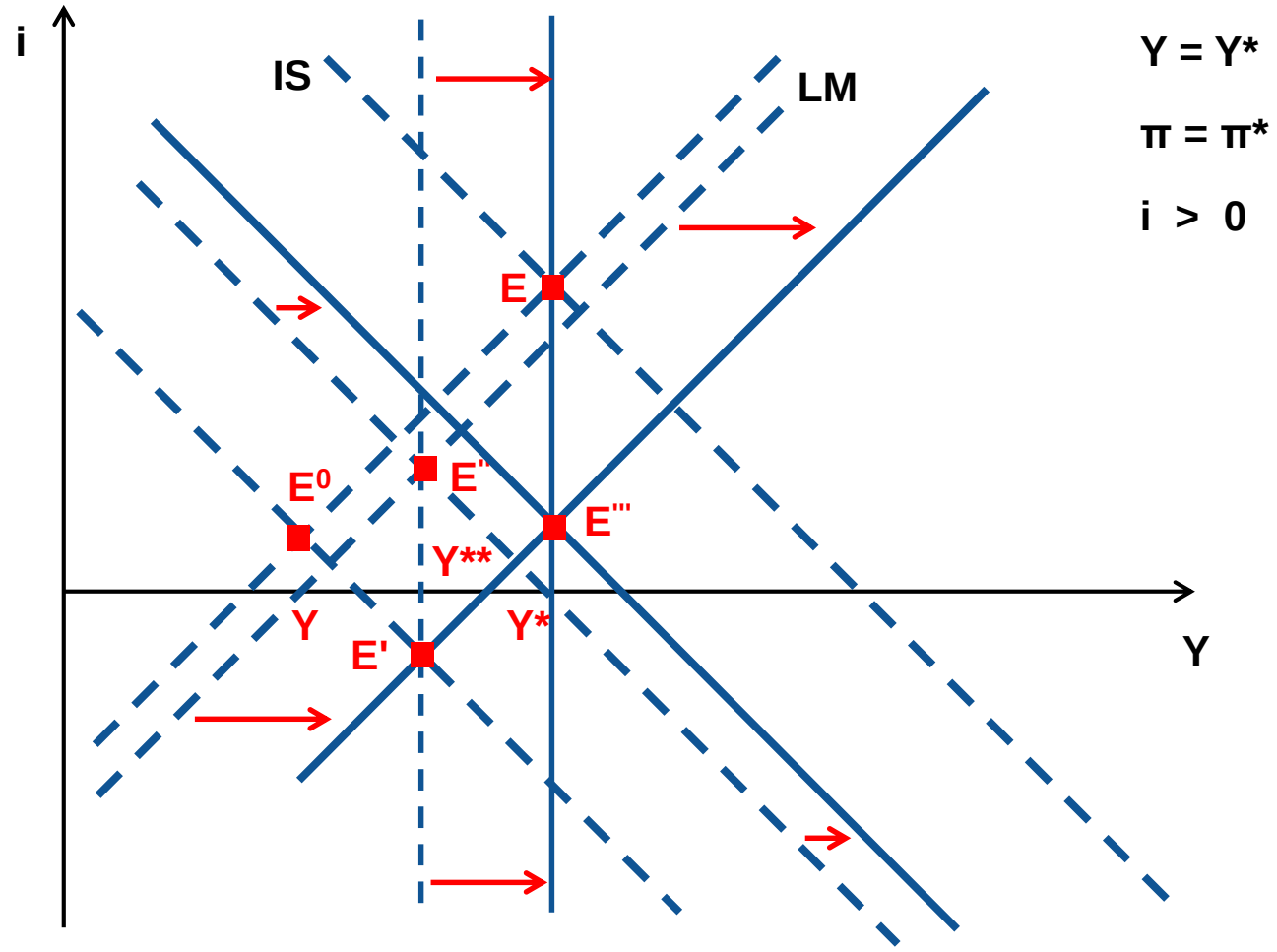
2. The policy-mix: excessive reliance on MP

Balanced macroeconomic policy mix (E'')



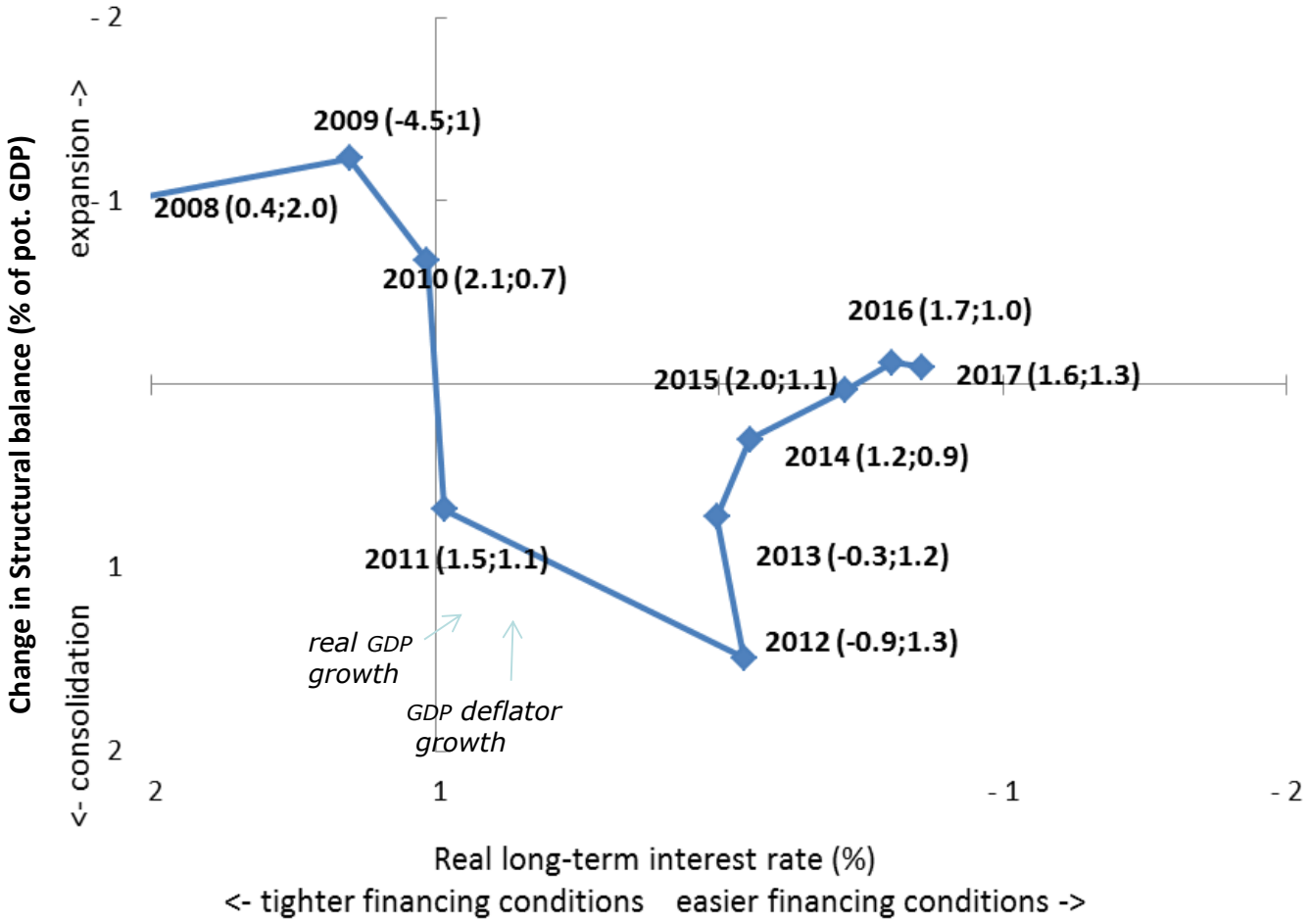
2. The policy-mix: excessive reliance on MP

Three-pronged strategy (E''')



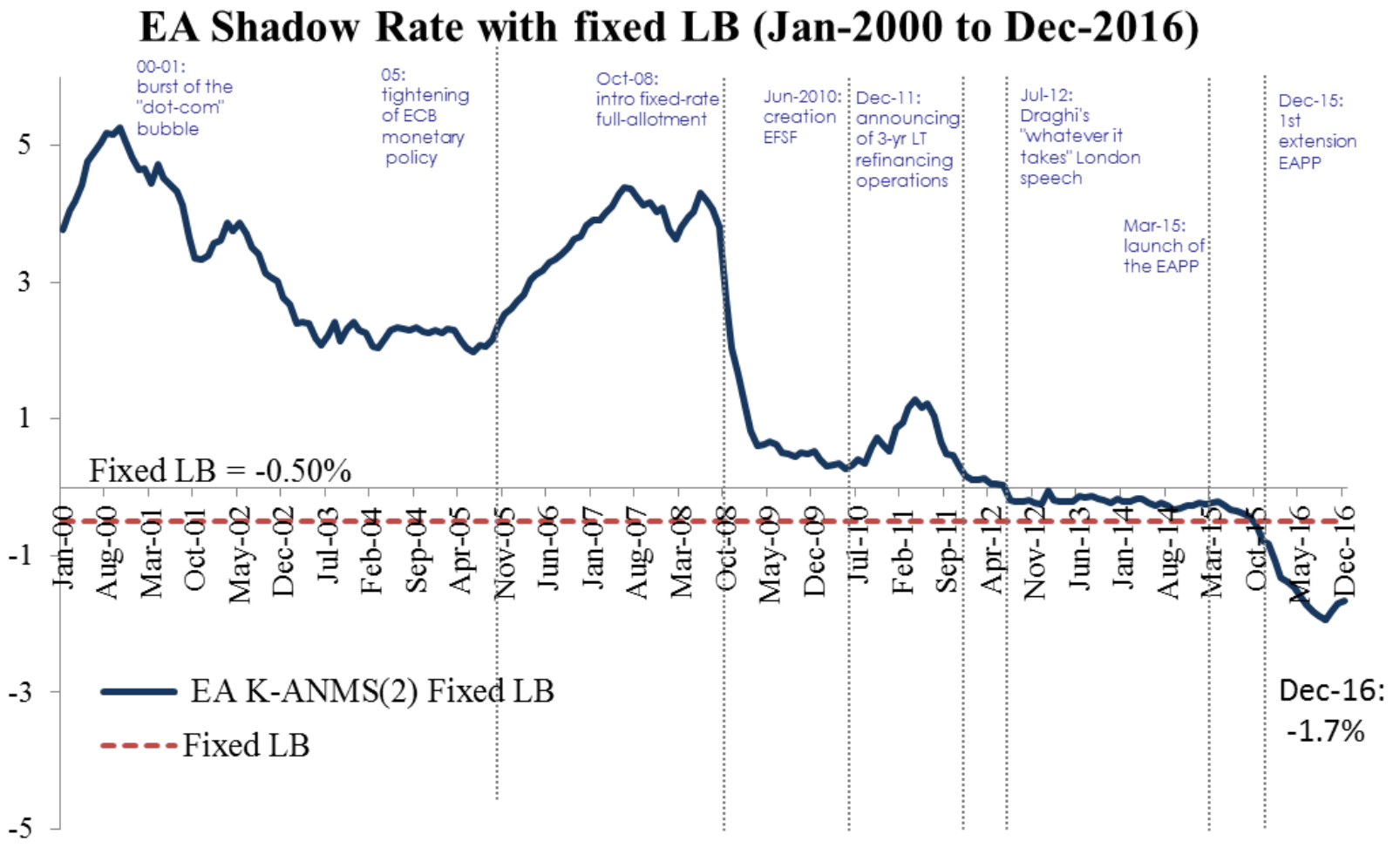
2. The policy-mix: excessive reliance on MP

Real long term interest rates and structural balance change, euro area



2. The policy-mix: excessive reliance on MP

The shadow rate reflects the accommodative effect of expansionary monetary policy

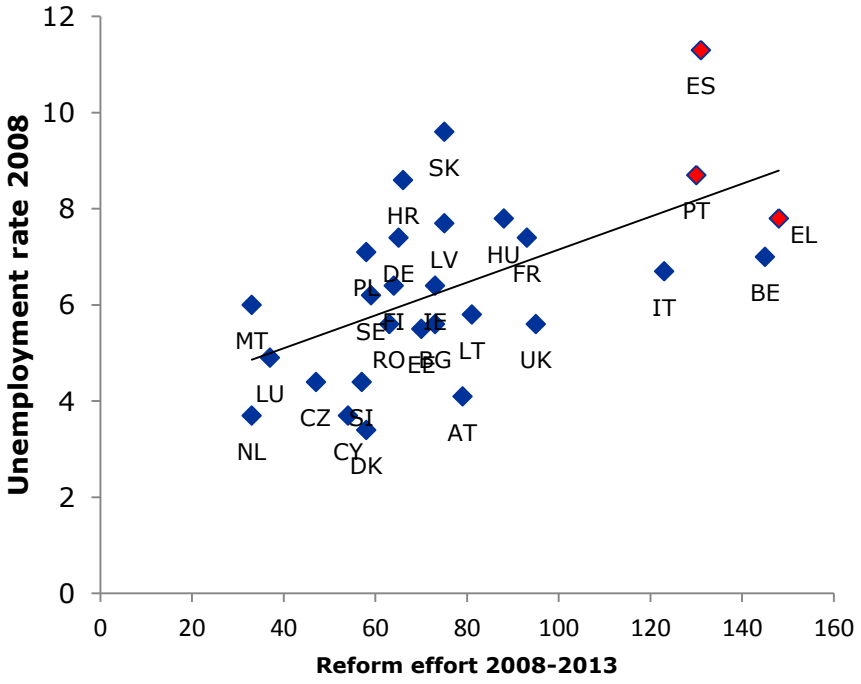


2. The policy-mix: excessive reliance on MP

Large reform efforts in countries under pressure

Labour market reforms

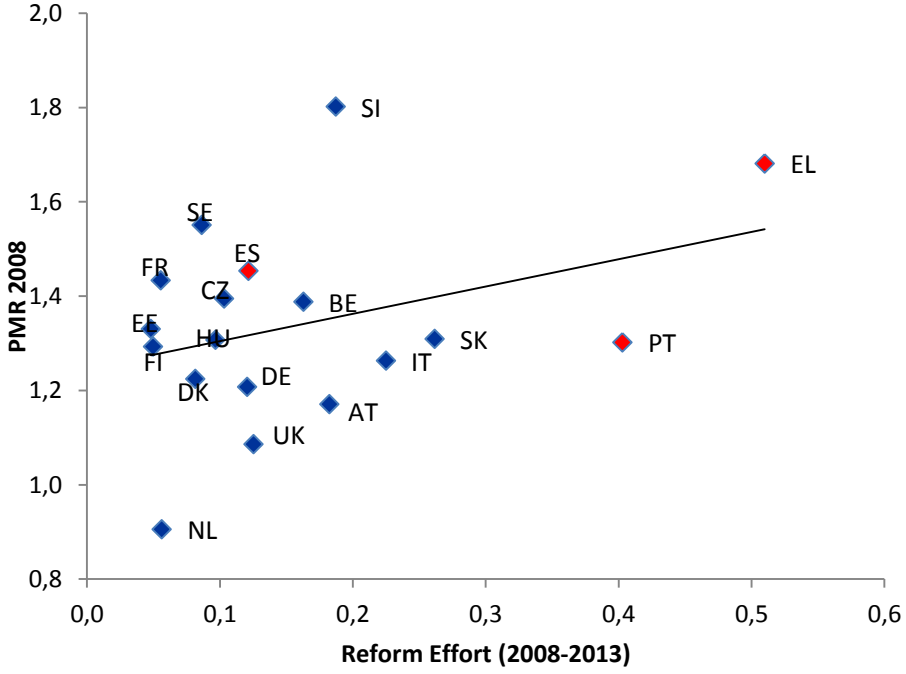
Reform effort (2008-13) and unemployment rate (2008)



Source: European Commission

Product market reforms

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



Source: OECD (PMR)

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3. The aggregate fiscal stance

Relevant concept from different points of view:

- Economic:
  1. Coordination of fiscal policies is crucial in a monetary union. Lack of central budget reinforces this need, given spillovers.
  2. Currently, there is no instrument to manage the aggregate orientation of the fiscal stance.

- Legal

  The Two Pack requires the Commission to *'make an overall assessment of the budgetary situation in the euro area as a whole*' and *'outline measures to reinforce the coordination of budgetary and macroeconomic policies at the euro area level'*

3. The aggregate fiscal stance

- Commission adopted a recommendation for an positive fiscal stance in 2017
  - Need to support monetary policy of the ECB and rebalance the overall policy mix of the euro area
  - A positive fiscal stance of 0.5% is mid-way between the expansion needed to half the euro area output gap or to close it by 2017 [range: 0.2%-0.8%]
  - Current fiscal stance conceals a very uneven and sub-optimal fiscal distribution across Member States
  - Surplus MS should channel excess savings to domestic economy.
  - Fiscal effort should be differentiated, taking spillovers into account.

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4. Fiscal space

- "Fiscal space" is an increasingly relevant concept

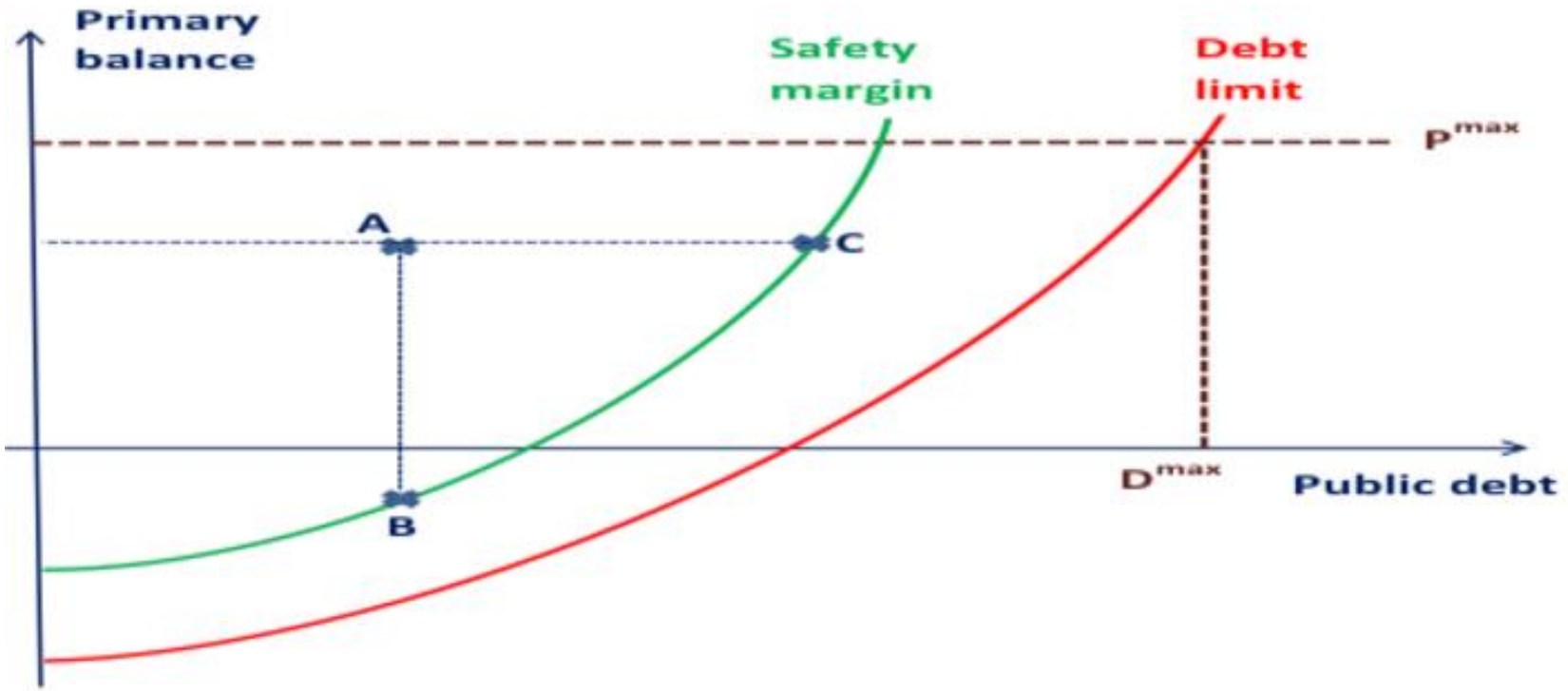
- How to characterise the fiscal space
  - One criterion directly drawn from the SGP: difference between the SB and the country-specific MTO
  - Difference between PB and PB*, where PB* is the norm consistent with a long-run debt anchor, derived from:

$$b^{anchor} = PB^*/(r^*-g^*)$$

- Durably lower interest rates and stronger growth imply larger available fiscal space
  - The average (r-g) on government bonds has fallen considerably since the start of EMU.
  - Generally low interest rates are expected to stay for a while (e.g. Fisher 2016).

4. Fiscal space

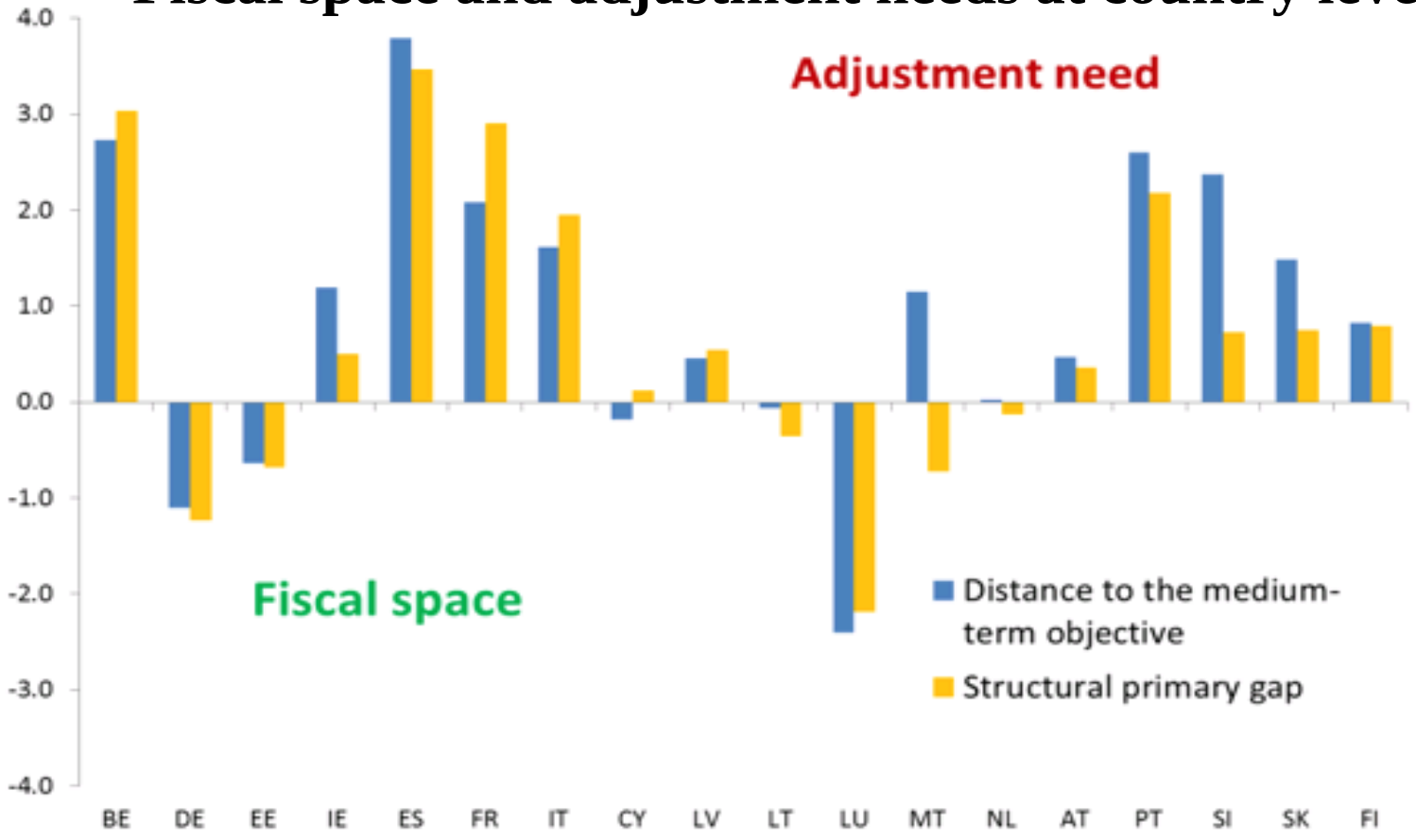
- Operationalising fiscal space: A Blanchard (1984)-inspired framework



4. Fiscal space

- Fiscal space is heterogeneously distributed in the euro area
  - ➢ Some countries have clear margin and should use it

Fiscal space and adjustment needs at country level



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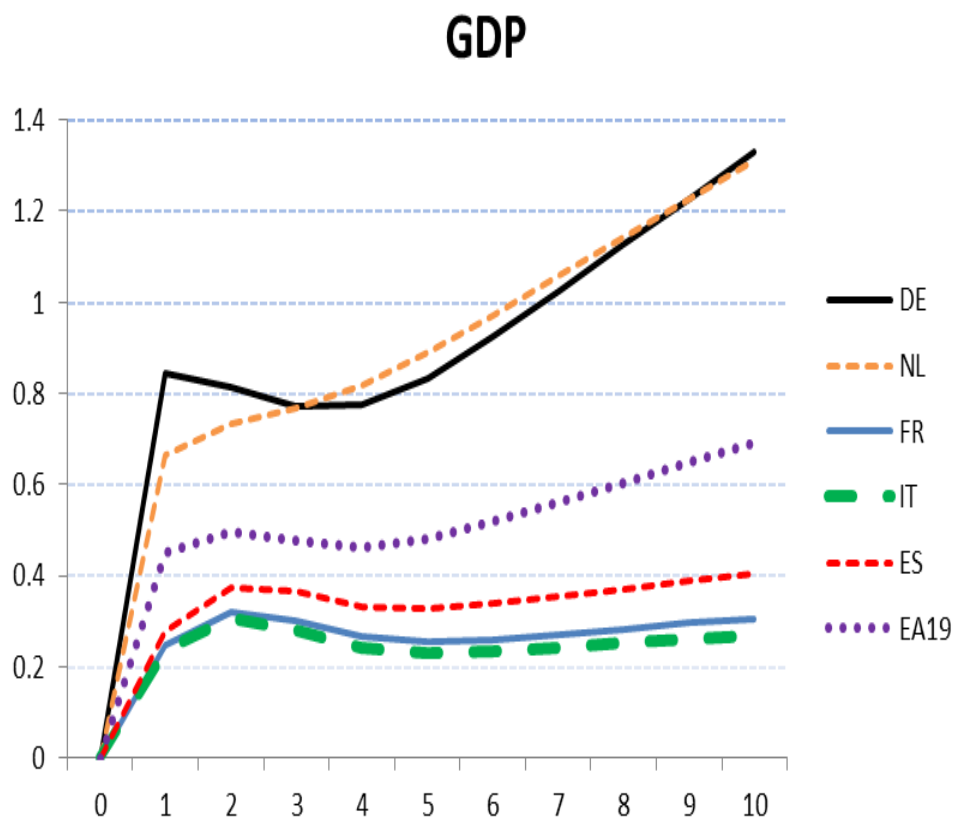
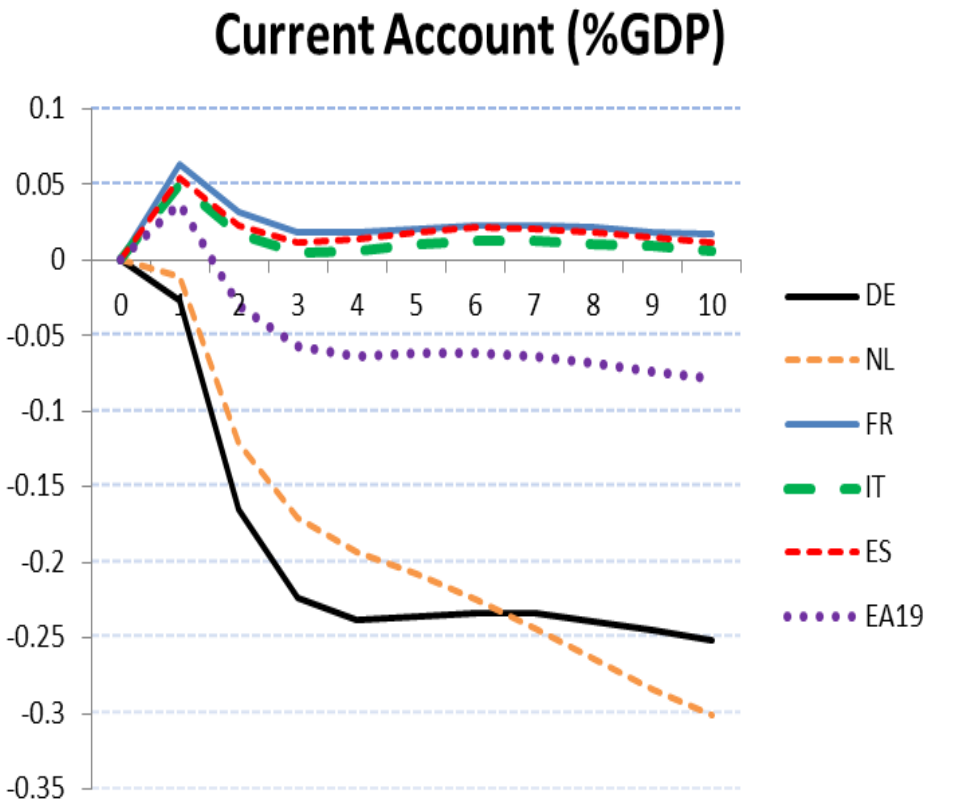
5. Impact of an expansionary fiscal policy

- Simulation of a debt-financed 1% increase in govt investment in DE and NL; ZLB; low borrowing costs





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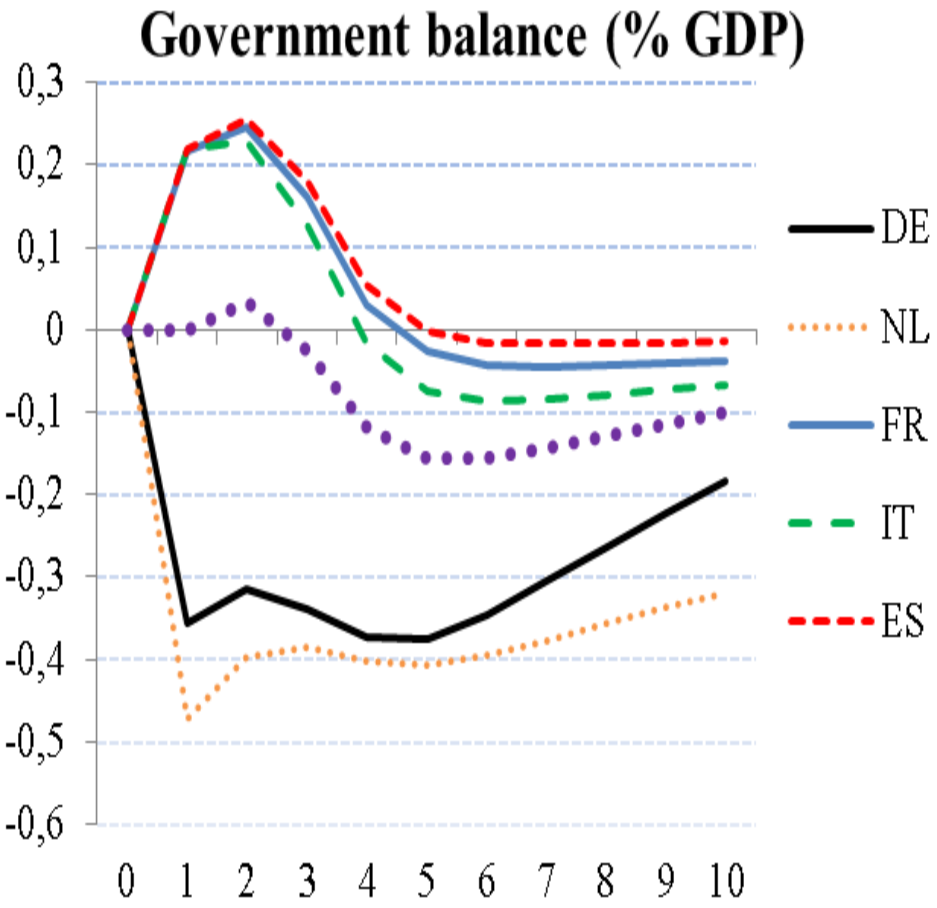
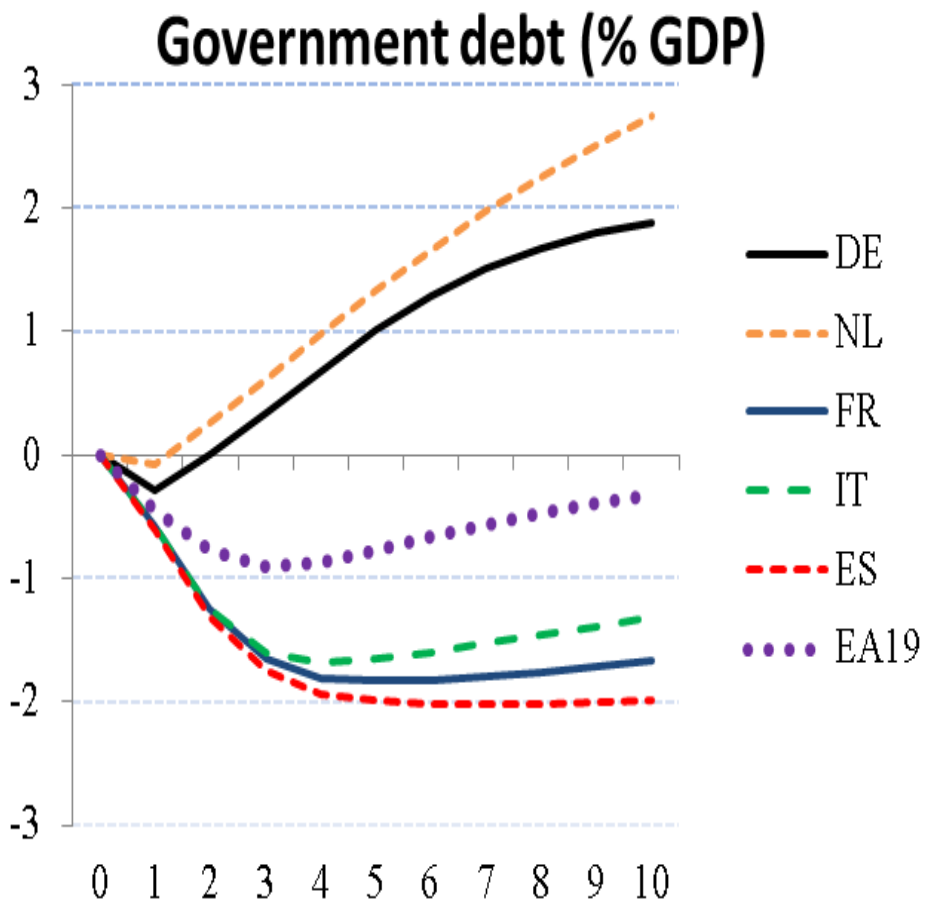
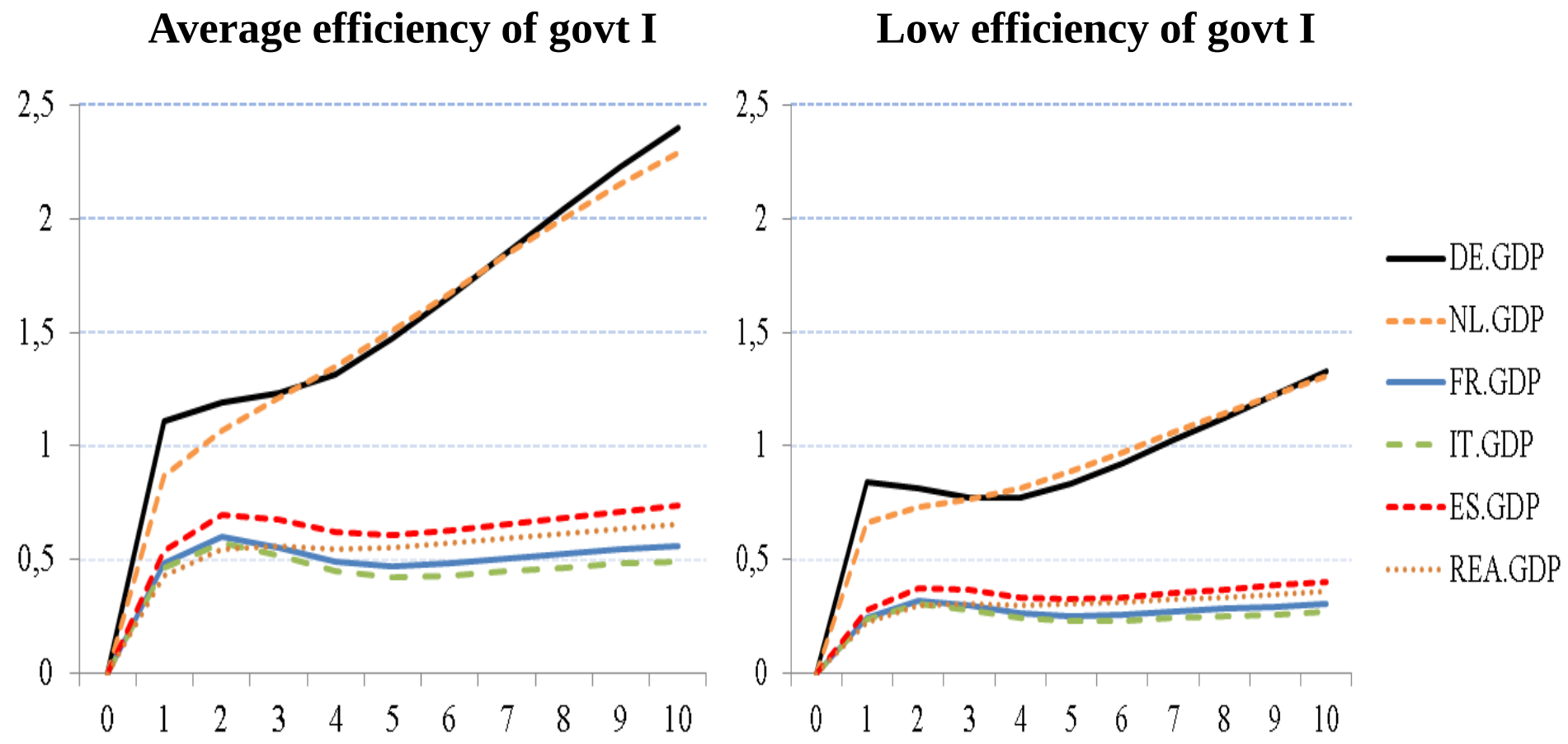




5. Impact of an expansionary fiscal policy

- Fiscal policy supportive of growth is not only a matter of the sign of the budget balance but also of the quality of the underlying public finances



5. Impact of an expansionary fiscal policy

- DE's CA surplus is linked to a persistent demand shortfall, which:
  - Does not support effort by MP to overcome very low inflation
  - Does not help the deleveraging process in EA

- Strengthening public investment in DE would:
  - Help address the demand slack in both DE and REA, while strengthening growth potential.
  - Contribute to a more symmetric rebalancing in the EA
  - Lead to a quite modest correction in DE's CA surplus over the short to medium term

5. Impact of an expansionary fiscal policy

- The public sector in DE is contributing to excess savings at the global level

- However, impact of fiscal expansion on global imbalances is very muted under ZLB scenario

  - Under a ZLB scenario:

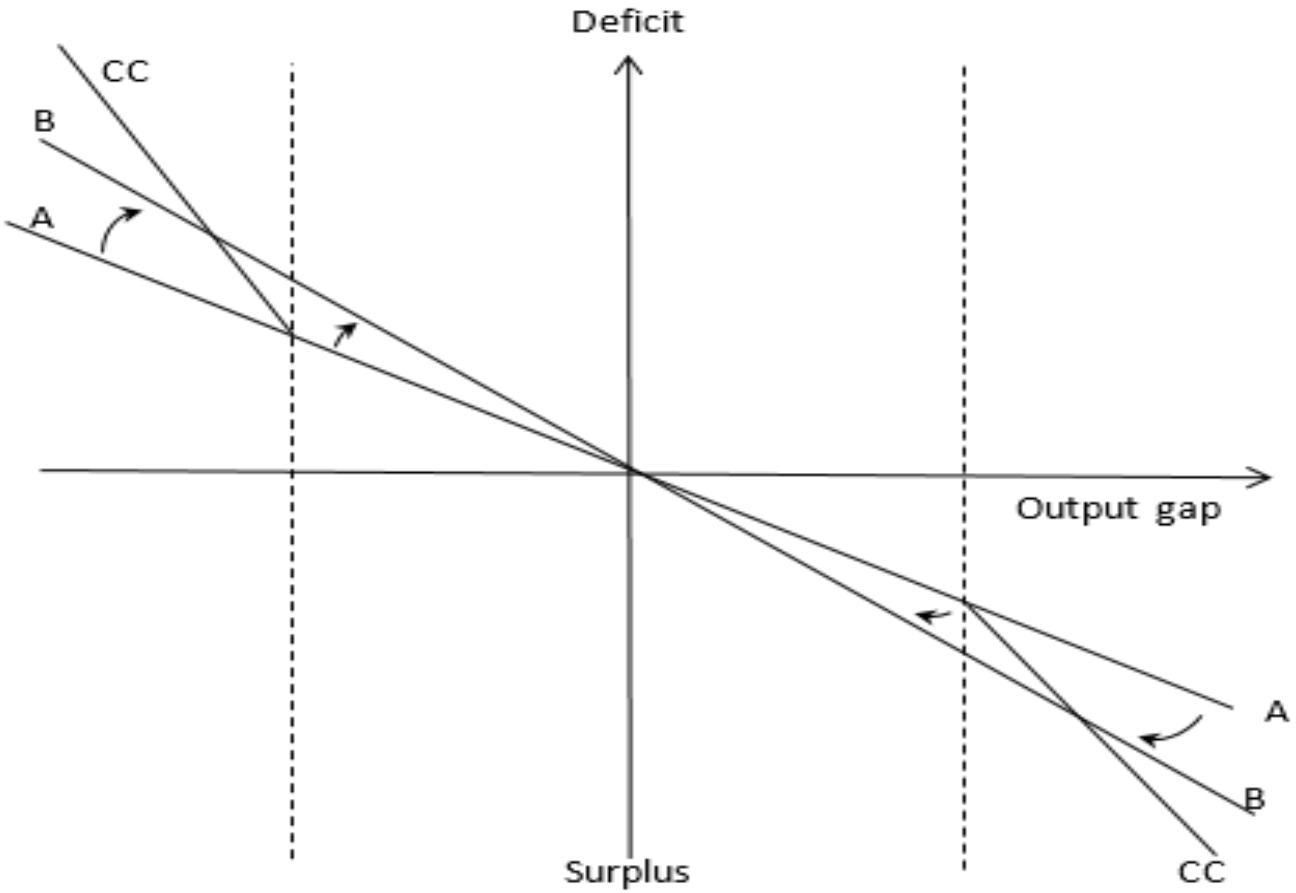
    Expansionary FP ➡ Decline RIR ➡ K outflows ➡ ER depreciation ➡ Increase in exports

  - This compensates for the increased domestic demand

- The fact that the US is already away from ZLB (but not the EA) is also contributing to the euro depreciation

Strengthening the effectiveness of automatic stabilizers

Avenues for increasing automatic fiscal stabilisation



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6. Policy orientations: four take-aways

1. Respecting fiscal rules enshrined in the SGP:
   - Fiscal sustainability concerns are particularly relevant for some MS, which should consolidate
   - Also in light of likely increase in long-term interest rates

2. Those MS who have fiscal space should use it:
   - Particularly effective at ZLB in boosting growth at both domestic and EA level (higher multipliers/ higher spillover effects).
   - Contribute to a symmetric unwinding of EA imbalances

6. Policy orientations: four take-aways

3. Greater focus on the quality of public finances:
   - Identify priority areas that would benefit from increased/better spending or shifts in taxation
   - Increase the shock-absorbing properties of automatic stabilisers

4. Create a central fiscal capacity, with two windows:
   - Earmarked grants for investments
   - Reinsurance of national unemployment benefits

   Access conditional to compliance with a convergence code

Thank you

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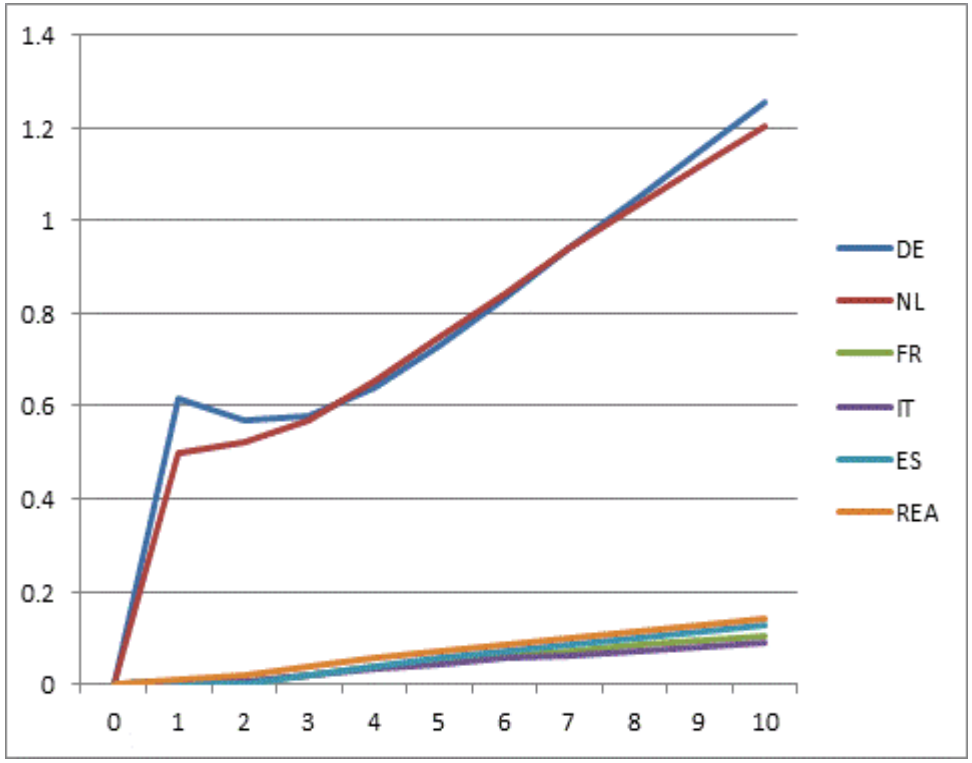
Background slide

Comparison 'normal' monetary policy vs ZLB

1. Normal reaction (without monetary accommodation)

GDP

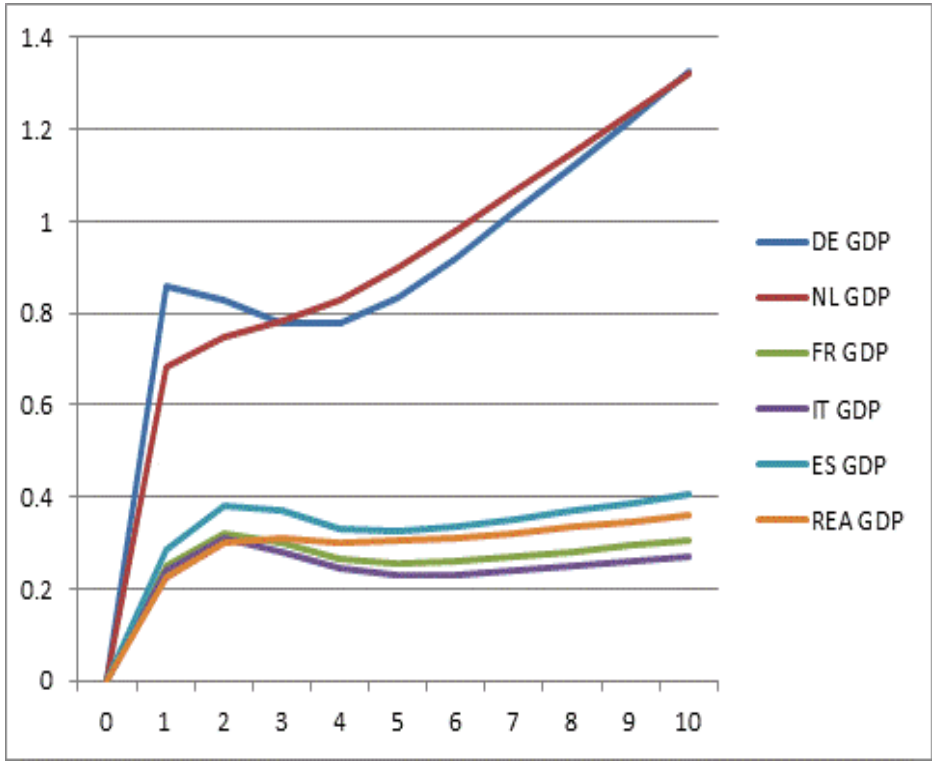


Demand	+
Higher interest rates	-
Appreciation	-

=> Small GDP spillovers

2. Under ZLB (monetary accommodation)

GDP



Demand	+
Lower real interest rates	+
Depreciation	+

=> Larger GDP spilovers