Towards the 'new normal'
Financial and economic challenges in post-crisis European Union recovery

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Outline

1. ***Economic outlook***
2. ***Policy strategy***
3. ***The way forward for EMU deepening***

Economic outlook (ST)

- **Cyclical recovery is underway: is this time different?**
- **Several tailwinds, but impact uncertain and temporary**
  - ECB actions, including quantitative easing
  - Low oil price
  - Weak euro
  - Neutral fiscal stance
  - Lagged impact of structural reforms in some vulnerable countries
- **Risks to the short-term outlook tilted to the downside**
  - Weakness in emerging markets/Asia
  - Market volatility and changes in asset valuation
  - Greece: no contagion but work ahead
  - Geo-political risks
  - New elements: Refugee inflows and VW emissions scandal

Economic outlook (MT)

- **Medium-term prospects: Not out of the woods yet**
  - Economic activity still below pre-crisis level
  - Downward revisions to potential growth
  - Falling behind major competitors

- **Pre-crisis structural impediments to growth and jobs**
  - Unfavourable demographics
  - Weak productivity growth
  - High unemployment
  - Rigid product and labour markets

Economic outlook (MT)

- **Legacy of the crisis**
  - Investment gap
  - Deleveraging private and public debt
  - Bank capitalisation and high non-performing loans
  - Still high unemployment, increasingly youth and long-term
  - Ongoing sectoral adjustment in countries that e.g. underwent housing boom-bust
  - Protracted low inflation
  - Halt/reversal in convergence process
  - Elevated uncertainty and depressed animal spirtis
  - Rising inequality
  - Citizens' declining systemic trust

Policy strategy

- **Turning green shoots into a sustained, balanced recovery: A concerted four pillar policy response**
  - Continuing demand support
    - Maintain accommodative monetary stance; quid broadening/extending QE
    - Deficit-neutral, targeted fiscal expansion: strengthening automatic stabilisers / automating discretionary fiscal policies; tax shift;
    - Expediting investment: Juncker plan
  - Cleaning up bank balance sheets
    - Strengthening prudential supervision
    - Addressing high level of NPLs
    - Discouraging ring-fencing
  - Incentivizing structural reforms
    - Use of SGP flexibility
    - Benchmarking
  - Completing EMU

Completing EMU

- **Rationale**
  - Despite significant progress, EMU architecture remains incomplete
  - Doubts about long-term viability; undermining economic recovery
- **Sequencing logic**
  - Front-loading private sector risk sharing (BU; CMU)
  - Linking public sector risk sharing to progress on pooling sovereignty
  - Moving from rules to institutions

Completing EMU

- **Stage I (to 30 June 2017)**
  - Complete Banking Union (add EDIS) and launch Capital Market Union
  - Create European Fiscal Board
  - Set up European system of Competitiveness authorities
  - Streamline and reinforce European Semester
  - Consolidate external representation of the euro area
- **Stage II**
  - Fiscal capacity to better cushion asymmetric shocks
  - Euro Area Treasury
  - Common high-level standards to formalise convergence process
  - Strengthen democratic accountability

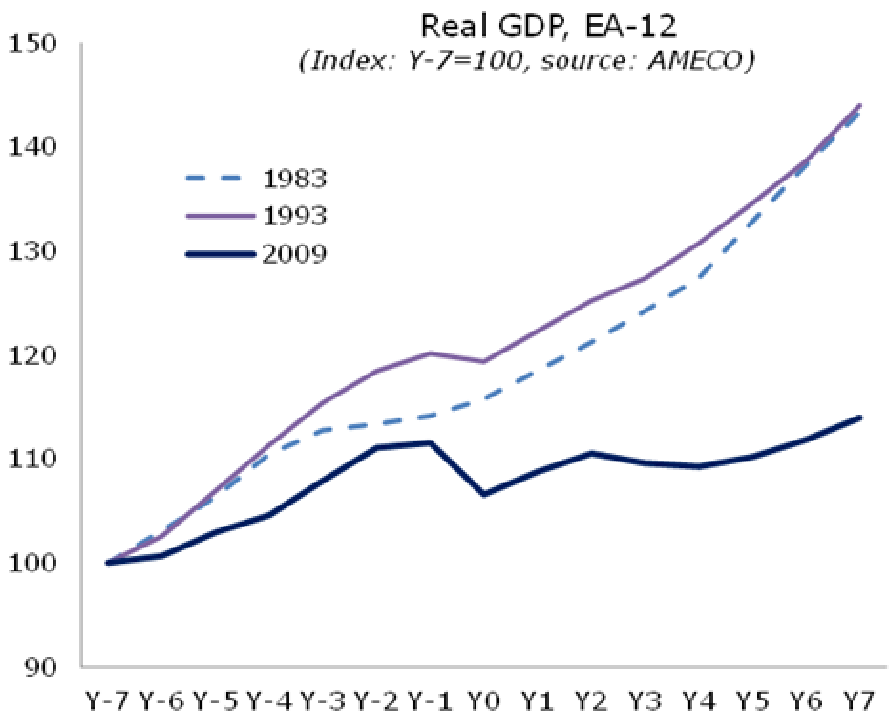
Background

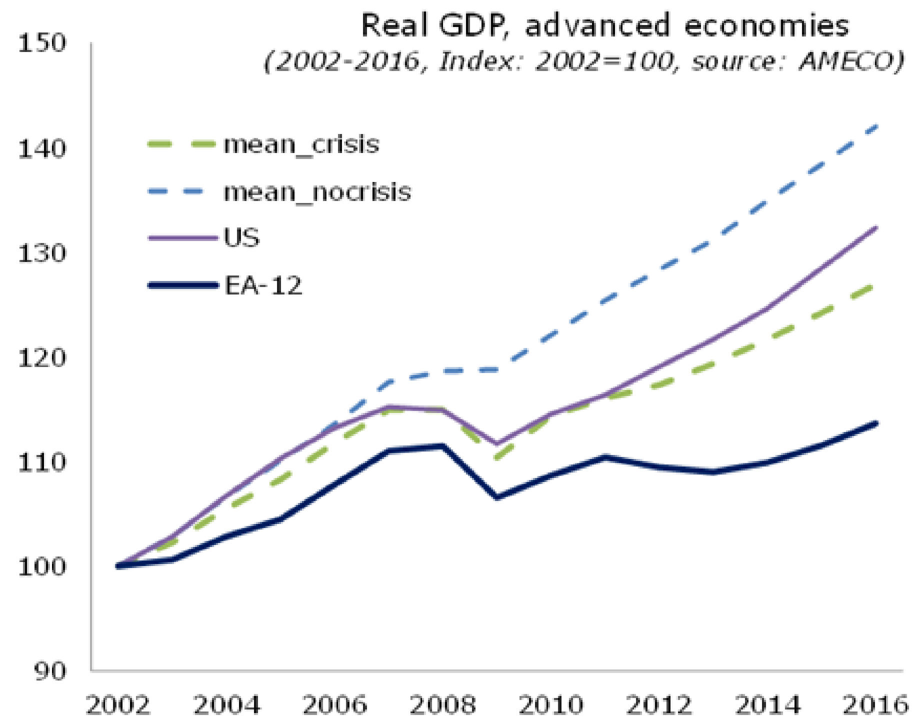
Oil price decline, QE and euro depreciation are driving euro-area growth

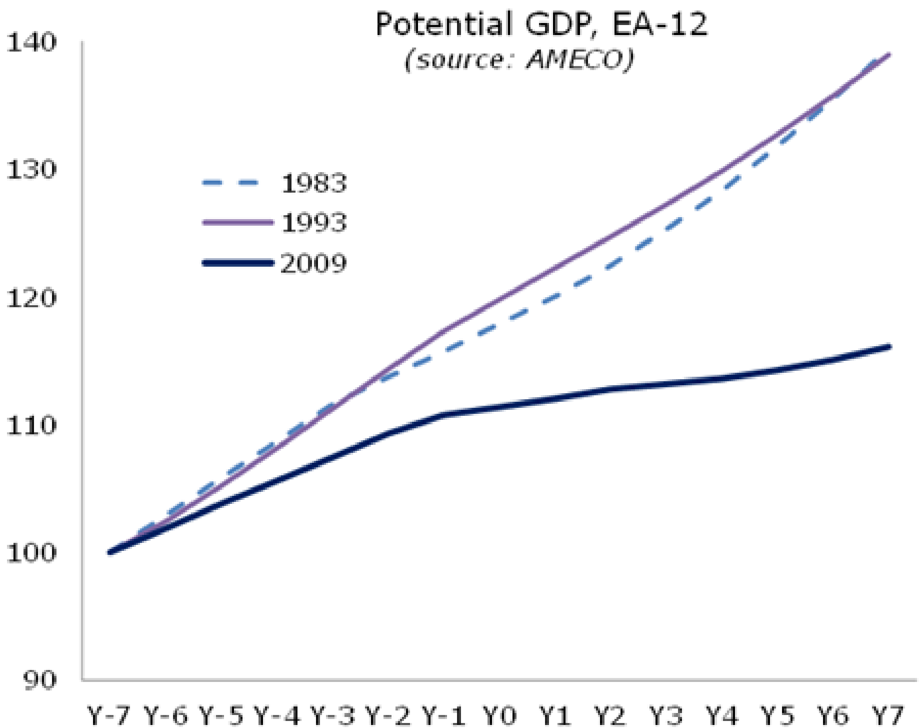
Euro-area real GDP growth in 2015 (%)	
2015 Spring forecast	**1.5**
Potential growth	*0.8*
Oil price decline	*0.5*
Quantitative easing	*0.4*
Euro depreciation	*0.4*
EU-Russia sanctions	*-0.2*
Residual	*-0.4*

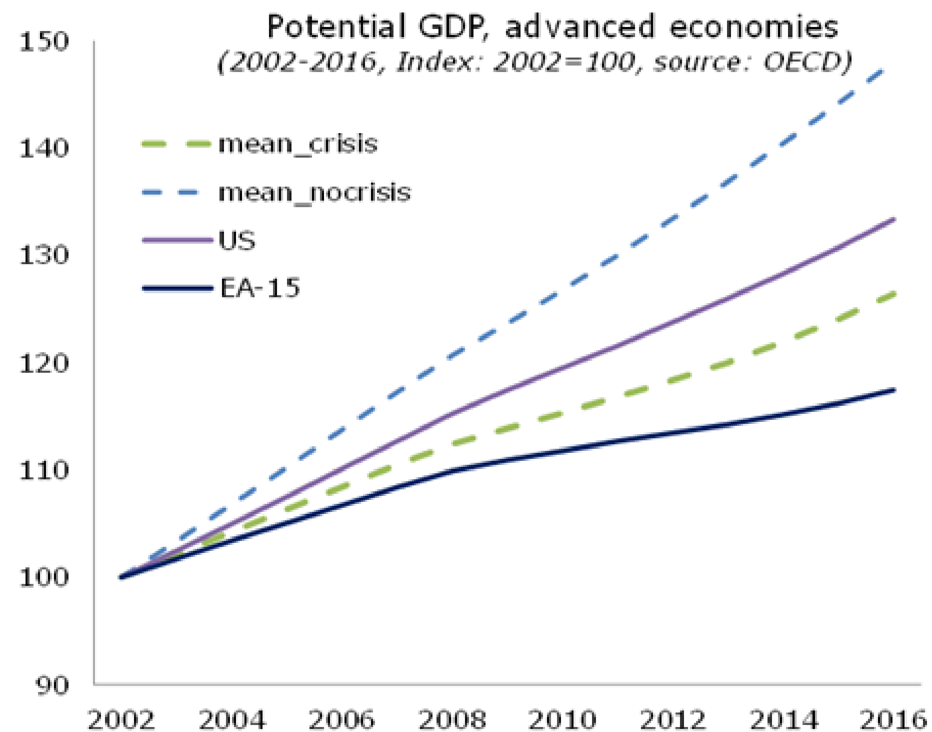
Recovery perspectives

Recoveries after major recessions and after the global financial crisis

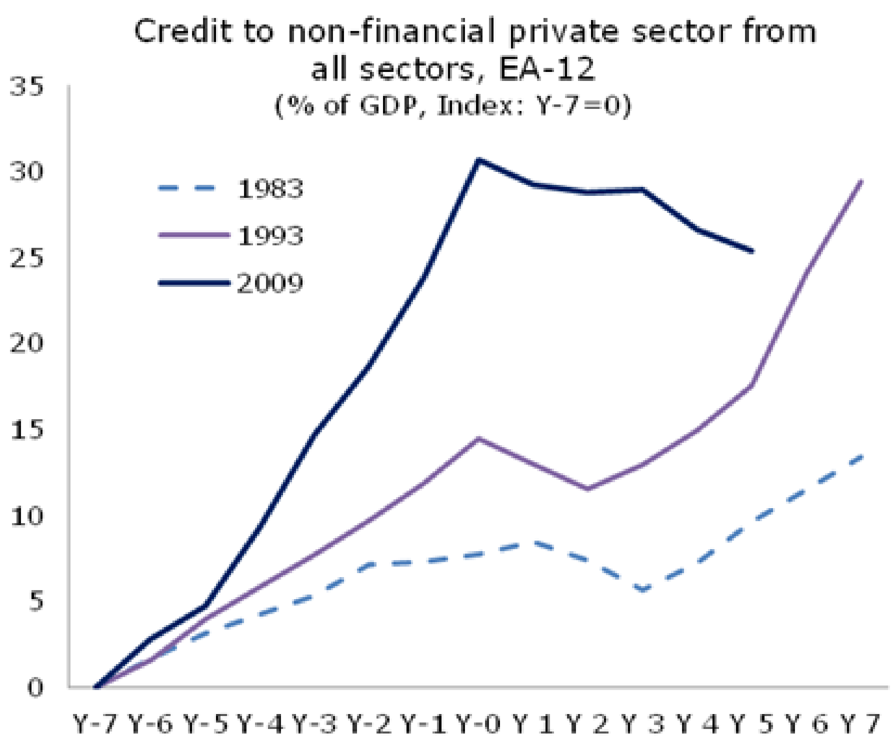


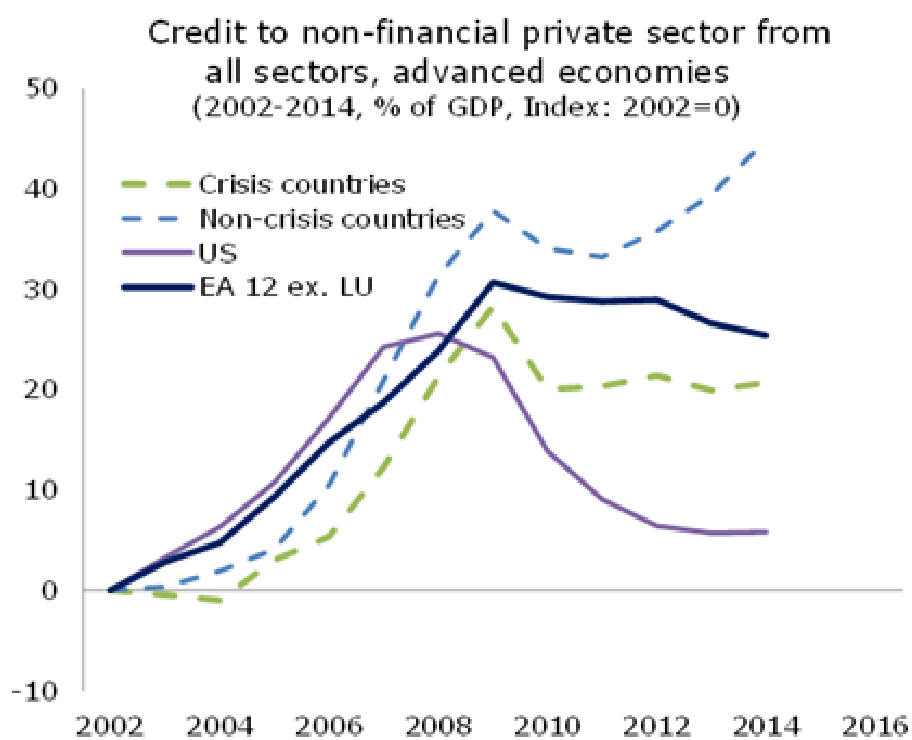



Potential GDP, EA-12
(source: AMECO)
140
130
120
110
100
90
1983
1993
2009
Y-7 Y-6 Y-5 Y-4 Y-3 Y-2 Y-1 Y0 Y1 Y2 Y3 Y4 Y5 Y6 Y7

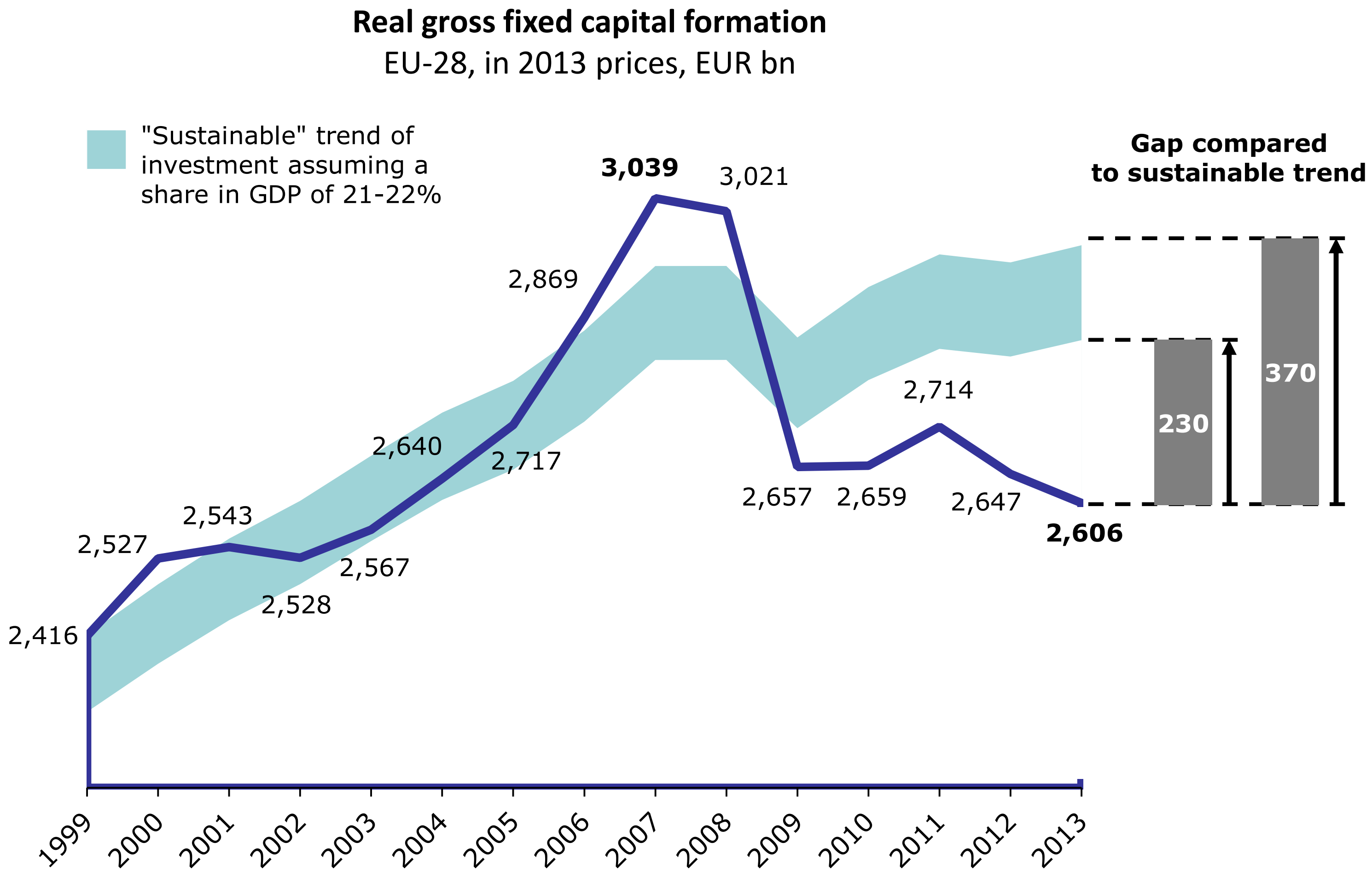

Potential GDP, advanced economies
(2002-2016, Index: 2002=100, source: OECD)
150
140
130
120
110
100
90
mean_crisis
mean_nocrisis
US
EA-15
2002 2004 2006 2008 2010 2012 2014 2016

Private and public debt





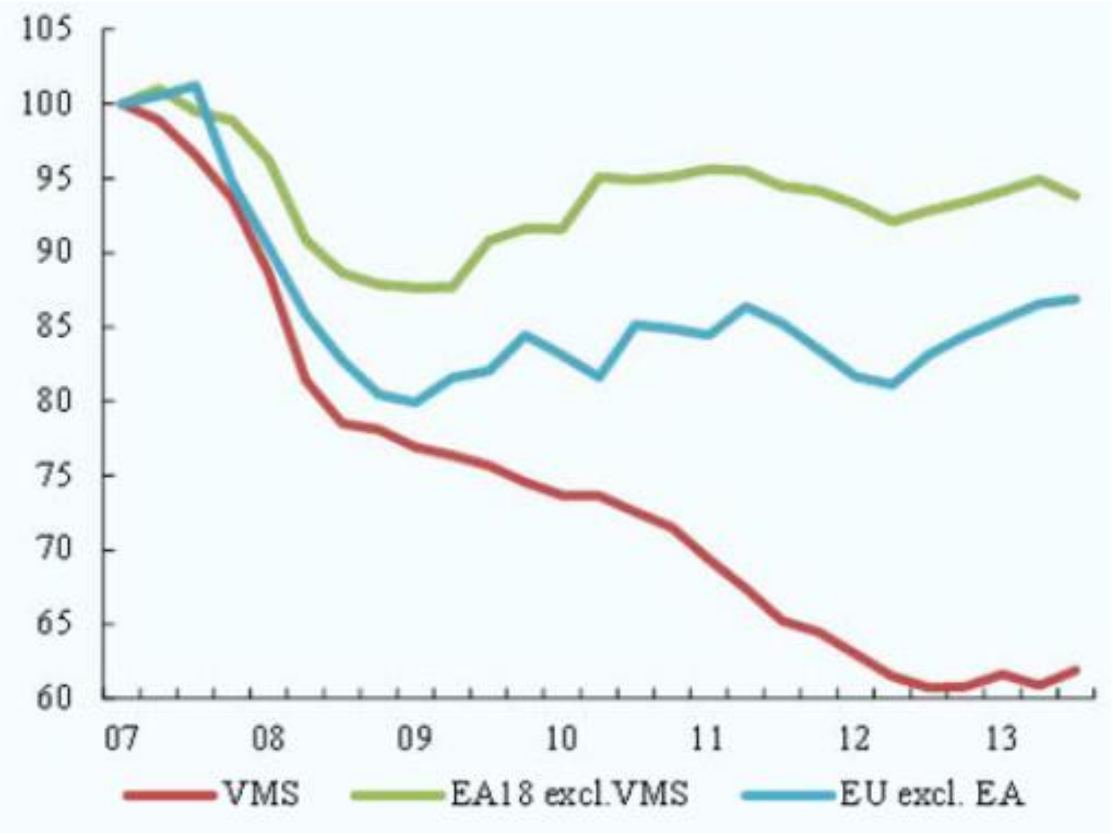
The investment gap in the EU is sizeable



Source: European Commission

Slump in investment

Total investment in levels
Index, 2007Q4=100



Source: European Commission, Autumn Forecast 2014

EU INVESTMENT TRIANGLE

MOBILISING FINANCE FOR INVESTMENT

- Strong boost to strategic investments
- Better access to investment finance for SMEs and mid-cap companies
- Strategic use of EU budget
- Better use of the European Structural and Investment Funds

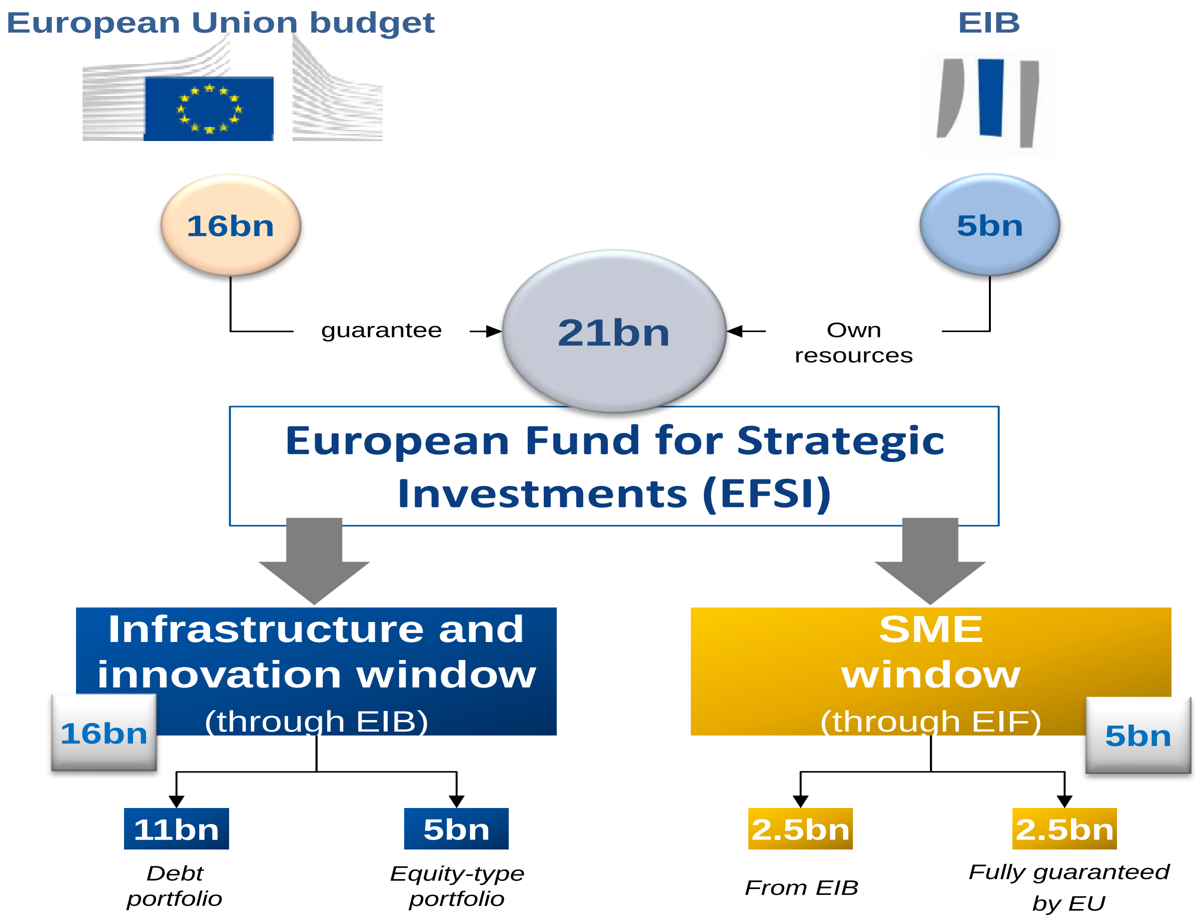
MAKING FINANCE REACH THE REAL ECONOMY

- Project pipeline preparation and selection
- Technical assistance at all levels
- Strong cooperation between National Promotional Banks and the EIB
- Follow-up at global, EU, national and regional level, including outreach activities

IMPROVED INVESTMENT ENVIRONMENT

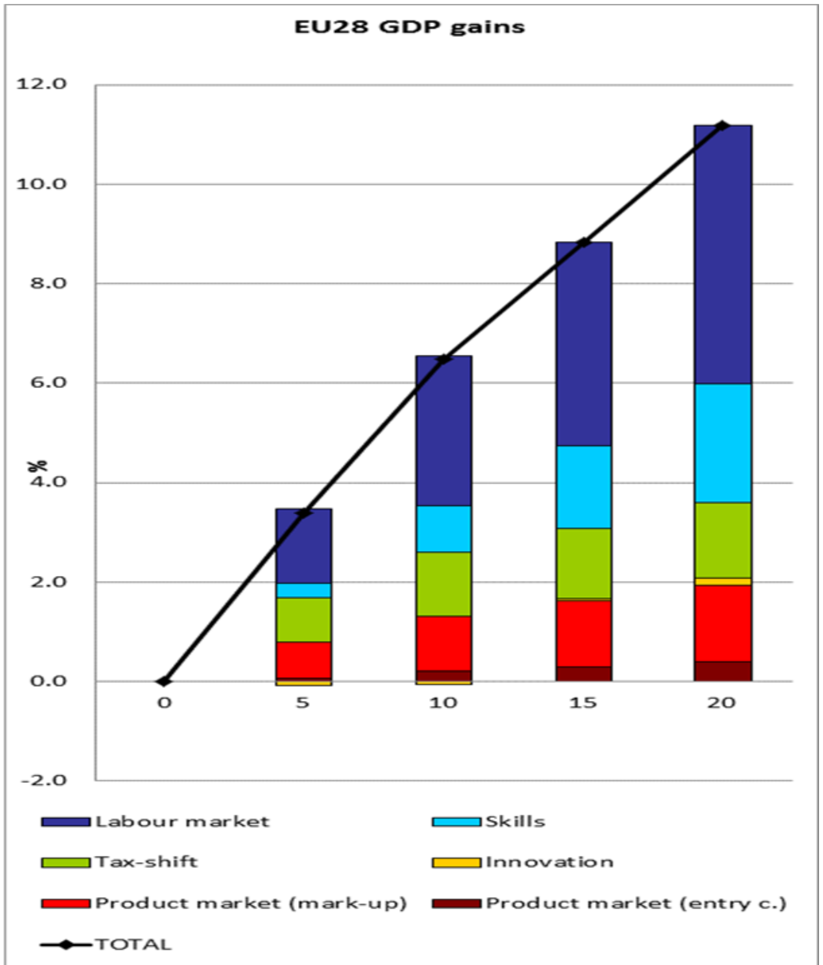
- Predictability and quality of regulation
- Quality of national expenditure, tax systems and public administration
- New sources of long-term financing for the economy
- Removing non-financial, regulatory barriers in key sectors within our Single Market

Structure and Investment target



Total EIB/EIF financing	49bn	12bn
Total investment mobilised	240bn	75bn

GDP effects of closing half the gap with best practice



Potentially large GDP effects if each MS closes half the gap vis-à-vis best performers:

GDP after 5 years: EU +3½%
< SE +1% ; EL +5% >

GDP after 10 years: EU +6½%
< SE +2% ; EL +10% >

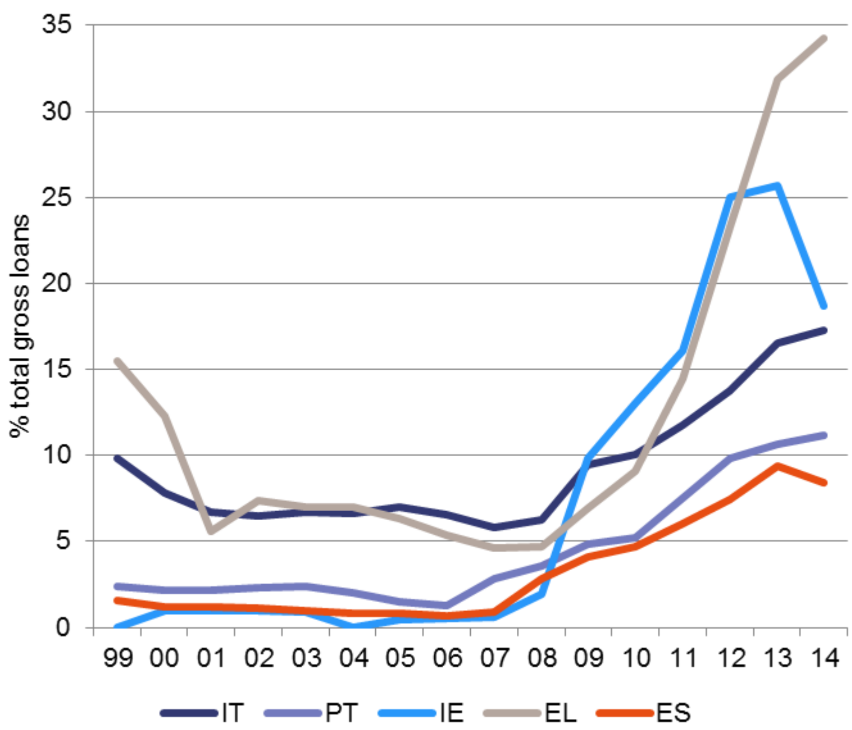
Effects take time to materialise

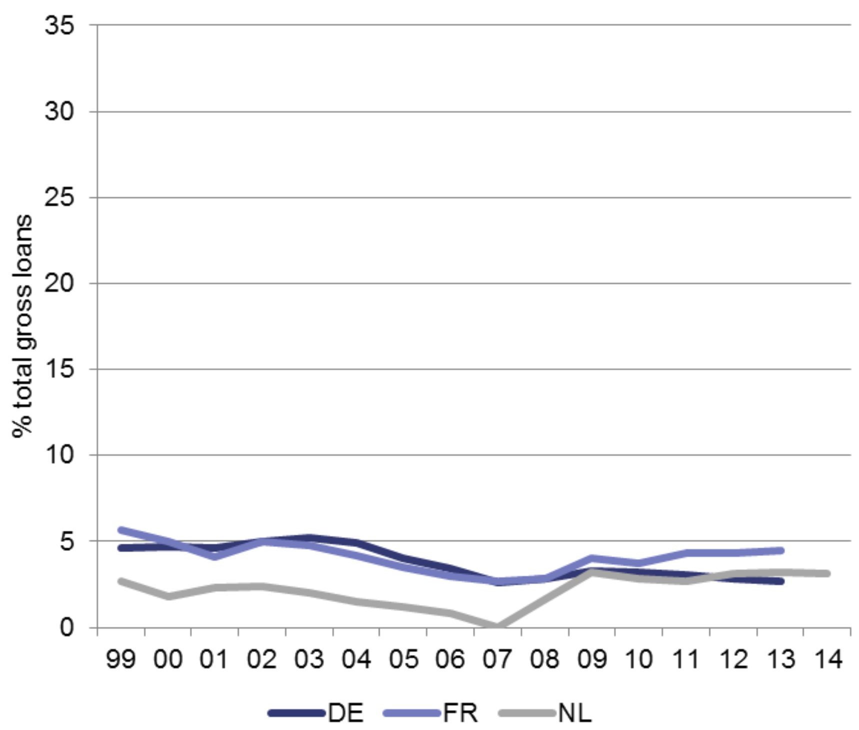
- Effects of tax shift relatively fast
- Labour market reforms slower
- Innovation and education slowest

Source: Varga and in 't Veld (2014)

Banks ran into trouble

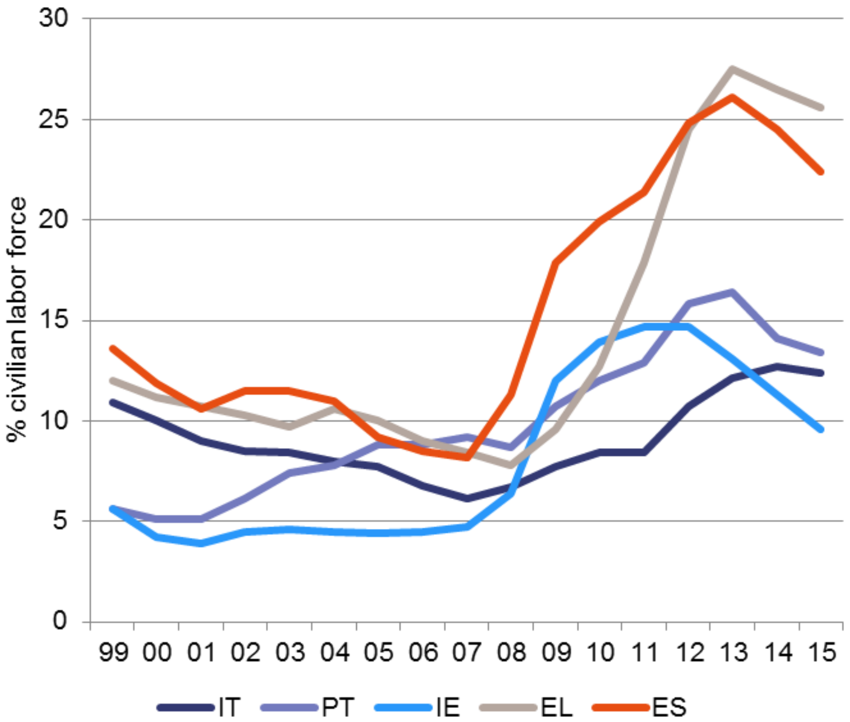
Non-performing loans
% total gross loans

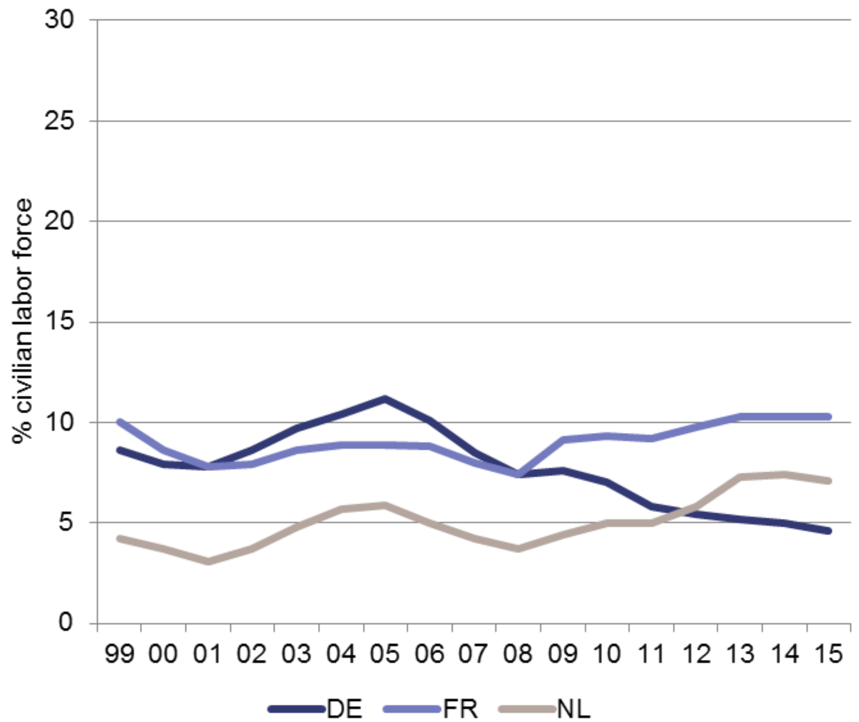




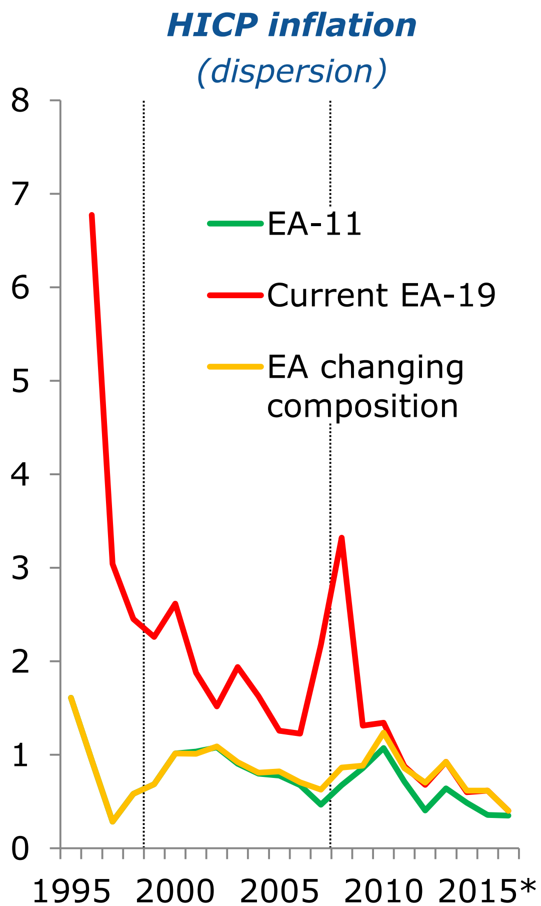
From boom to bust

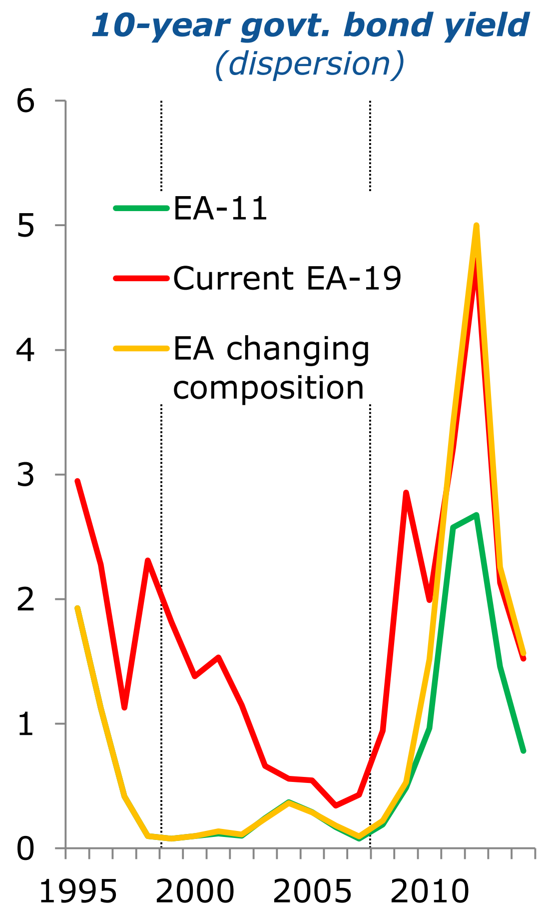
Unemployment rate
% civilian labor force

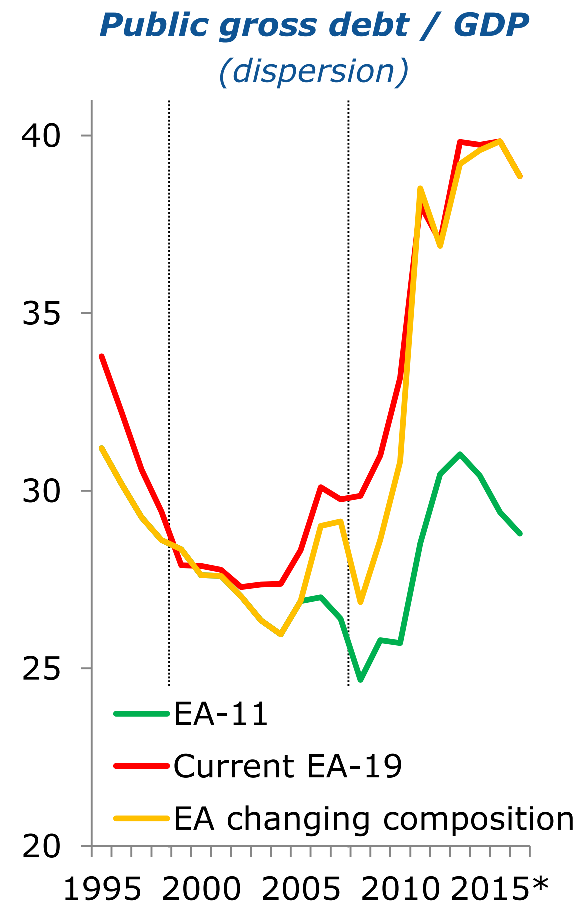




Strong nominal convergence pre-EMU; limited further progress due to weak market pressure and policy complacency





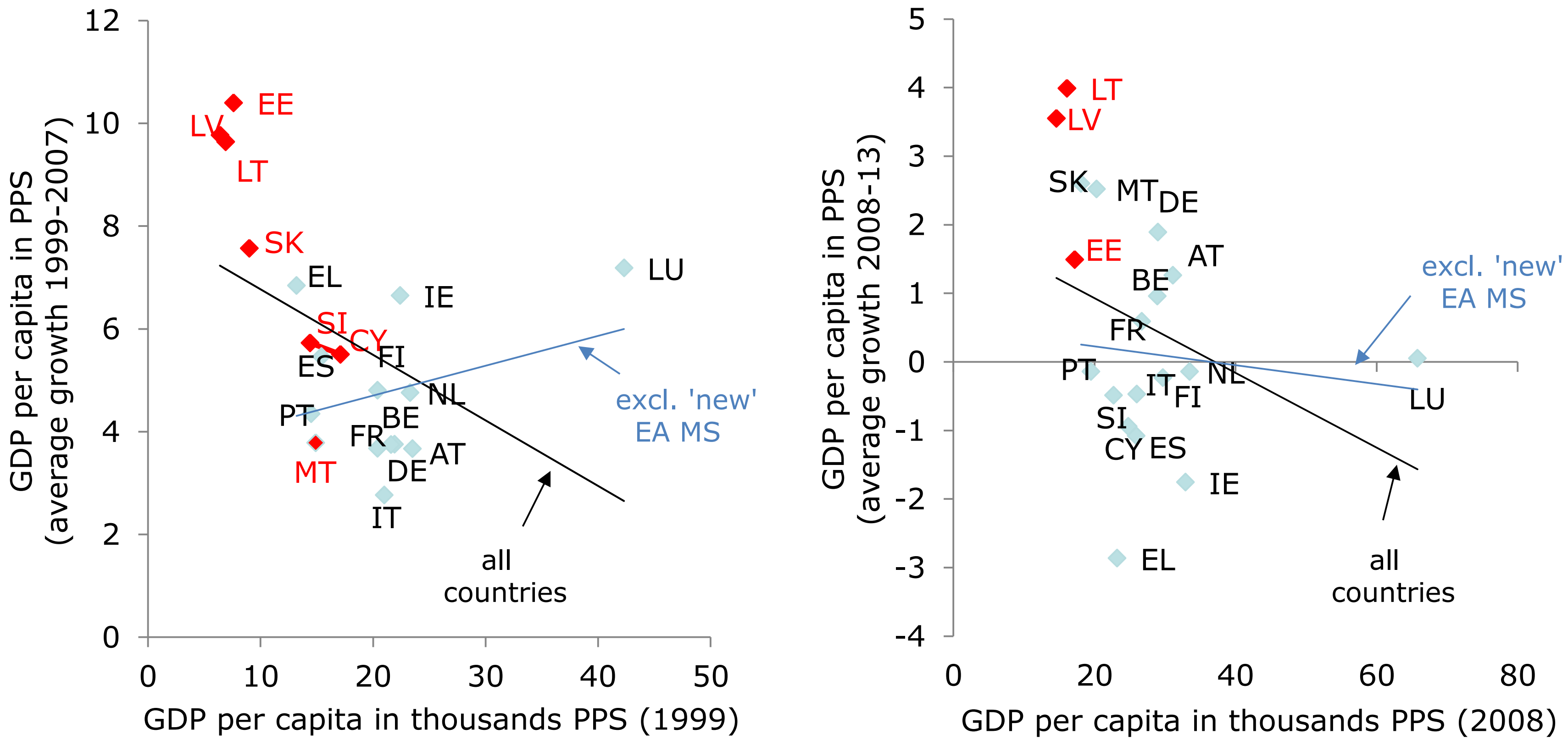


Note: Dispersion measured as an unweighted standard deviation. "" indicates projected values. HICP inflation measured as y-o-y growth rate of the HICP index. 10-year nominal govt. bond yield. Public gross debt in line with EDP definition based on ESA 2010.*

Source: Ameco.

Real convergence: Catching-up process mostly driven by 'new' euro area Member States

GDP per capita (in PPS) before and after the start of the financial crisis



Note: Countries which were in 1999 (left chart) and in 2008 (right chart) not members of the euro area are highlighted in red. The black regression line is based on the full sample of countries, the blue one excludes the 'new' euro area Member States, which are highlighted in red.

Source: Eurostat.

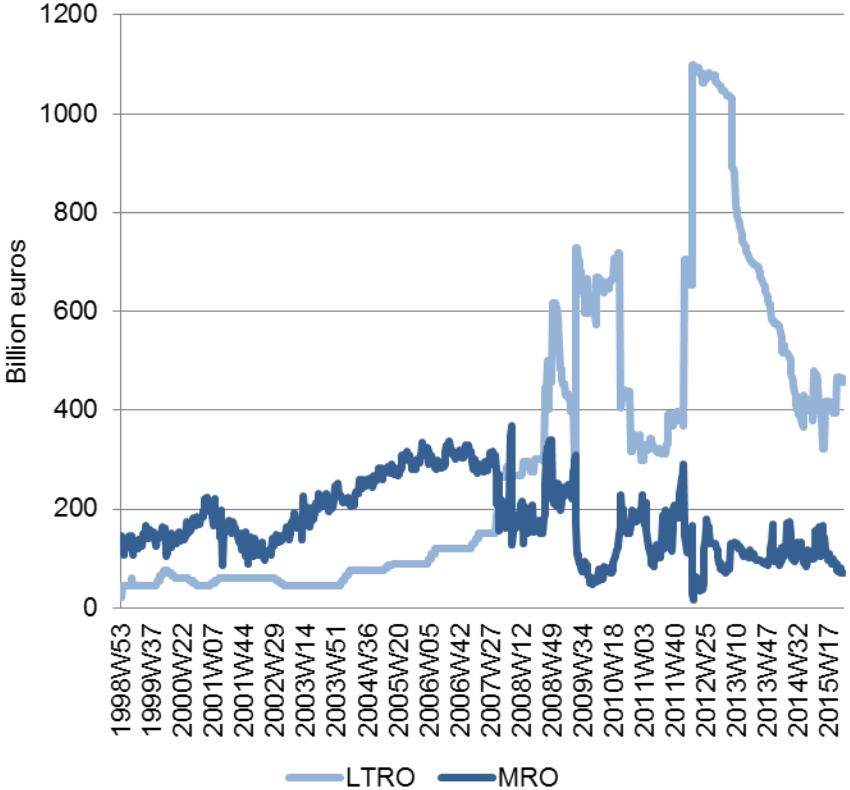
Insufficient real convergence: a problem?

Economic argument	**Heterogeneity can be costly, but it can be overcome by appropriate adjustment mechanisms**	**Reduce heterogeneity** by reinforcing single market integration, risk-sharing financial market integration and cross-border labour mobility, whilst allowing for system competition and national idiosyncracies
		Ensure adequate **adjustment mechanisms** which make heterogeneous economies resilient to shocks (asymmetric/common) and respond effectively to internal and external imbalances
Political-economy argument	**A monetary union of heterogeneous economies depends on political cohesion and identity**	Monetary unions with heterogeneous economies can be sustainable as long as a **certain degree of political cohesion and identity** exists, e.g. US, Belgium, Germany
		If political cohesion is defined in terms of **convergence of economic welfare levels and in the absence of large transfers**, the sustainability of heterogeneous monetary unions is less clear.

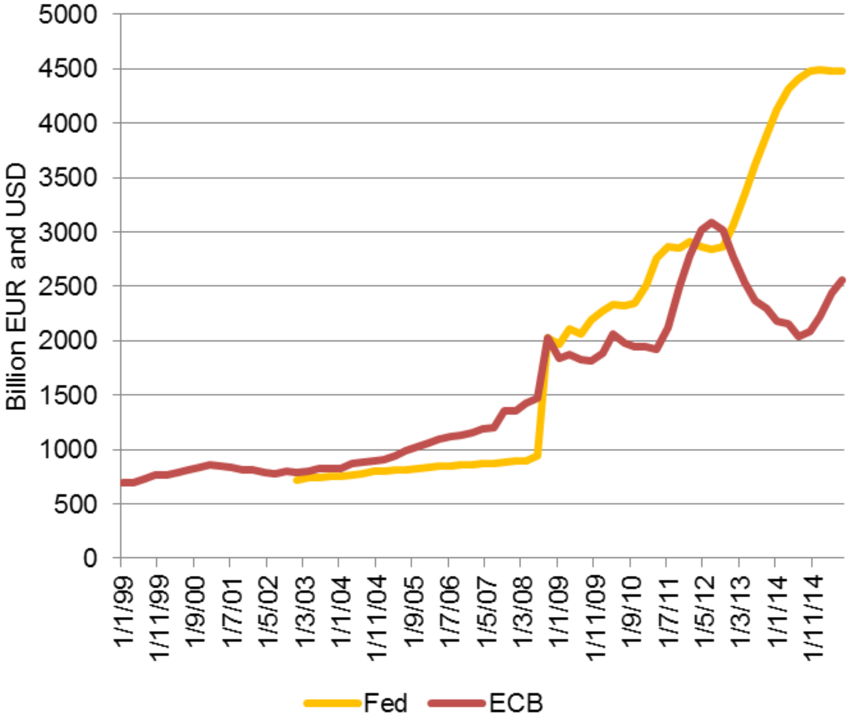
Preventing a meltdown

Lending to banks

ECB refinancing operations in euro area



Asset purchases



QE impact

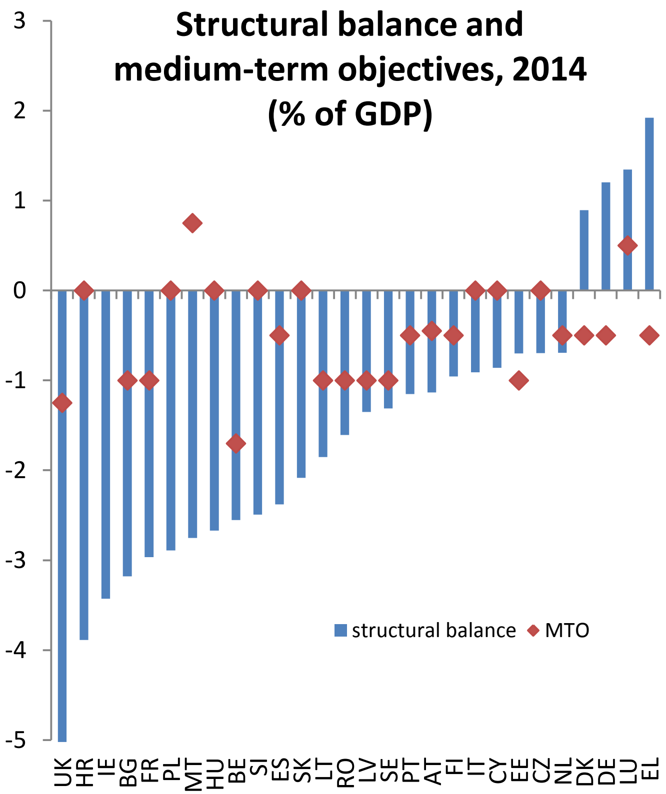
TRANSMISSION CHANNELS

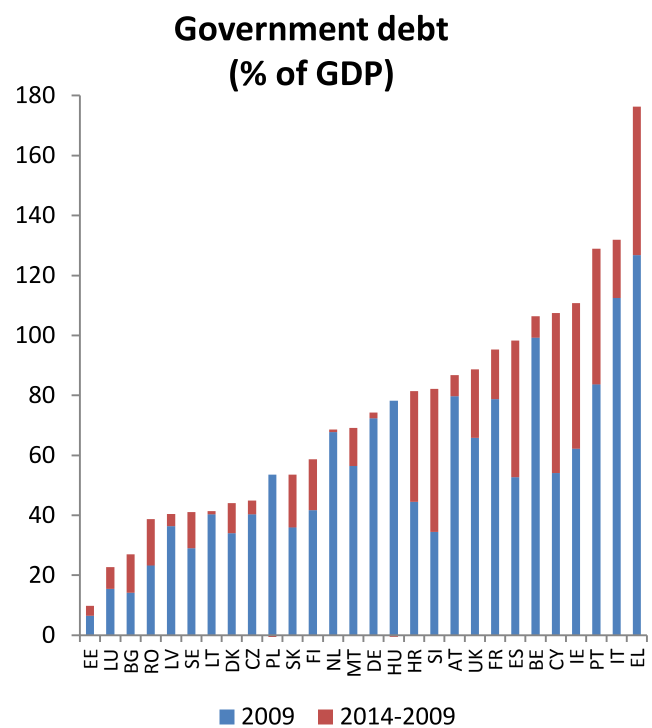
- **Signalling effect** on inflation expectations and confidence
- **Portfolio balance effect**, crowing investors out into riskier asset classes and driving down risk and term premia
- **Exchange rate channel**, resulting from increasing monetary policy divergence with the US
- **Credit channel**, increasing banks' incentives and ability to extend credit

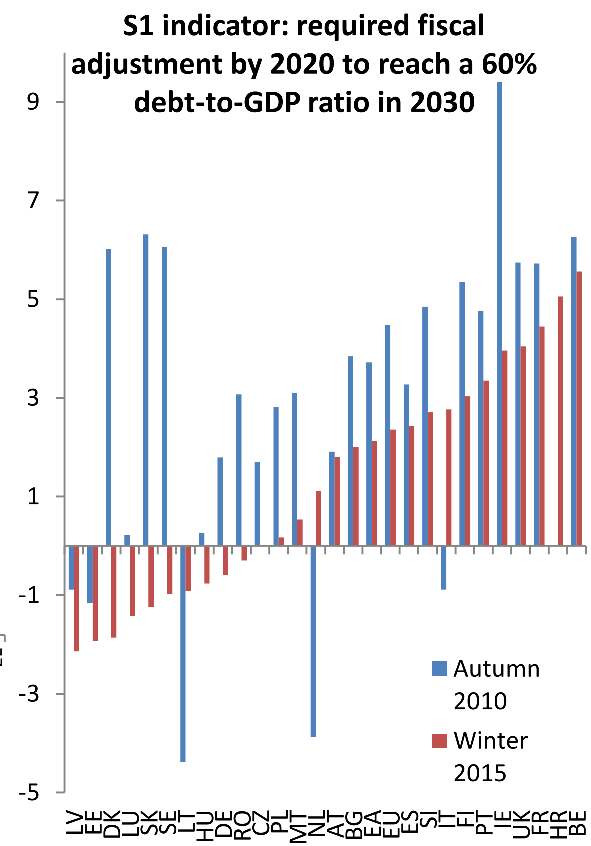
UNCERTAINTIES AND RISKS

- **Liquidity trap:** increasing money supply may have limited effect on prices and output at the zero lower bound
- **Increased search for yield** may push asset valuations to fundamentally unjustified levels; interaction with macro-prudential tools untested
- **QE exit** remains unchartered territory
- **CB profitability/capital position** may suffer when increasing short-term rates amid excess liquidity

Fiscal responsibility remains key as government debt is high and fiscal adjustment needs are large







Source: European Commission

Using SGP flexibility to promote investment and structural reforms

	Preventive arm	Corrective arm
Investment	Allowed deviation from the MTO or the adjustment path towards it	EFSI contribution SGP-neutral
Structural reform	Allowed deviation from the MTO or the adjustment path towards it	Whether to open or not an EDP (relevant factors) -Deficit (if breach is close and temporary) -Debt EDP recommendation -Setting the deadline and length of poss. Extension
Cyclical conditions	Modulation of fiscal effort with economic conditions (and sustainability risks)	Effective action methodology
	Severe economic downturn clause: redefining fiscal effort	

Lesson from the crisis: fiscal policy with constrained monetary policy

- Effect of fiscal policy on monetary policy
  - ✓ **Risk of overburdening monetary policy in the short run by lack of demand support**
  - ✓ **Risk of overburdening monetary policy in the long run via pressure for debt monetisation**

- Effect of monetary policy on fiscal policy
  - ✓ **Interest rate falls impact national budgets differently according to the debt structure in terms of maturity**
  - ✓ **Propensity of governments to use lower interest rate payment as a windfall to relax fiscal discipline.**

Lesson from the crisis: stabilisation vs sustainability

- The large increase in public debt reduces fiscal space even if the increase in debt is the consequence of the crisis
- Fiscal multipliers may be higher under financial constraints, but risk of loss of market access
- A clever balancing-act is required between stabilisation ans sustainability

Five Presidents' Report: 3 stages, 4 unions

Stage 1
- "Deepening by doing"
- by 30 June 2017

Stage 2
- "Completing EMU"

Stage 3
- "Final stage"
- At the latest by 2025

Economic Union

Financial Union

Fiscal Union

"Political Union"