



Prospects and challenges for the Euro Area economy

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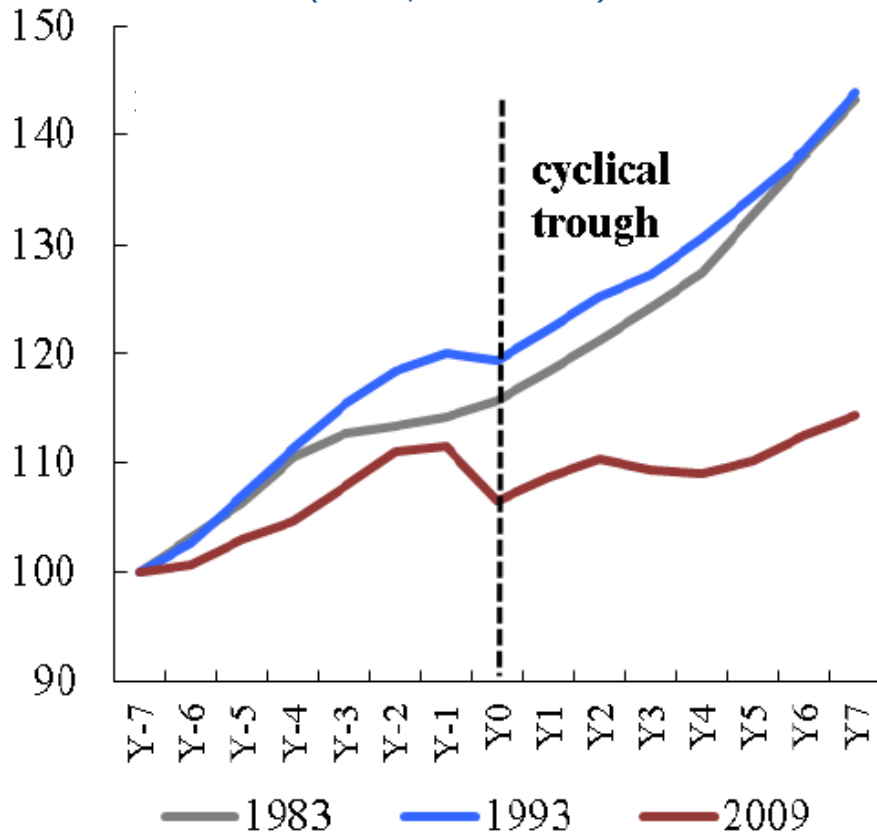
*Think Tank Europe
Copenhagen, 28 April 2017*

Outline

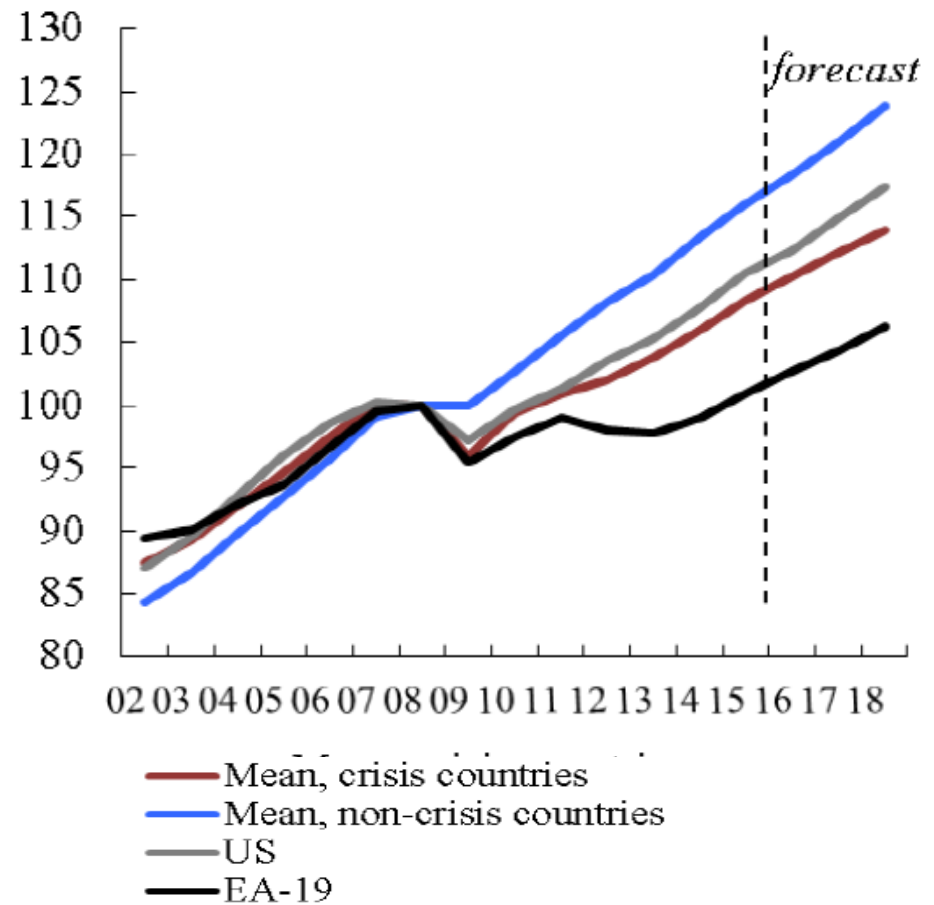
- 1. *Economic outlook:*** Brightening growth prospects, propelled by improving fundamentals and supportive policy mix
- 2. *Challenges:*** Addressing long-standing structural weaknesses and crisis legacies
- 3. *Future of Europe:*** How could a sustainable institutional architecture for EMU look like?

Sluggish post-crisis recovery

Real GDP, Euro Area
(index, Y-7 = 100)



Real GDP, advanced economies
(index 2008 = 100)

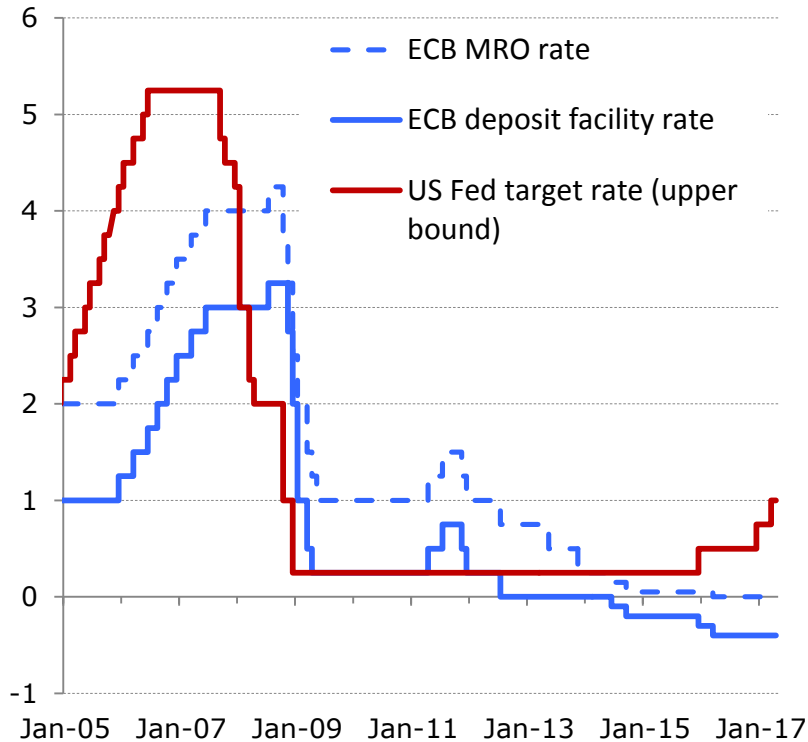


Key drivers of the recovery

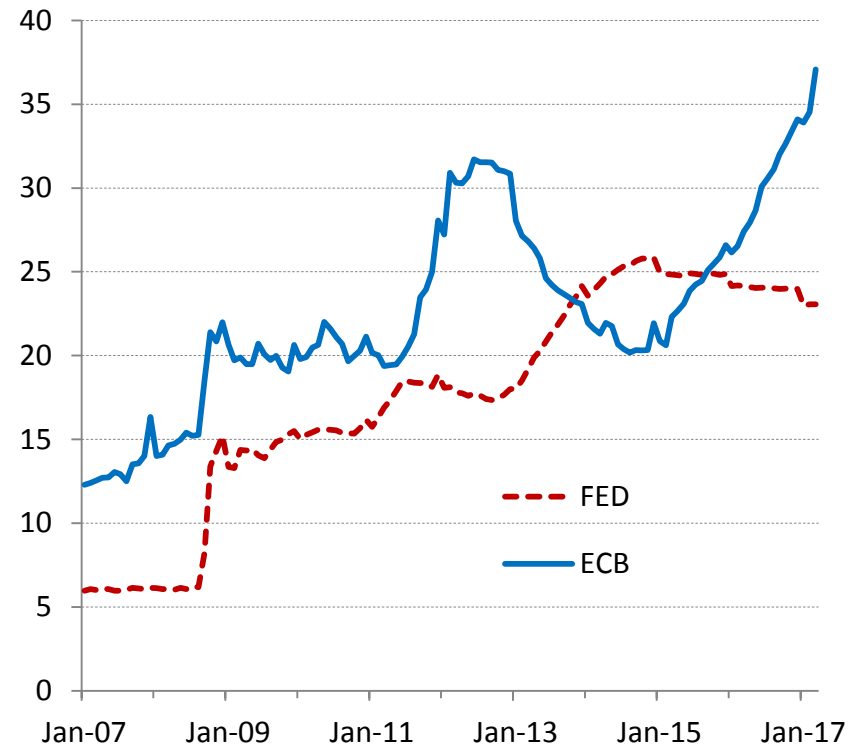
- ❑ **Waning initial favourable tailwinds**
- ❑ **Improving fundamentals**
 - Job-rich recovery, fuelling private consumption
 - Switch from *balance sheet* to *macro* deleveraging in the private sector
 - Safer and sounder banking sector
 - Improved competitiveness
- ❑ **Continued supportive policy mix**

Highly accommodative monetary policy

Policy rates set by the ECB and US Fed
(in %)



ECB and Fed balance sheet expansion
(in % of annual nominal GDP)



Source: Left side: IHS, last observation 24 April 2017; right side: Datastream, last observation 24 April 2017.

Diverging views on the role of fiscal policy

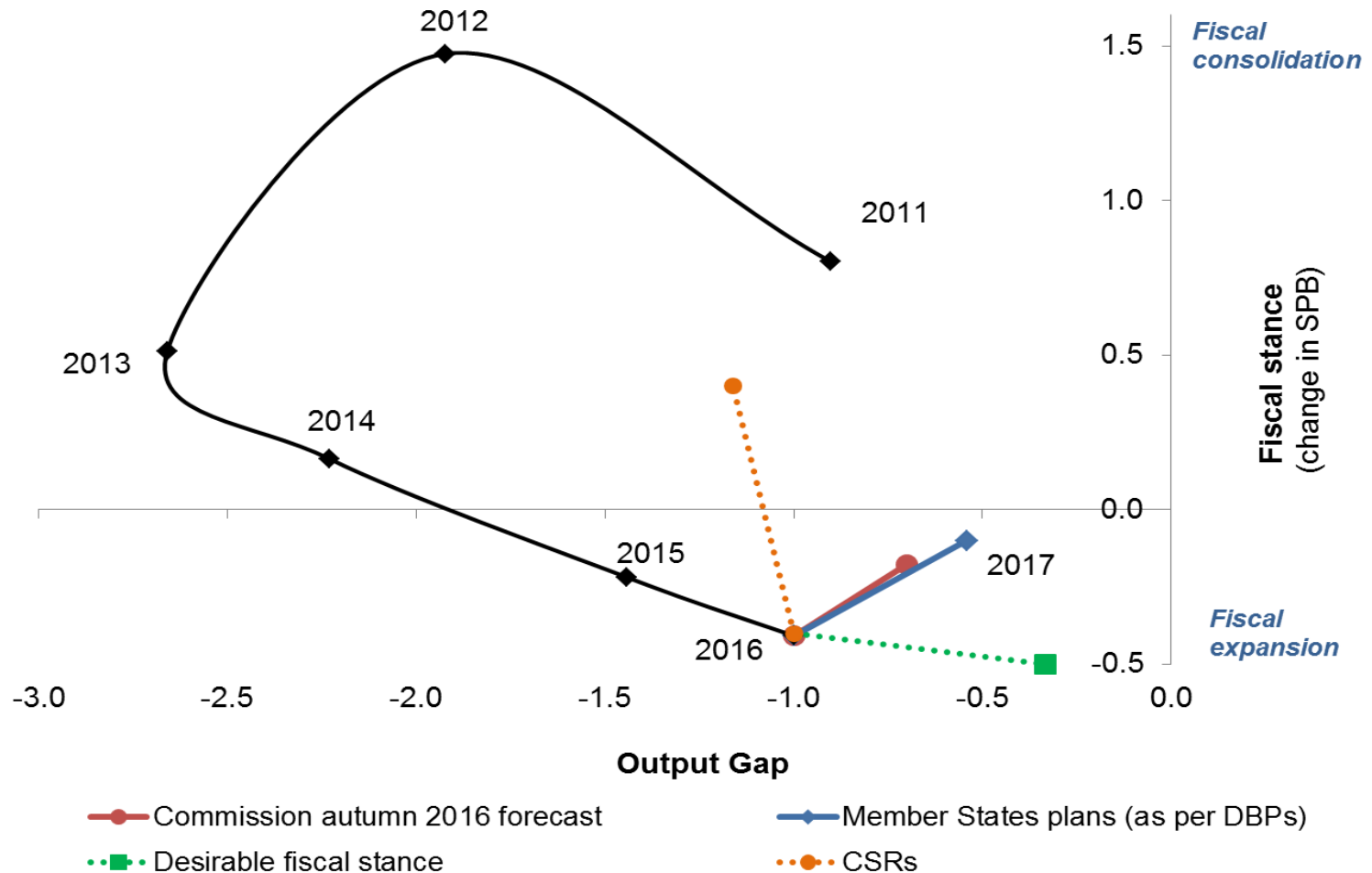
❑ Discretionary fiscal policy is fraught with problems

- It should be limited to exceptional circumstances
- Fiscal policies in EMU should focus on prudent medium-term positions in each and every country

❑ The macroeconomic role of fiscal policies is essential in EMU

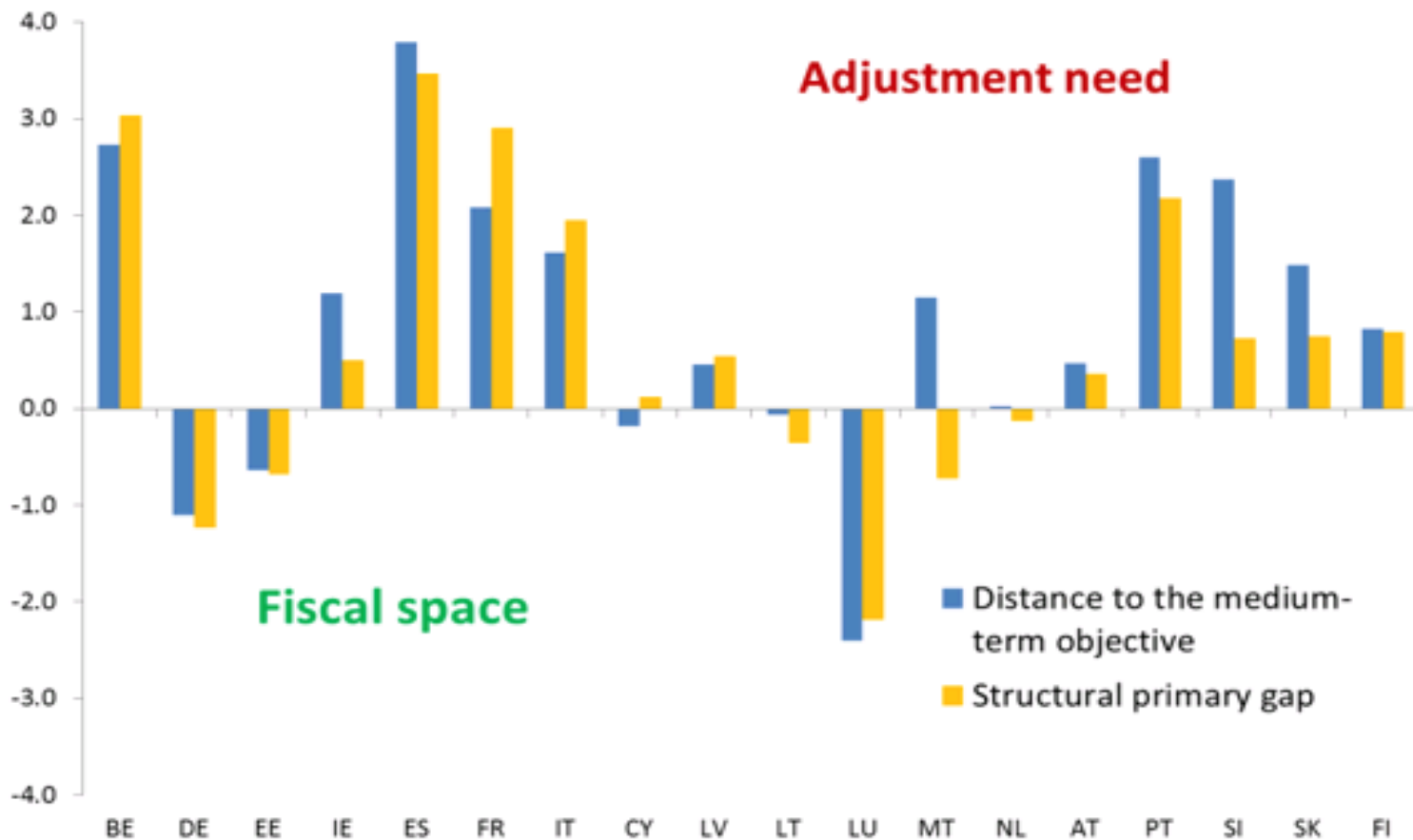
- At country level, as individual Member States have lost the channel of monetary policy
- Aggregate fiscal stance important too, complements monetary policy (at least in some circumstances)

What fiscal stance for the euro area?



Differentiated fiscal space

Fiscal space and adjustment needs at country level



Challenges

Pre-crisis structural impediments to growth

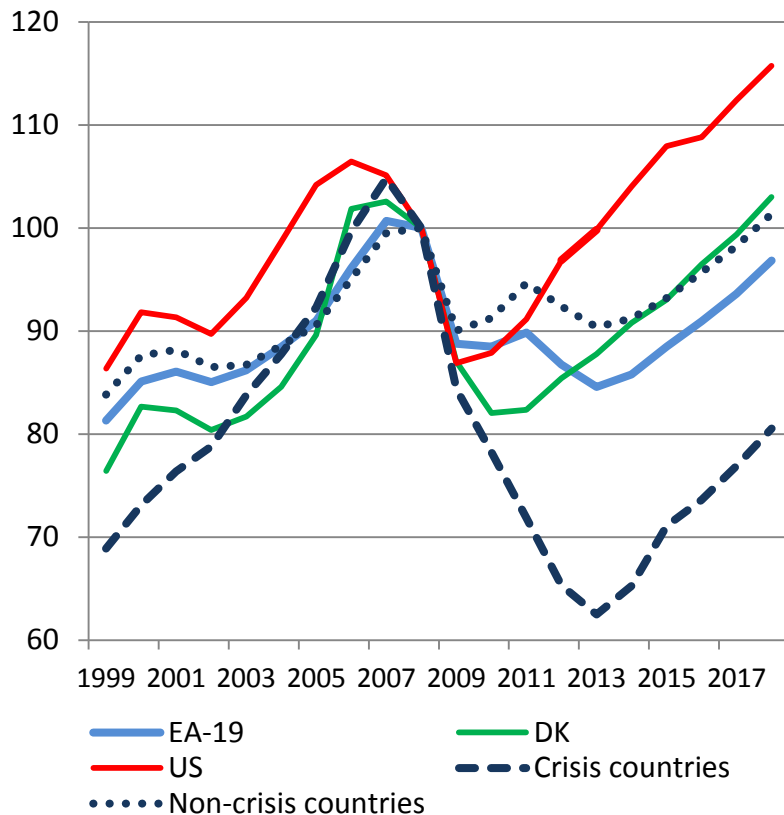
- Population ageing
- Slow productivity growth
- High unemployment
- Rigid product and labour markets

Crisis legacy

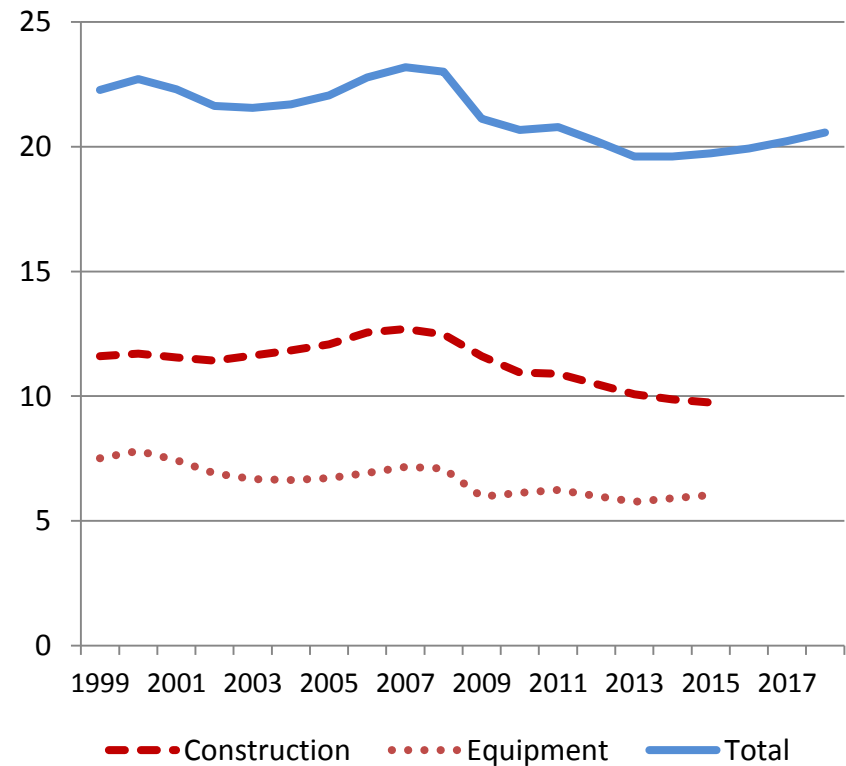
- Investment gap
- Low potential growth
- Persistently low inflation
- High debt (private/public)
- Weak banks (high NPL, low profitability, high costs)
- Asymmetric rebalancing
- Halt/reversal convergence process
- Rising inequality
- Citizens' declining systemic trust

Sluggish recovery of investment

Gross fixed capital formation
(in local currency, index 2008 = 100)



Gross fixed capital formation breakdown, EA-19
(in % GDP)

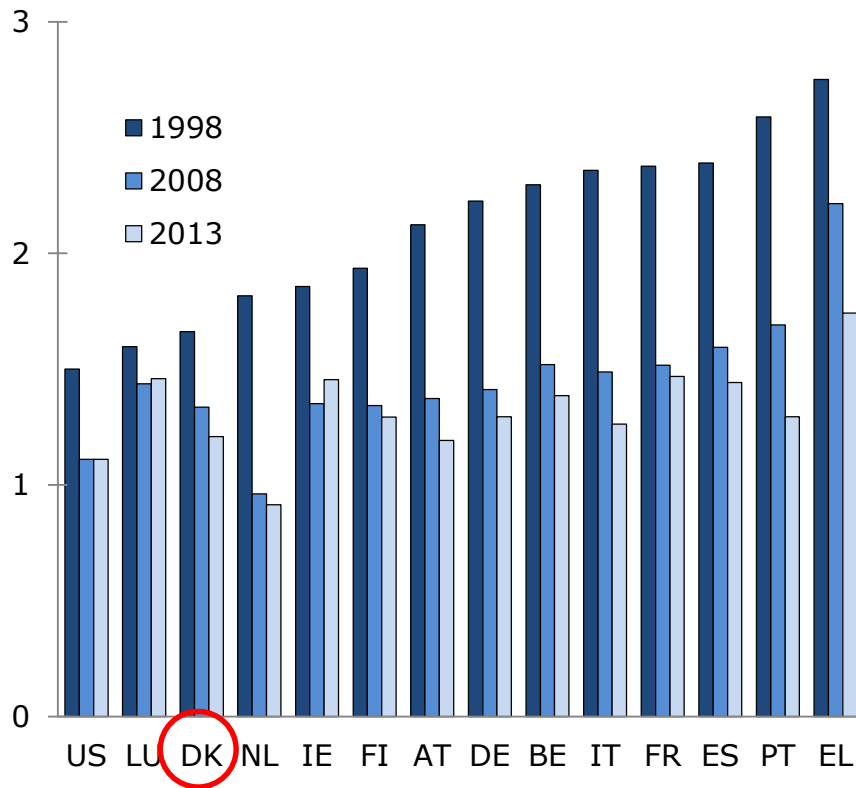


Note: Crisis countries include Cyprus, Greece, Ireland, Portugal, Spain. Data for construction and equipment only available until 2015.

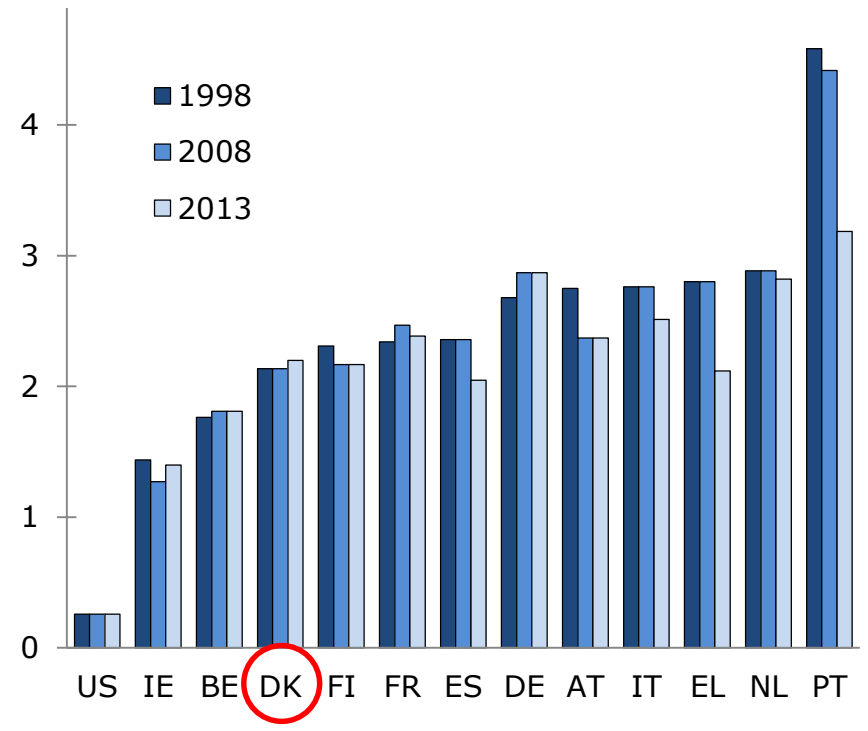
Source: European Commission winter forecast 2017.

Economic structures less resilient

Product market regulation



Employment protection legislation

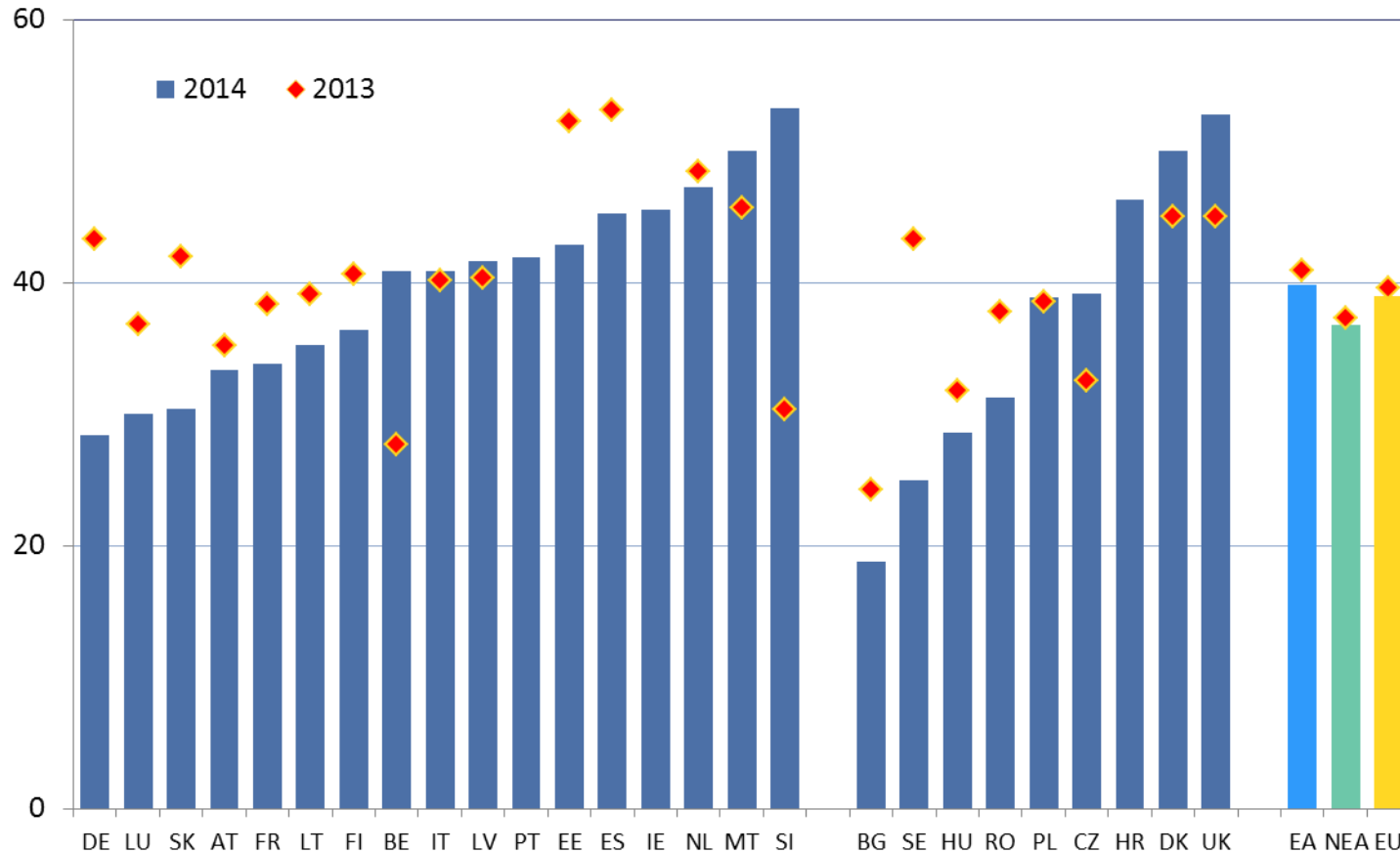


Note: The graph shows OECD indicators measuring the degree of product and labour market regulation (the latter refers to individual and collective dismissals). Indicators range on a scale from 0 (least restrictions) to 6 (most restrictions). Latest data available 2013.

Source: OECD.

Structural reforms fatigue

Implementation record of COM country-specific recommendations (CSRs)

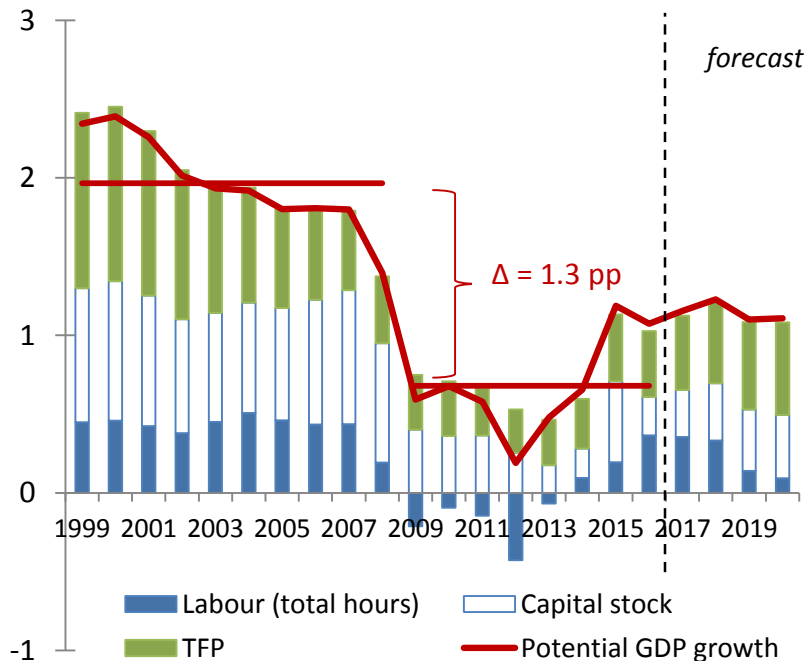


Note: Implementation record is measured by a COM composite indicator ranging from 0 (no implementation) to 100 (full implementation). The country-specific recommendations (CSRs) list key reform needs of Member States as part of the European Semester.

Secular decline in potential growth

Contributions to potential growth (in ppt., unless otherwise indicated)

EA-19



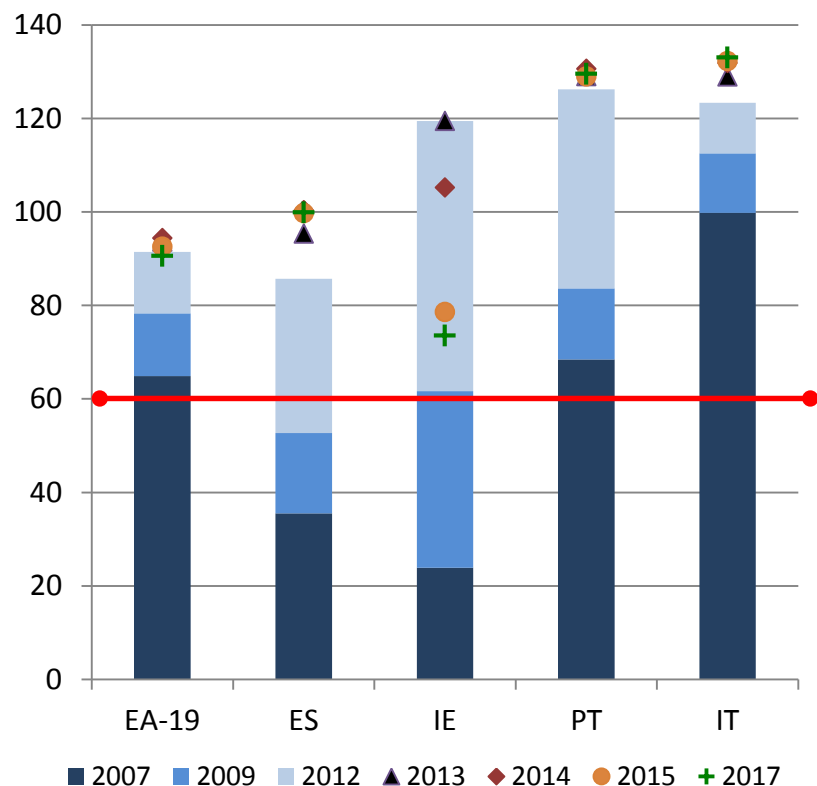
EA-19 vs. US

	Potential growth (annual % change)	Contributions to potential growth (in ppt.)			
		Labour (persons)	Capital	TFP	
EA-19	1999-08	2.0	0.4	0.8	0.8
	2009-16	0.7	0.0	0.3	0.3
	Diff.	-1.3	-0.5	-0.5	-0.4
US	1999-08	2.6	0.2	1.1	1.3
	2009-16	1.4	0.4	0.5	0.5
	Diff.	-1.2	0.1	-0.6	-0.7

Source: European Commission winter forecast 2017.

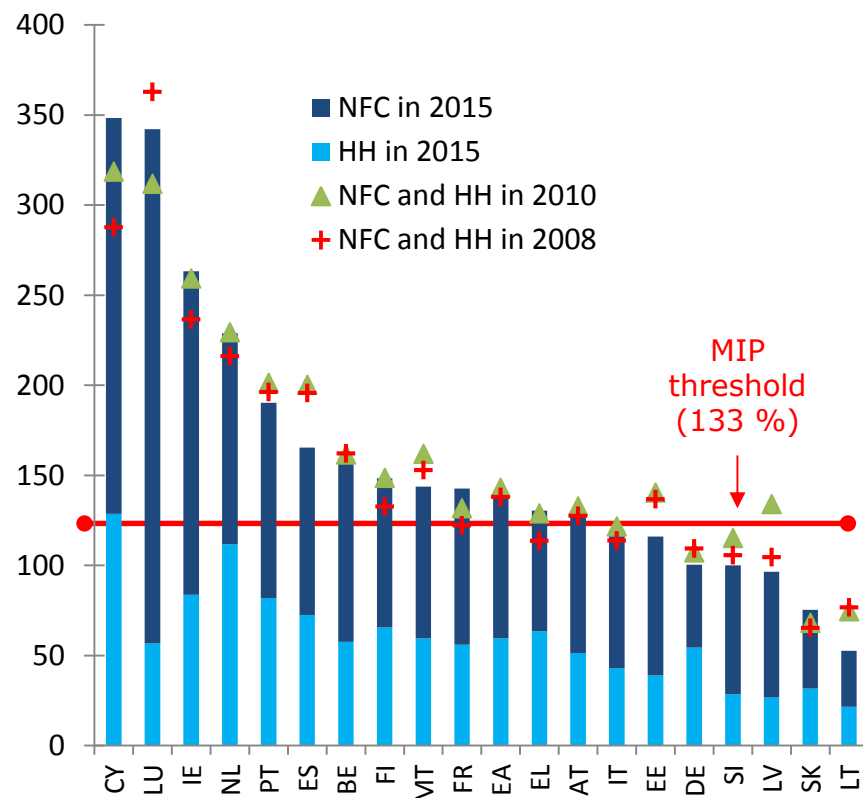
High public and private debt

Gross debt general government
(in % of GDP)



Note: General government debt in line with Maastricht definition. Red line shows the Maastricht reference value.
Source: European Commission winter forecast 2017.

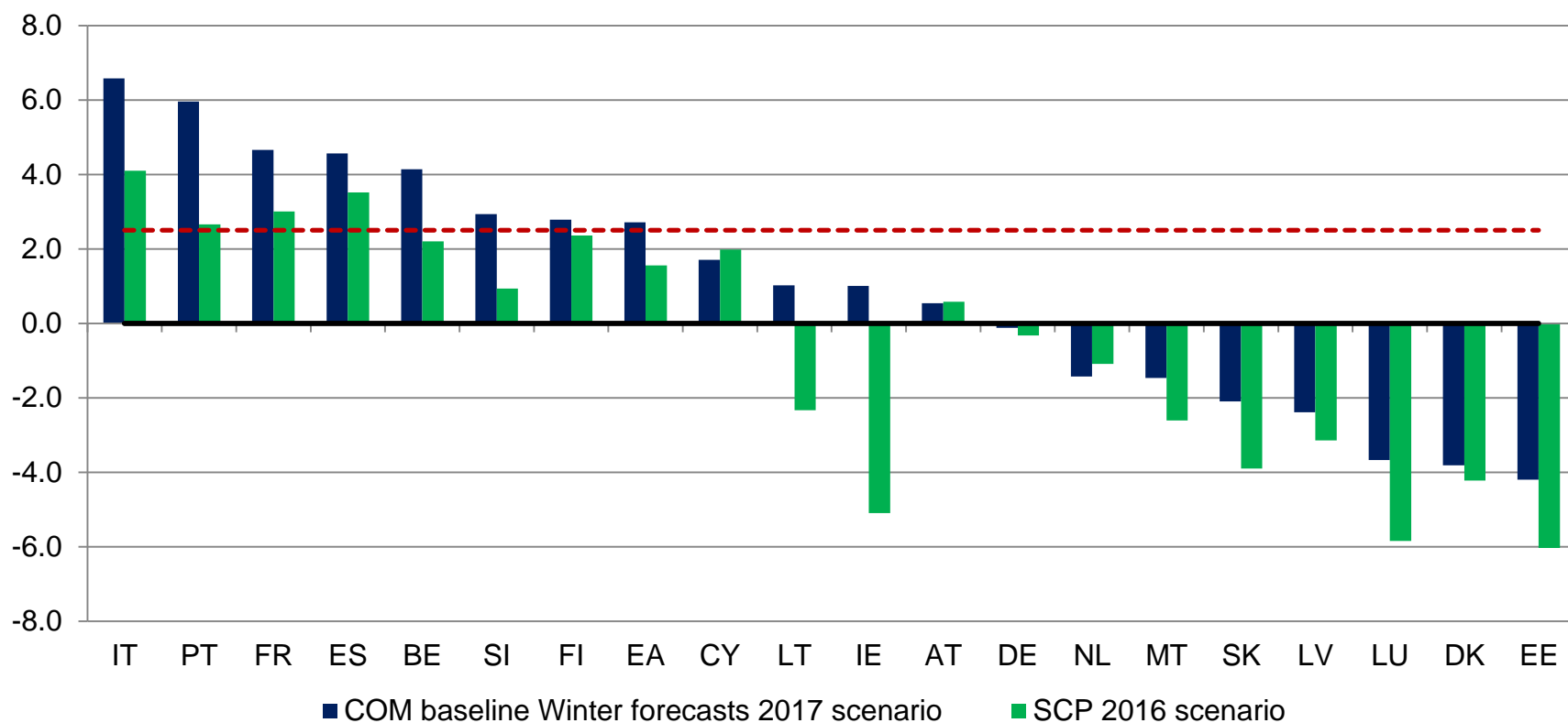
Private sector debt
(NFC and HH; in % of GDP)



Note: The private sector debt is the stock of liabilities in the form of loans and securities other than shares excluding financial derivatives held by the sectors non-financial corporations and households and non-profit institutions serving households. Transactions within sectors are eliminated (consolidation).
Source: Commission services.

Limited fiscal buffers to cope with shocks

**Fiscal adjustment required to reach a 60% public debt-to-GDP ratio by 2031
(in % of GDP)**



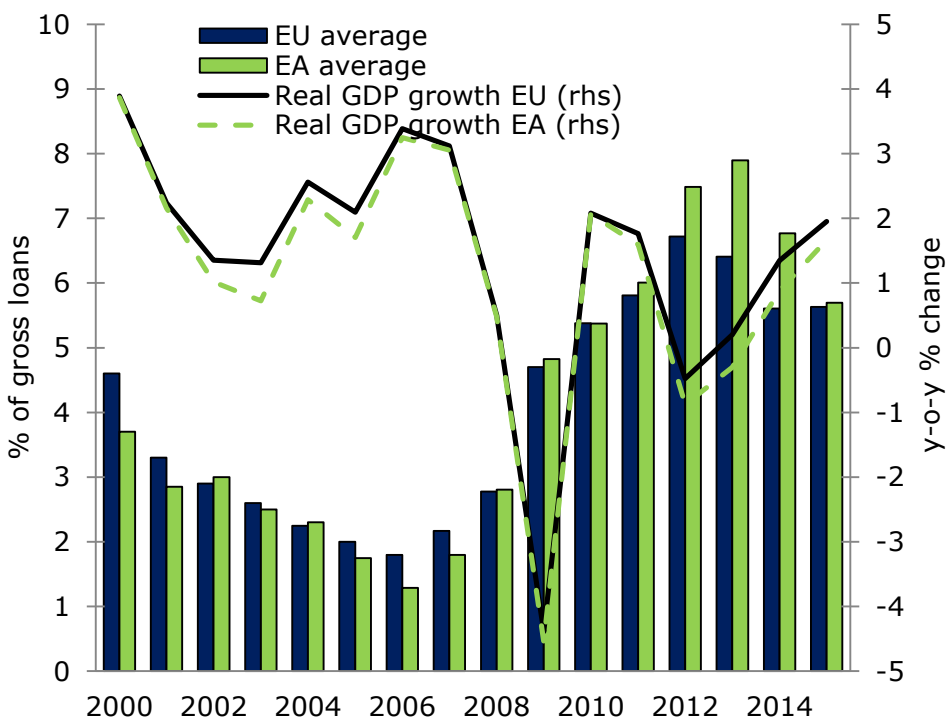
Note: COM baseline scenario comes from the winter forecast 2017. 2016 Stability and Convergence Programmes (SCP). Dotted line indicates COM assessment of high/medium risk (above the dotted line/between the dotted and zero line/below the zero line).

Source: Commission services.

High non-performing loans (NPL)

The evolution of the NPL ratio and real GDP growth, EU and EA

(2000 - 2015)

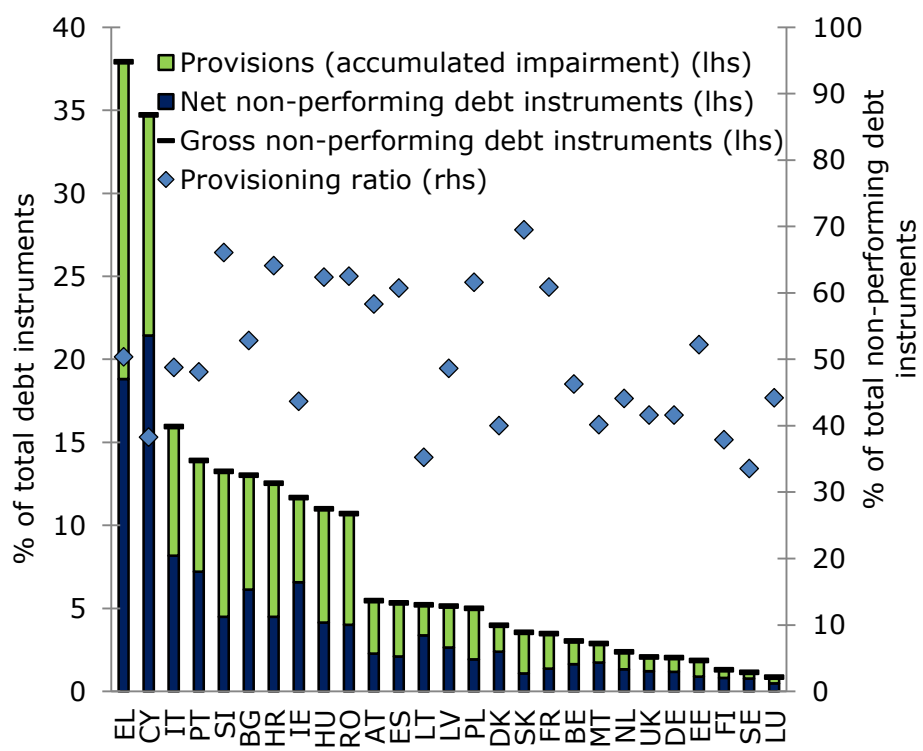


Note: Data based on Worldbank, ECB, DG ECFIN calculations.

Source: European Commission (2017): A macroeconomic perspective on non-performing loans (NPLs), Quarterly Report on the Euro Area, 2017(1).

NPL per Member State

(in % of GDP)

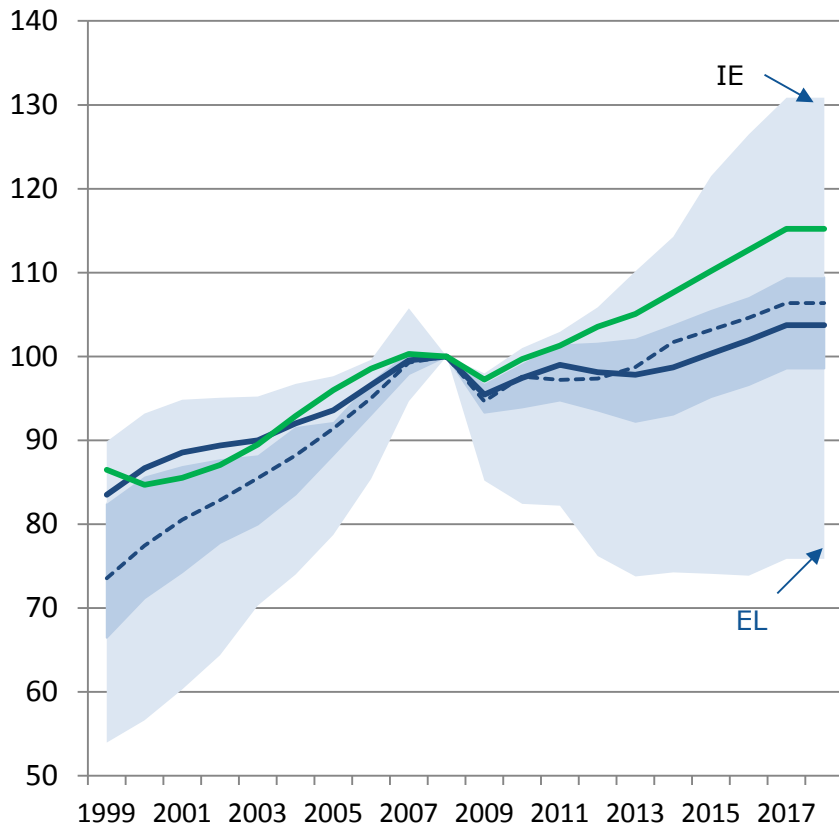


Note: ECB and DG ECFIN calculations.

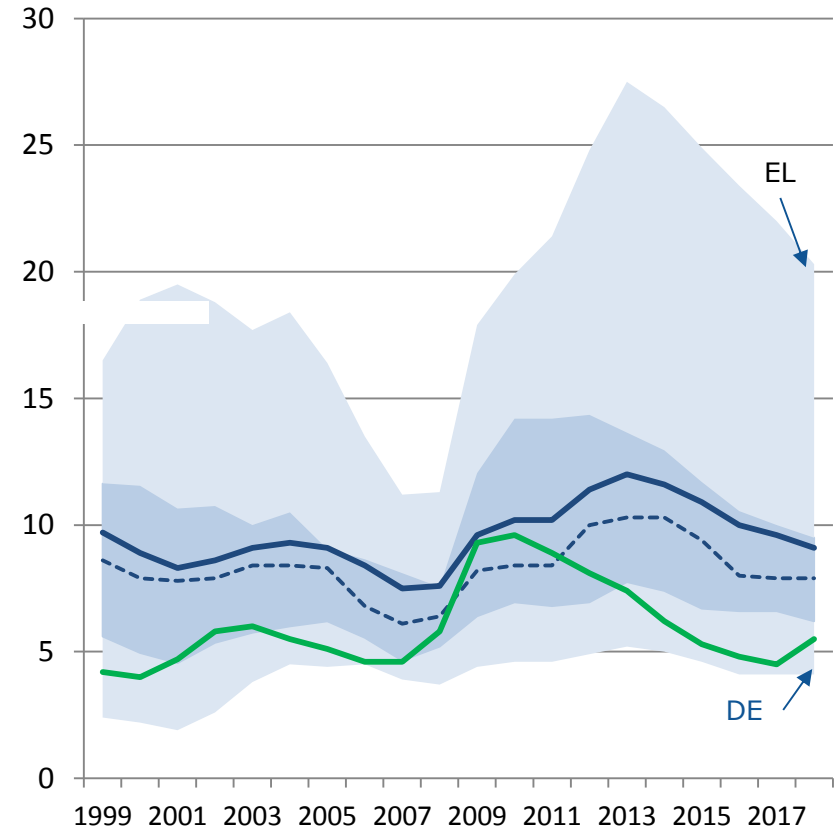
Source: European Commission (2017): A macroeconomic perspective on non-performing loans (NPLs), Quarterly Report on the Euro Area, 2017(1).

Sizeable heterogeneity in the Euro Area

Real GDP
(in %)



Unemployment rate
(in %)



Note: Dark blue line shows the weighted EA-19 average; dotted line shows the simple un-weighted EA-12 average. Light blue area defines the whole range of observed values (from maximum to minimum), while the darker blue area defines the area between the first and second quartile based on un-weighted data for EA-19. Green line shows Denmark.

Source: European Commission winter forecast 2017.

EMU today: an unsustainable equilibrium?



- ↳ **Insufficient private and public risk-sharing**
- ↳ **Impossible to achieve simultaneously:**
 - ↳ **an appropriate fiscal stance for the euro area as a whole**
 - ↳ **an optimal distribution of the fiscal effort**
- ↳ **Leads to the overburdening of monetary policy**
- ↳ **Risk of renewed financial instability**
- ↳ **Weak/challenged democratic accountability**

Two competing models for EMU

"Back-to-Maastricht"

- Stronger enforcement of EU fiscal rules to rein debt and deficits
- MIP focused on competitiveness of lagging countries
- Banking Union does not need common deposit insurance
- End to the risk-free status for sovereign debt and establish sovereign debt restructuring mechanism
- More market discipline

Fast forward to an integrated EMU

- Distribution of fiscal efforts to achieve an appropriate aggregate fiscal stance
- Symmetric adjustment to help weak countries and reduce Euro area current account surplus
- Full Banking Union to ensure financial stability and private risk sharing
- Fiscal capacity for public risk sharing and eventually sovereign debt mutualisation
- Euro area Treasury

Minimum governance requirements for a viable EMU

		Included in the Blueprint	Included in 5PR?	Possible w/o Treaty change?
Monetary	<ul style="list-style-type: none"> • ECB as a lender of last resort 	Red	Red	Red
Banking	<ul style="list-style-type: none"> • Establish a common European Deposit Insurance Scheme 	Yellow	Green	Green
	<ul style="list-style-type: none"> • Implement a common backstop to the SRF 	Yellow	Green	Green
	<ul style="list-style-type: none"> • Improve the effectiveness of direct bank recapitalisation in the ESM 	Yellow	Green	Green
	<ul style="list-style-type: none"> • Create a European safe asset 	Red	Red	Green
Fiscal	<ul style="list-style-type: none"> • Restore a credible no bail-out clause 	Yellow	Red	Green
	<ul style="list-style-type: none"> • Create a centralised fiscal capacity 	Red	Green	Yellow
	<ul style="list-style-type: none"> • Establish a sovereign debt restructuring mechanism 	Red	Red	Red
	<ul style="list-style-type: none"> • Establish a debt redemption fund 	Red	Red	Red
Economic	<ul style="list-style-type: none"> • Foster convergence towards similarly resilient economic structure 	Yellow	Green	Yellow

Note: This assessment only serves for indicative purposes. Inspired by Baldwin and Giavazzi (2016): How to fix the Eurozone: Views of leading economists, 12 February 2016, VoxEU.

European policy priorities

More balanced policy mix

- Unburdening the ECB
- Fiscal capacity and fiscal rules
- Private and public risk sharing

Structural Reforms 2.0

- Productivity / TFP
- Human capital
- New welfare and financial systems

Rethinking EMU architecture

- New European public goods
- Rebuilding trust to complete EMU
- Vertical budget coherence