EUROPEAN CENTRAL BANK
EUROSYSTEM

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Structural and fiscal policies and the functioning of the euro area

ECB Central Banking Seminar

Frankfurt am Main, 10 July 2018

The division of policy tasks in EMU

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Monetary Policy

- Single monetary policy
- The primary objective is maintaining price stability
- Without prejudice to this, support the policies in the Community
- Central bank independence
- No monetary financing of governments

Economic and Fiscal Policies

- Competence of Member States
- But: economic and fiscal policies are subject to common rules of economic policy coordination, budgetary discipline, and multilateral surveillance
- No bailout clause (no debt mutualisation)

Overview

Cross-country developments since the start of EMU

1999 – 2007	• Significant divergences of competitiveness and current account balances among EA countries; • unsustainable boom in domestic demand, excessive credit growth and accumulation of debt in some euro area countries up until 2007;
2008 – 2009	• Financial crisis and recession unmasked accumulated imbalances. Resulting in a costly process of rebalancing;
2010 – 2013	• Sovereign crisis; • Financial assistance programmes: 5 countries entered into a EU (and IMF) financial assistance (GR, IE, PT, CY, ES); • New Macroeconomic Imbalance Procedure (Nov. 2011).
2014 – 2018H1	• Programme exits in IE, ES (fin. sector progr.), PT, CY, GR (exit end of August); • Economic recovery/expansion; • Have vulnerabilities been overcome? How to make the euro area more resilient?

Accumulation of imbalances driven by, among others…

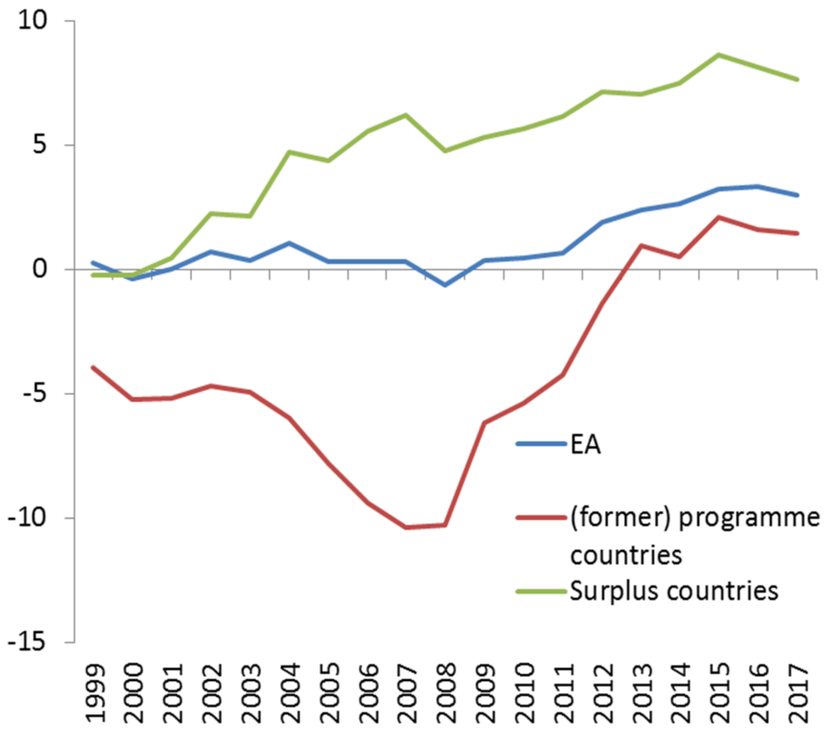
- **Overly-optimistic expectations** about future income streams;
- **Significant structural rigidities, partly weak institutions** and lack of competition leading to a misallocation of resources;
- **Shortcomings in national supervisory policies** (e.g. excessive risk taking by banks on the asset and funding side; insufficient capital buffers);
- **Under-appreciation of risks by financial markets and rating agencies** (e.g. compression of sovereign bond spreads);
- **Lack of counteracting national policies** to prevent the build-up of imbalances and erosion of competitiveness (e.g. unsustainable pro-cyclical fiscal policies; lack of structural reforms).

Caveat: These drivers overall characterise the accumulation of imbalances, but there has been significant cross-country heterogeneity as to their respective importance.

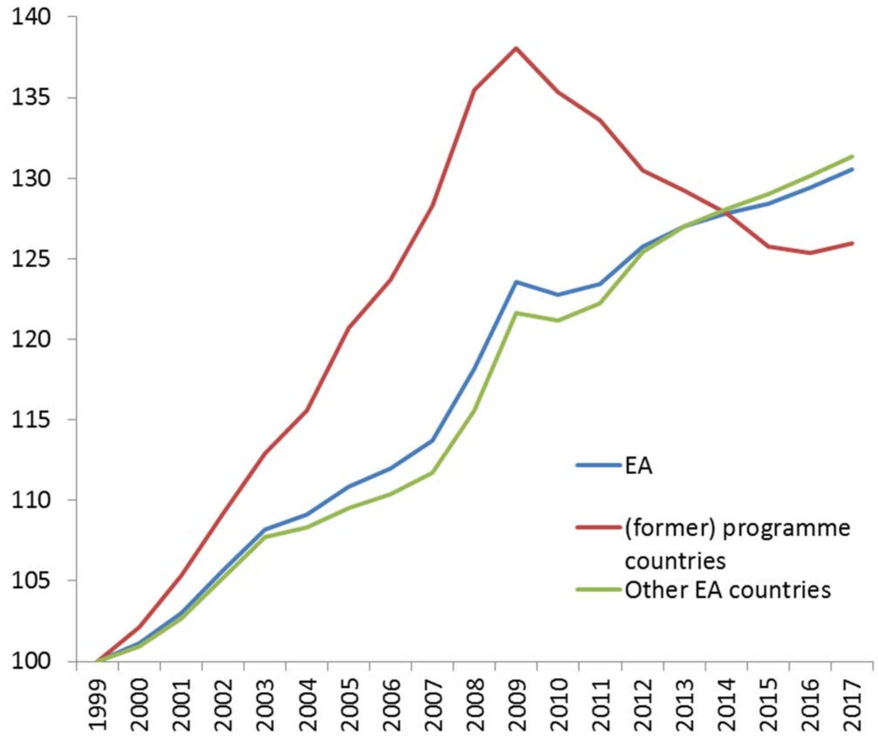
Adjustment of macroeconomic imbalances...

...remarkable in (former) programme countries, in particular in terms of external rebalancing & relative cost competitiveness.

Current account *(in % of GDP)*



Unit labour cost (*1999=100)*

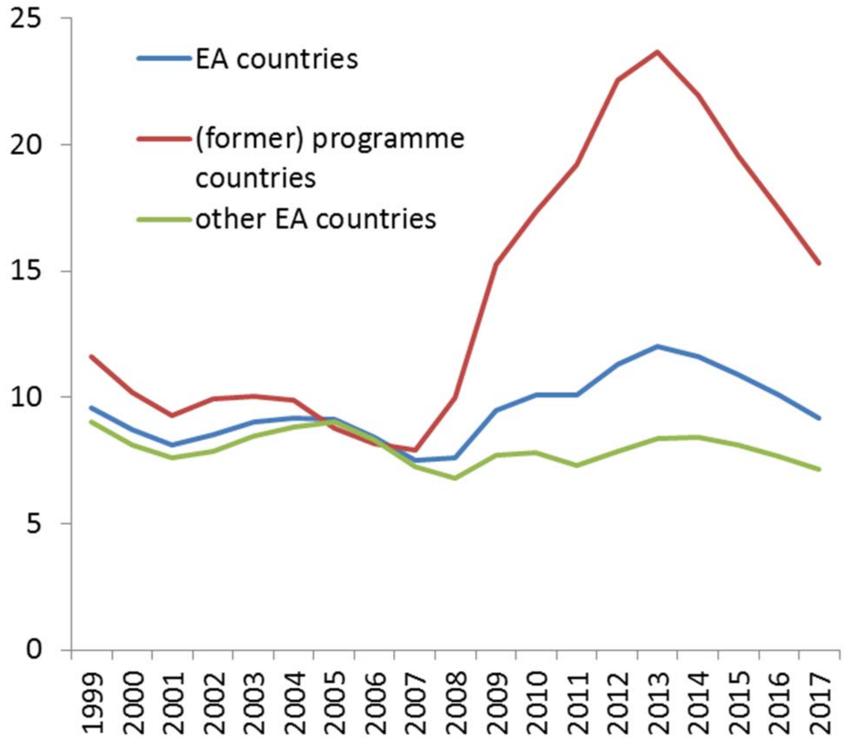


Sources: EC and ECB computations. Programme countries include: GR, IE, CY, PT and ES.
Note: GDP-weighted average within each group.

But adjustment has been very costly…

…in particular the high unemployment, and…

Unemployment rate *(in % of LF)*

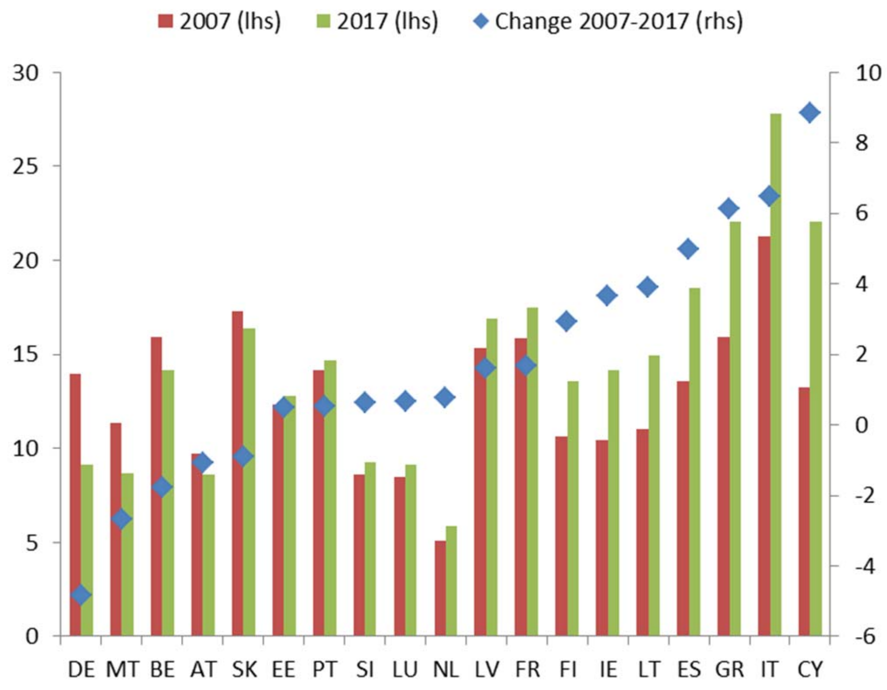


Sources: Eurostat. Note: GDP-weighted average within each group.

But adjustment has been very costly…

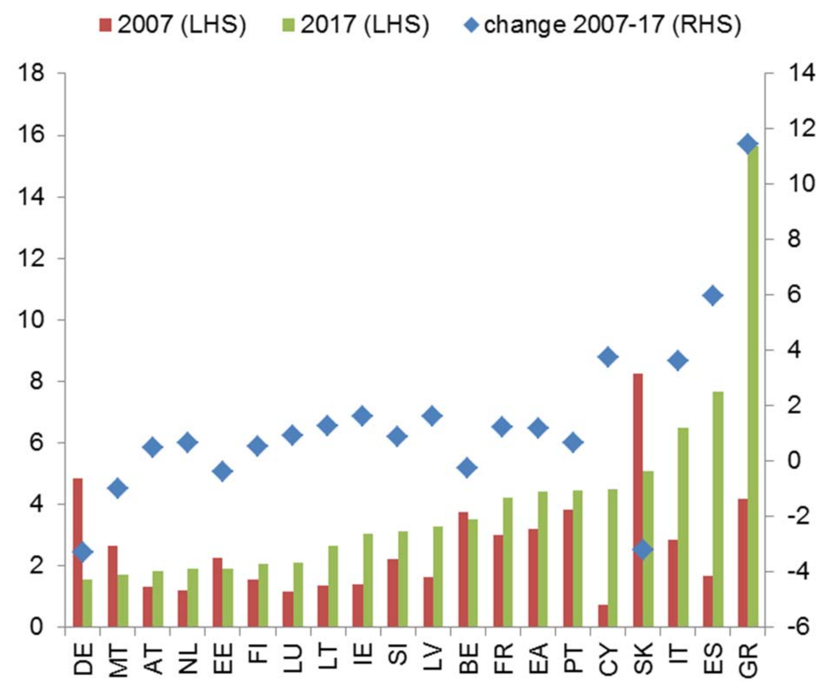
…youth and long-term unemployment

Youth not in employment, education or training *(in % of LF)*



Sources: LFS

Long-term unemployment rate *(in % of LF)*

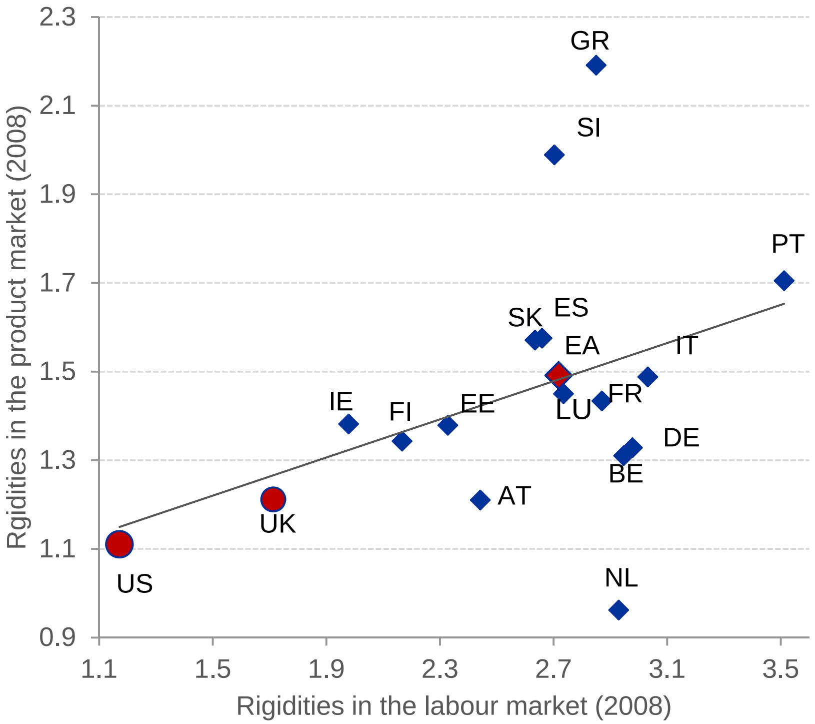


Sources: LFS

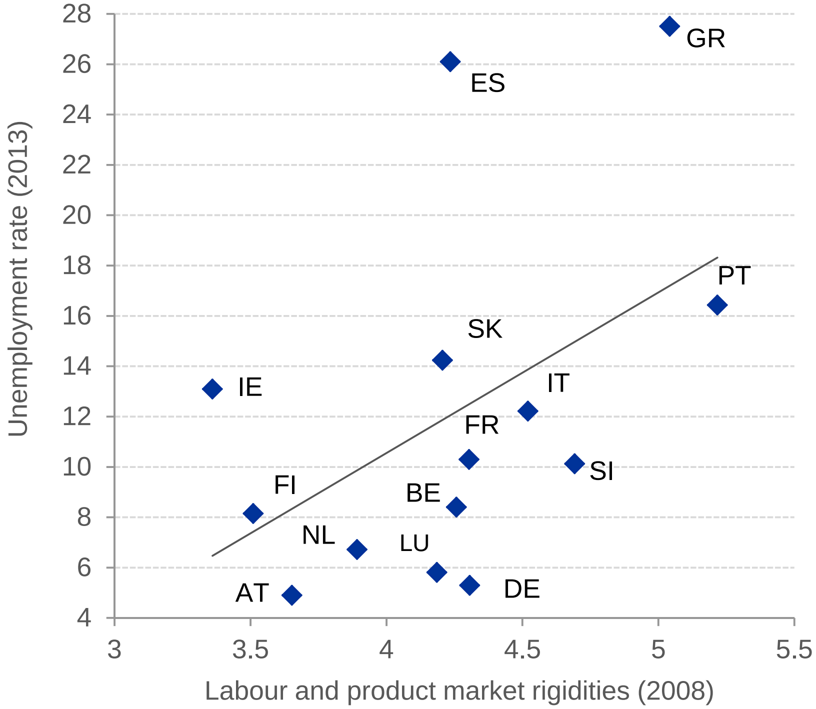
Cost of adjustment driven by structural rigidities...

... prior to the crisis. Often rigid labour markets coupled with rigid product markets.

Rigidities in labour and product markets (2008)



Rigidities in labour and product markets (2008) and unemployment (2013)



Sources: OECD, LFS.
Notes: Rigidities in labour market are summarised by the OECD employment protection index; rigidities in the product market are summarised by the OECD product market regulation index. A higher figure indicates higher rigidity.

Vulnerabilities remain severe in many countries...

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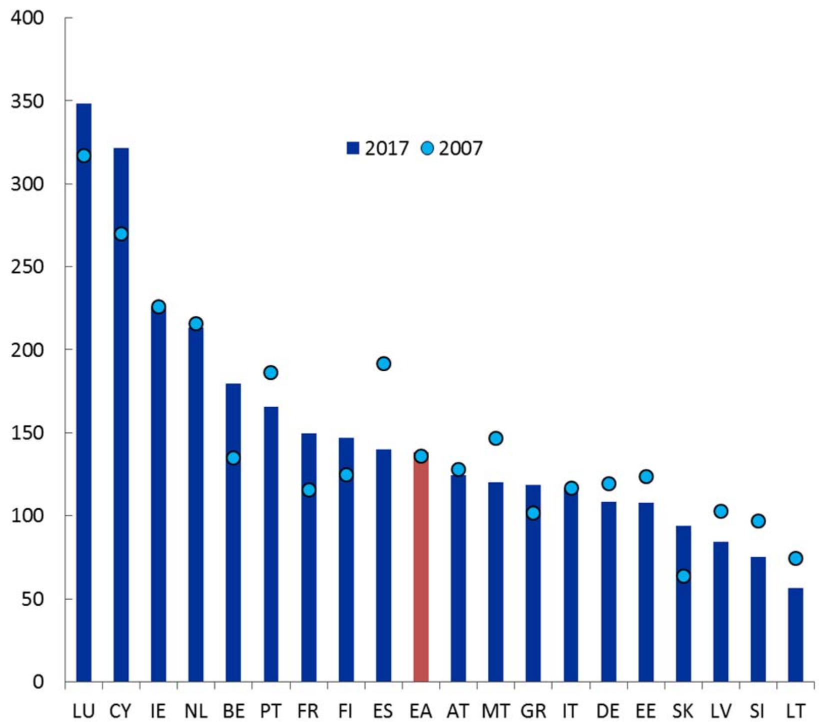
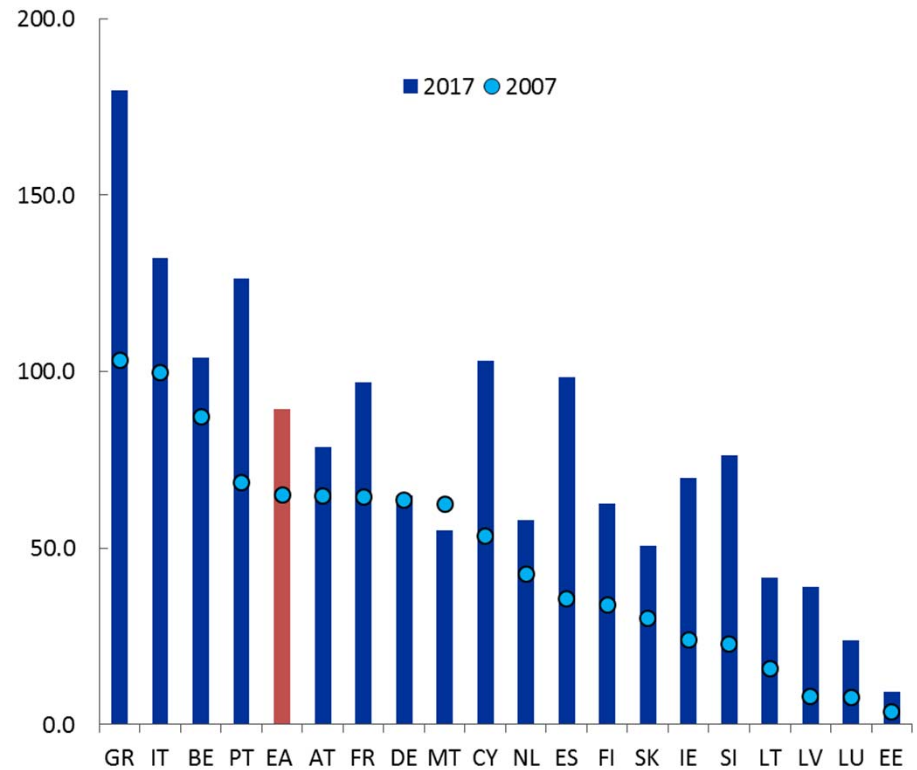
...in particular as regards stock of debt

Private (non-consolidated) **sector debt** *(in % of GDP)*



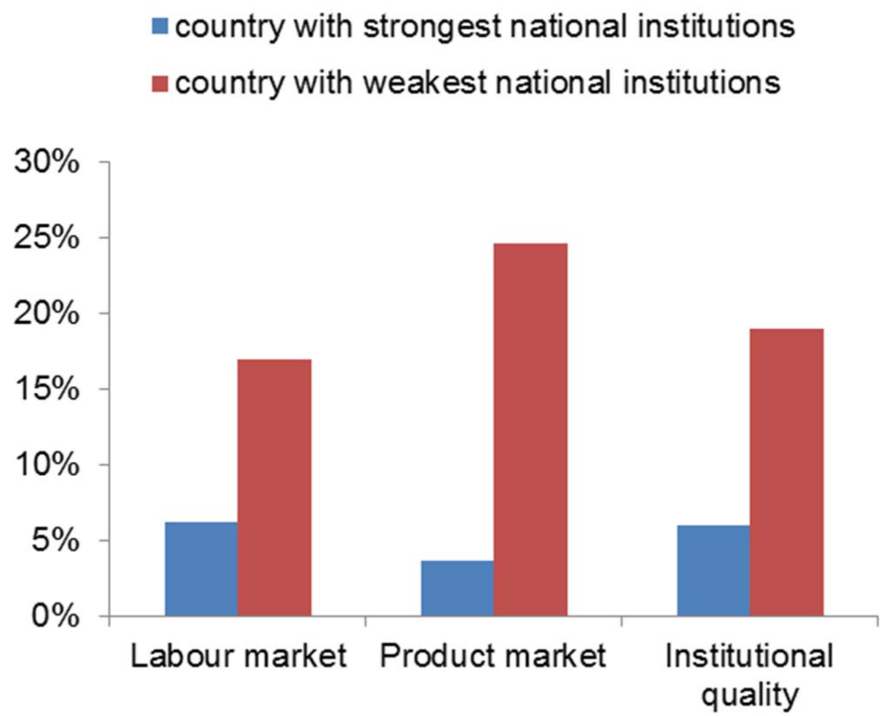
Sources: Eurostat, ECB

Public sector debt *(% of GDP)*



Sources: Eurostat, ECB

Stronger national institutions reduce crisis incidents

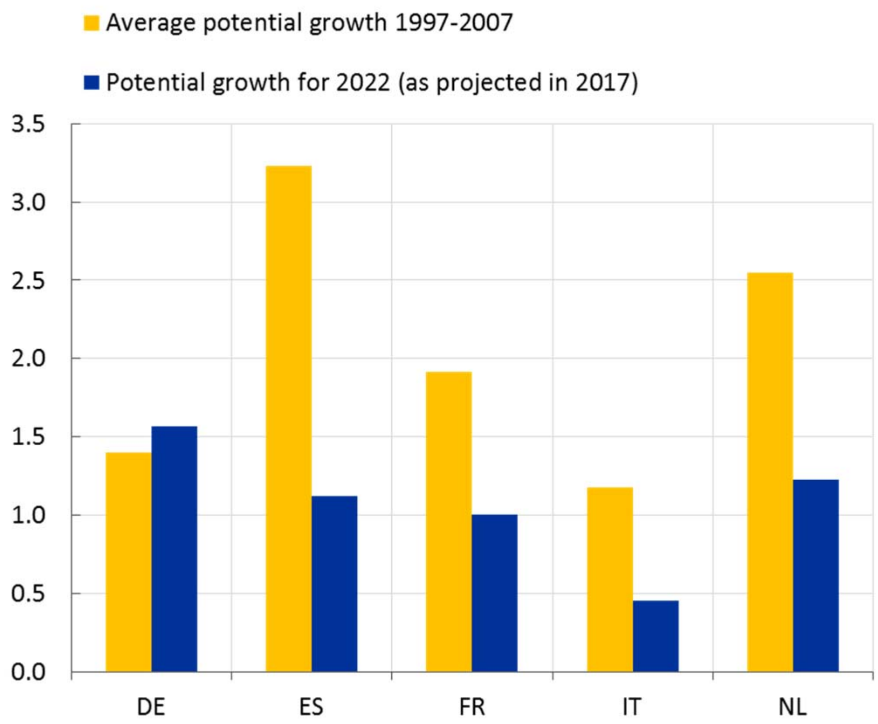


Sources: Sondermann (2018), Towards more resilient economies: The role of well-functioning economic structures, Journal of Policy Modeling, Vol. 40, pp. 97-117.

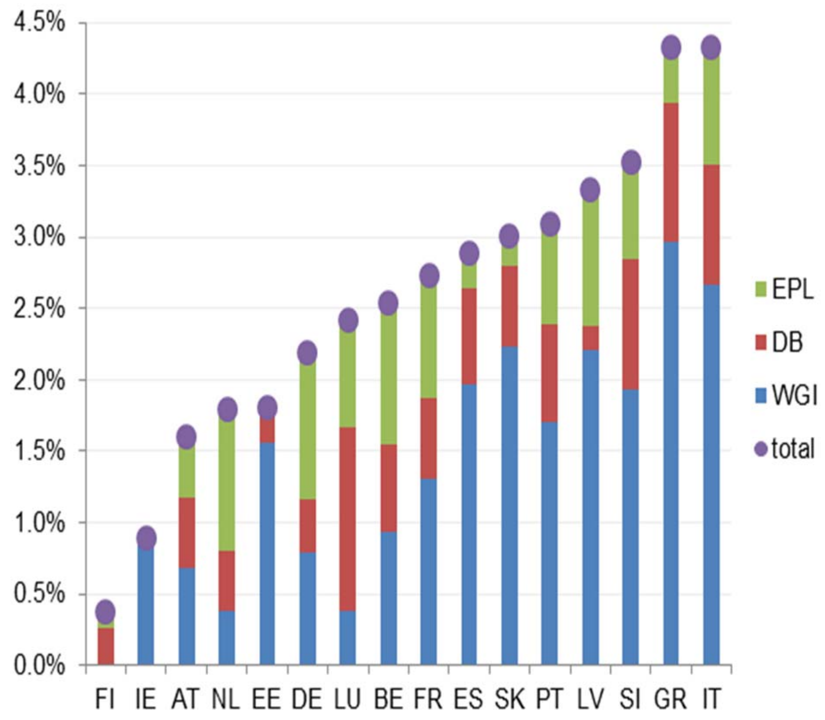
Notes: The chart shows the result of a probit model where the probability of crisis is computed on the extremes of institutional variables, i.e. the lowest and the highest institutional value across countries, while control variables (total government expenditure and nominal short-term interest rates) are assumed to be average. For institutional quality, the average probability is obtained from WGI; for product market institutions, the average probability is obtained from Doing Business and GCI product market efficiency; and for labour market institutions, average probability is obtained from EPL, GCI and Heritage labour market flexibility. Data are based on the period 1990-2014 and are for a sample of OECD countries.

Improving national institutions would support weak projected growth

Potential output growth according to different projections (average 2016-20)



Increase in TFP achievable by moving the national structural and institutional indicators towards best performers



Sources: Left chart Eurostat, EC, IMF, ECB calculations; right chart ECB calculations (internal work). Notes right hand chart: Best performers are: Ireland on doing business, Finland on governance, Estonia on employment protection

Overview

Bottom line so far:

1. Remarkable external and fiscal adjustment in former programme countries, but still need to build buffer;

2. Structural rigidities have delayed the nominal adjustment and made the real adjustment more costly (high unemployment);

Where sustainable growth can come from?

1. Higher flexibility in product and labour markets;

2. Efficient use of public spending and growth-friendly tax system;

3. Better institutions and more efficient framework conditions (competition framework, judicial system, etc);

4. Further rebalancing of cost/price competitiveness needed in some cases;

→ Role of structural reforms is key

(see among others Masuch et al 2018, Structural Policies in the Euro Area, ECB Occasional Paper, No 210)

Substantial reforms undertaken in programme countries...

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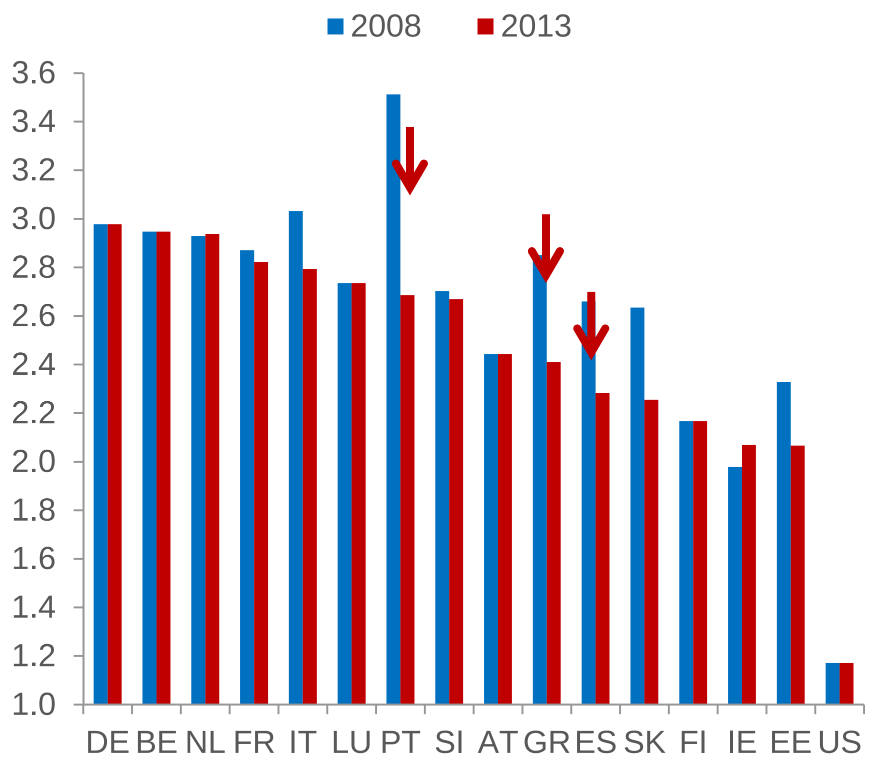
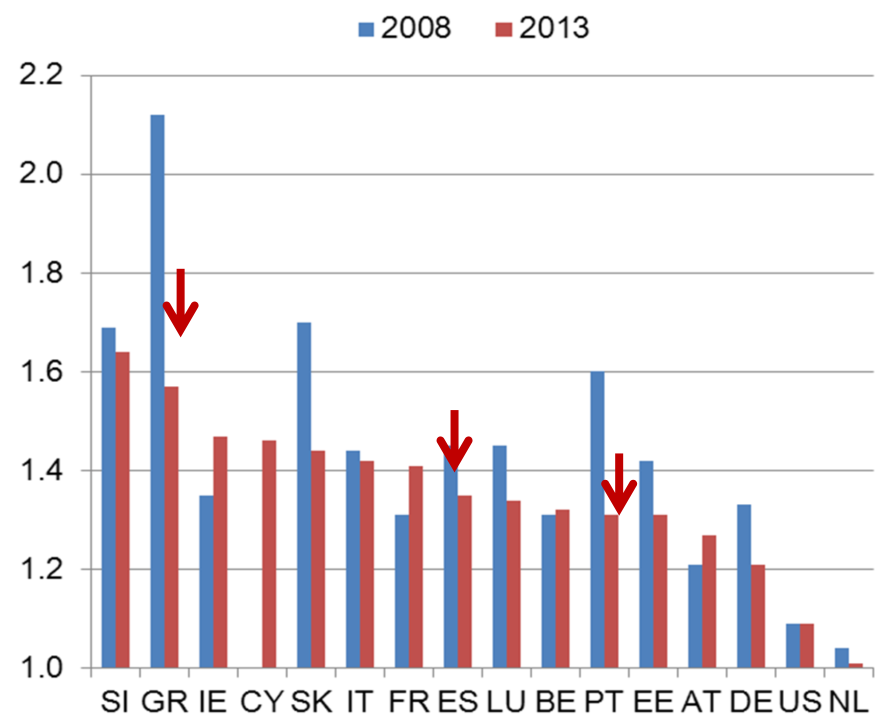
Employment-, competition- and productivity-enhancing reforms have taken place, but major challenges remain

Employment protection legislation
(overall strictness for individual and collective dismissals**)**



Product market regulation index



Source: OECD

…but now complacency on reform implementation in EA

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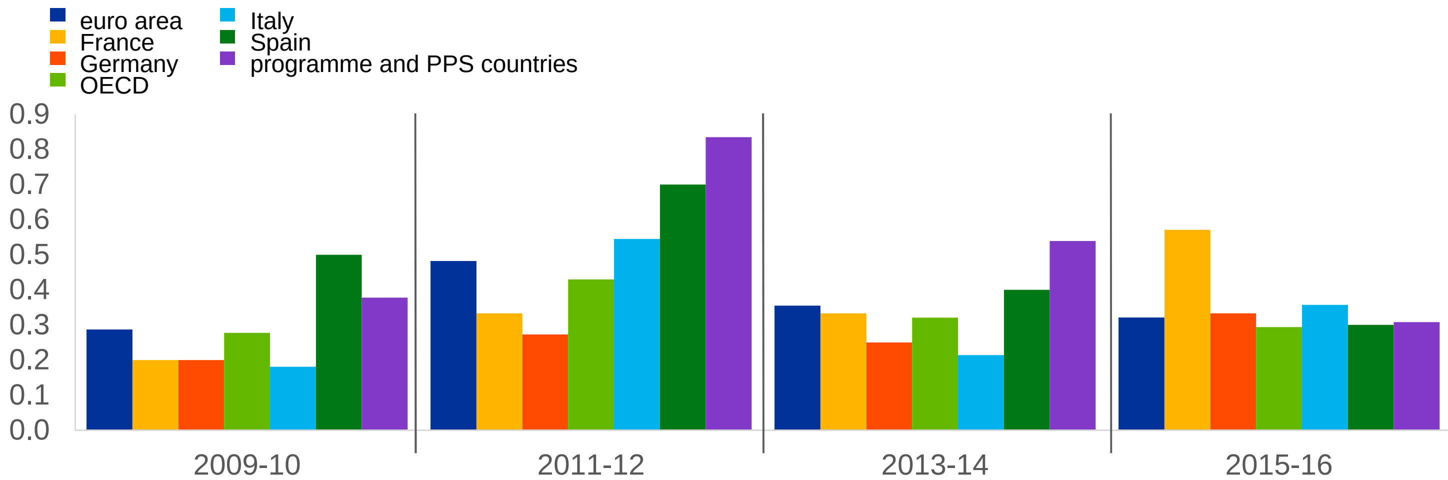
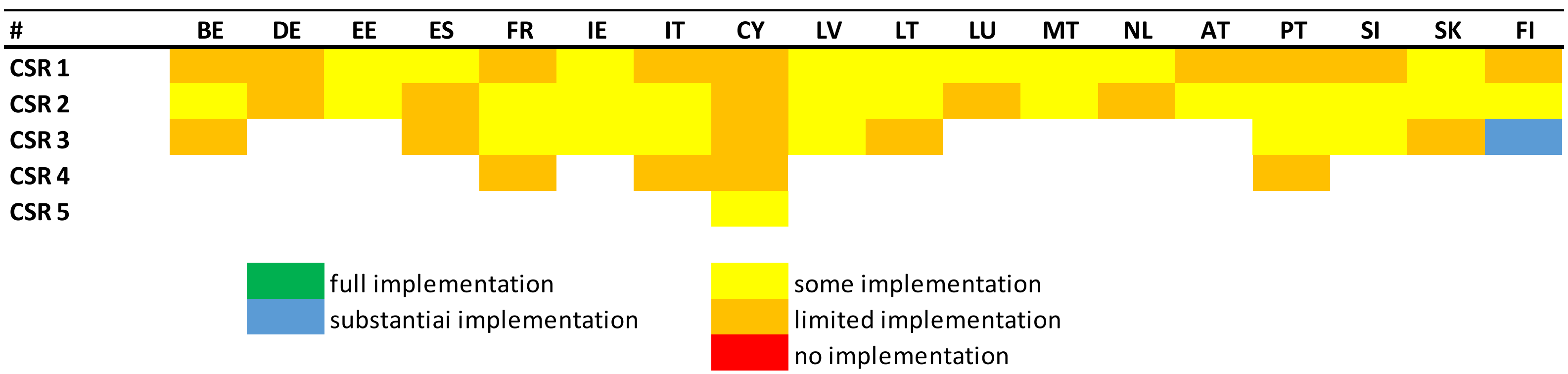
Implementation of OECD Going for Growth reform recommendations



Implementation of 2017 country-specific recommendations (CSRs)



Sources: European Commission, OECD. Note: Countries under a macroeconomic adjustment programme don't receive CSRs.

Overview

Objective: prevent the emergence of harmful imbalances and correct imbalances already in place.

November (year t-1)

Alert Mechanism Review (EC):

I. Scoreboard indicators

II. **Identifying** countries which require further analysis

March (year t)

In-depth reviews (EC):

I. Based on wider indicators than scoreboard and assessment of previous year's recommendations

II. Surveillance missions

March-June (year t)

- EC decides whether to open or not the **Excessive Imbalance Procedure (EIP)**
- Council adopts final **country specific recommendations**

No further analysis needed:
FI, BE, HU, RO, UK, AT, DK, LU, LT, LV, EE, CZ, MT, PL, SK

No problem Procedure stops	Imbalances	A: Excessive imbalances B: Excessive imbalance procedure
SI	BG, DE, IE, ES, FR, NL, PT, SE	A: HR, IT, CY B: --

2018 MIP:

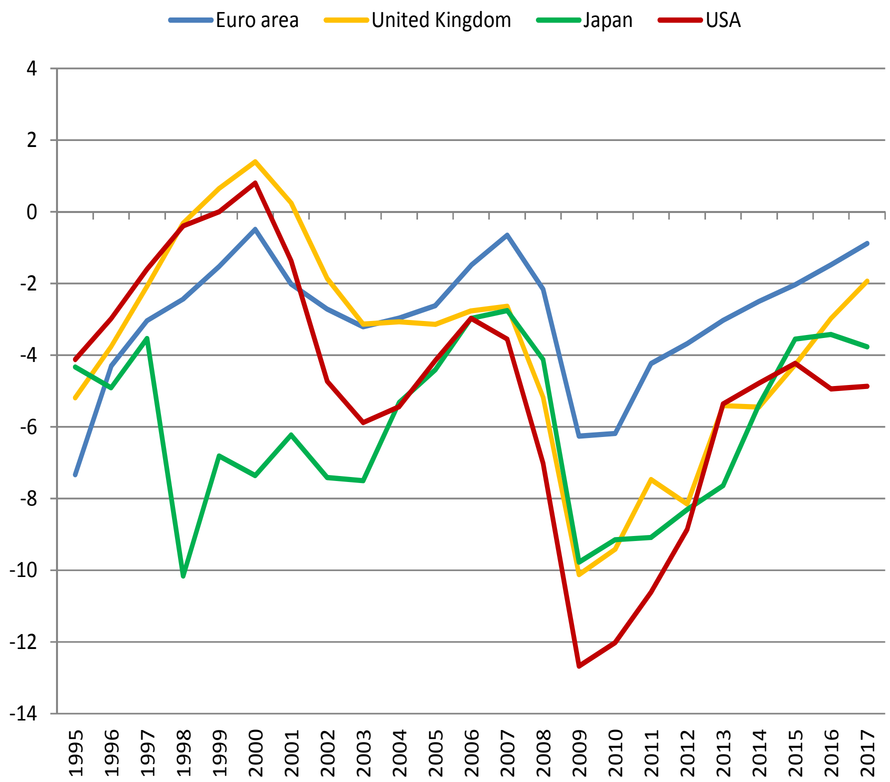
Overview

The need for fiscal discipline in EMU

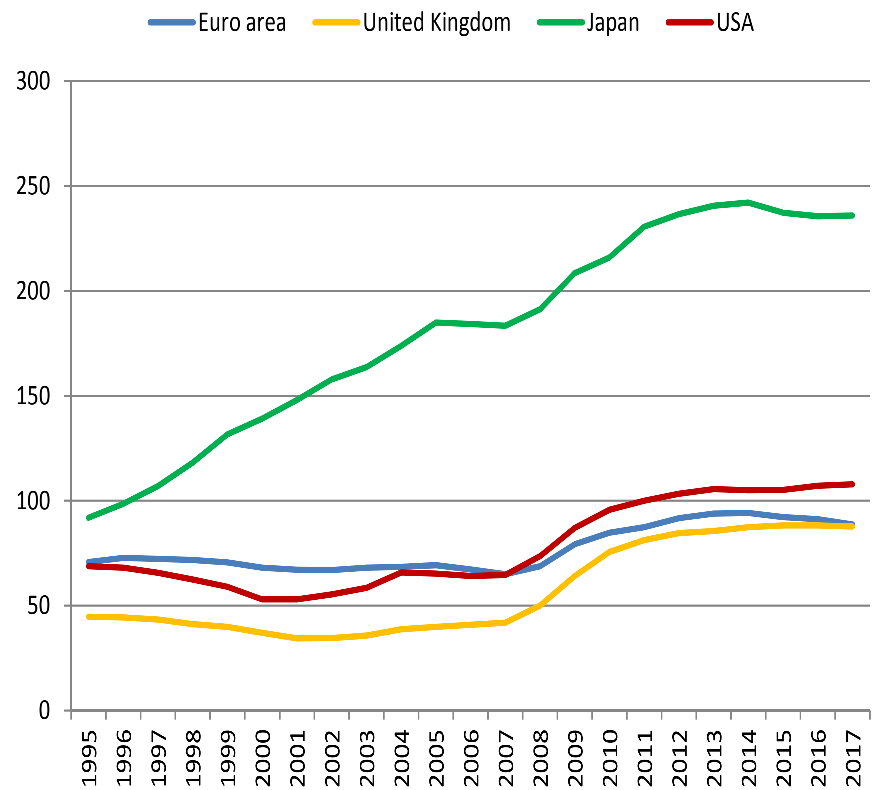
- Counteract deficit bias in form of expansionary fiscal policies/accumulation of high debt in a monetary union (no free-riding)
- Limit risk of spillover effects and contagion (limiting risk of sovereign-bank nexus)
- EMU stability is based on sound policies – debt limit (no bail-out clause)
- Sound fiscal positions allow for automatic stabilisers to work
  - dampen cyclical fluctuations
  - provide a buffer against shocks
- Avoid pro-cyclical fiscal policies under normal circumstances (i.e. no expansionary policies in boom period as this would require even higher consolidation needs during bad times)
- Building buffers in good times helps to reduce economic and social costs in recessions or crisis times

Currently lower deficits & debt compared to other regions …

General government budget balance
(1995-2017, percentage of GDP)



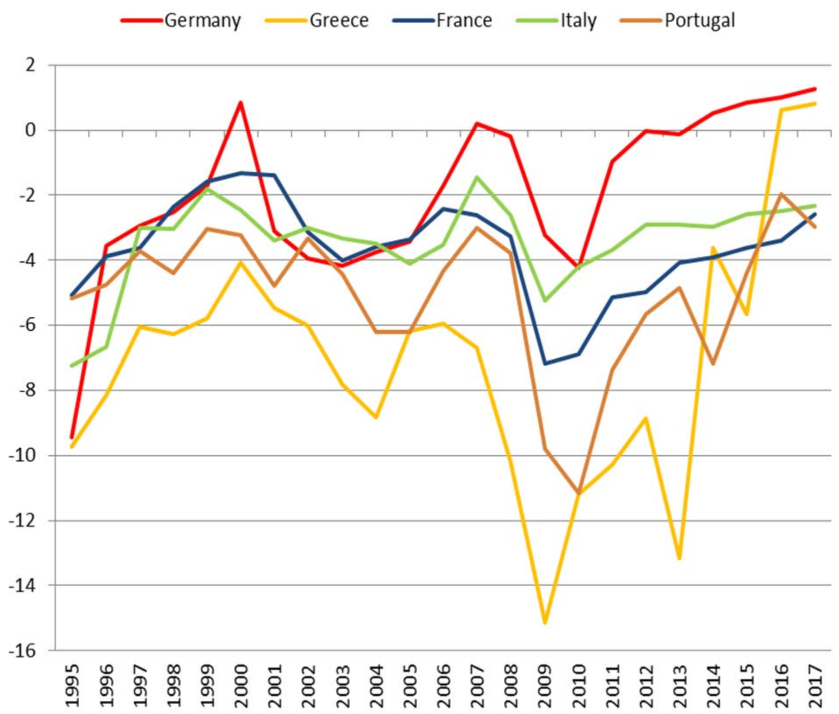
General government gross debt
(1995-2017, percentage of GDP)



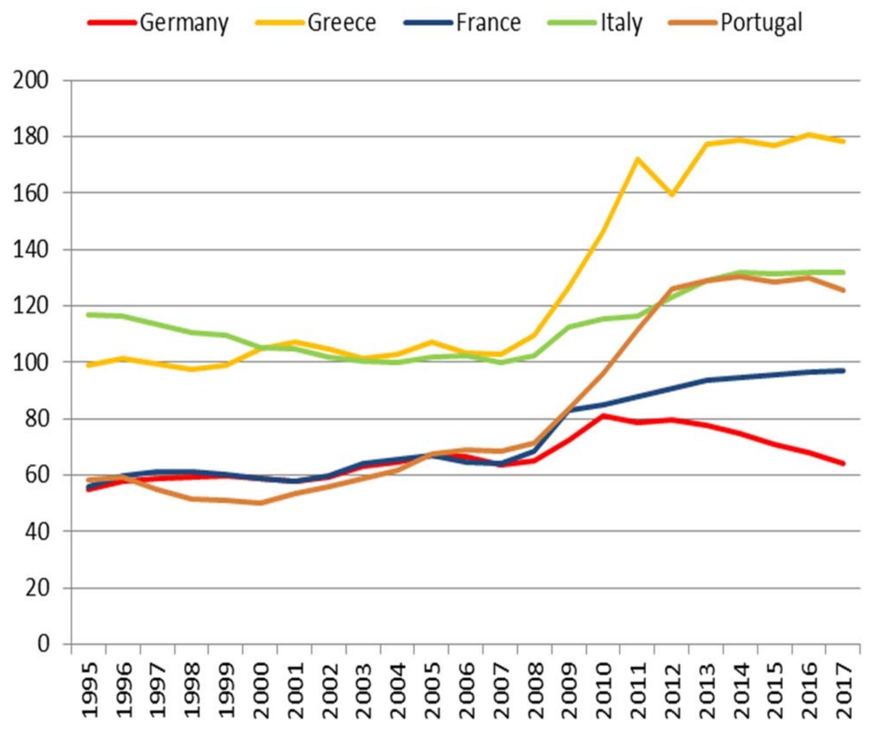
Data source: European Commission, Spring Forecast 2018.

… but sizeable differences across EA countries

General government budget balance
(1995-2017, percentage of GDP)



General government gross debt
(1995-2017, percentage of GDP)

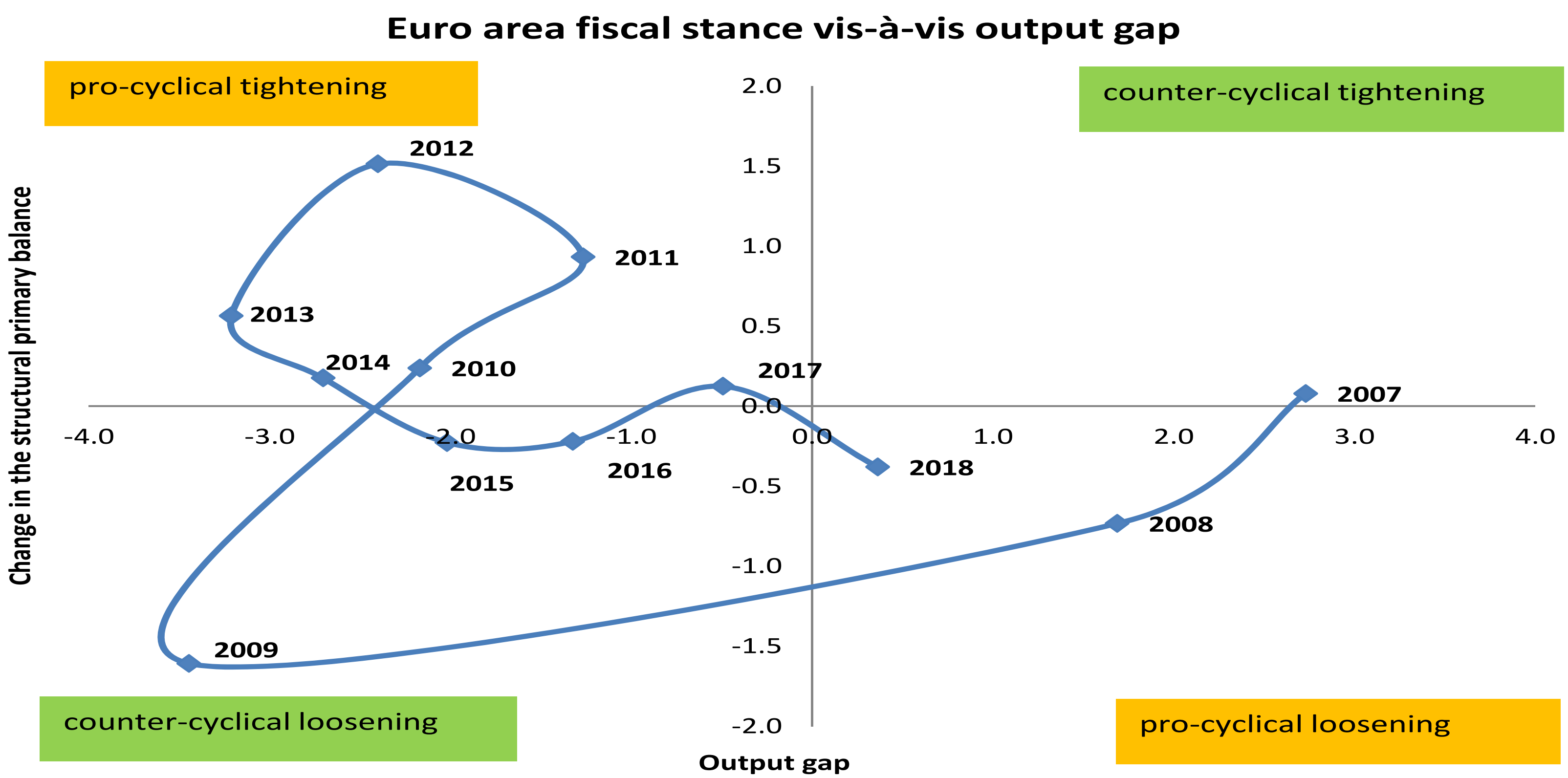


Data source: European Commission, Spring Forecast 2018.

Fiscal policy counter-cyclical in 2009, pro-cyclical in 2011-13

Euro area fiscal stance vis-à-vis output gap

(str. primary balance: percentage of GDP; output gap: percentage of potential GDP, *ex-post data*)



Data source: European Commission, Spring Forecast 2018

In run up and in response to financial crisis

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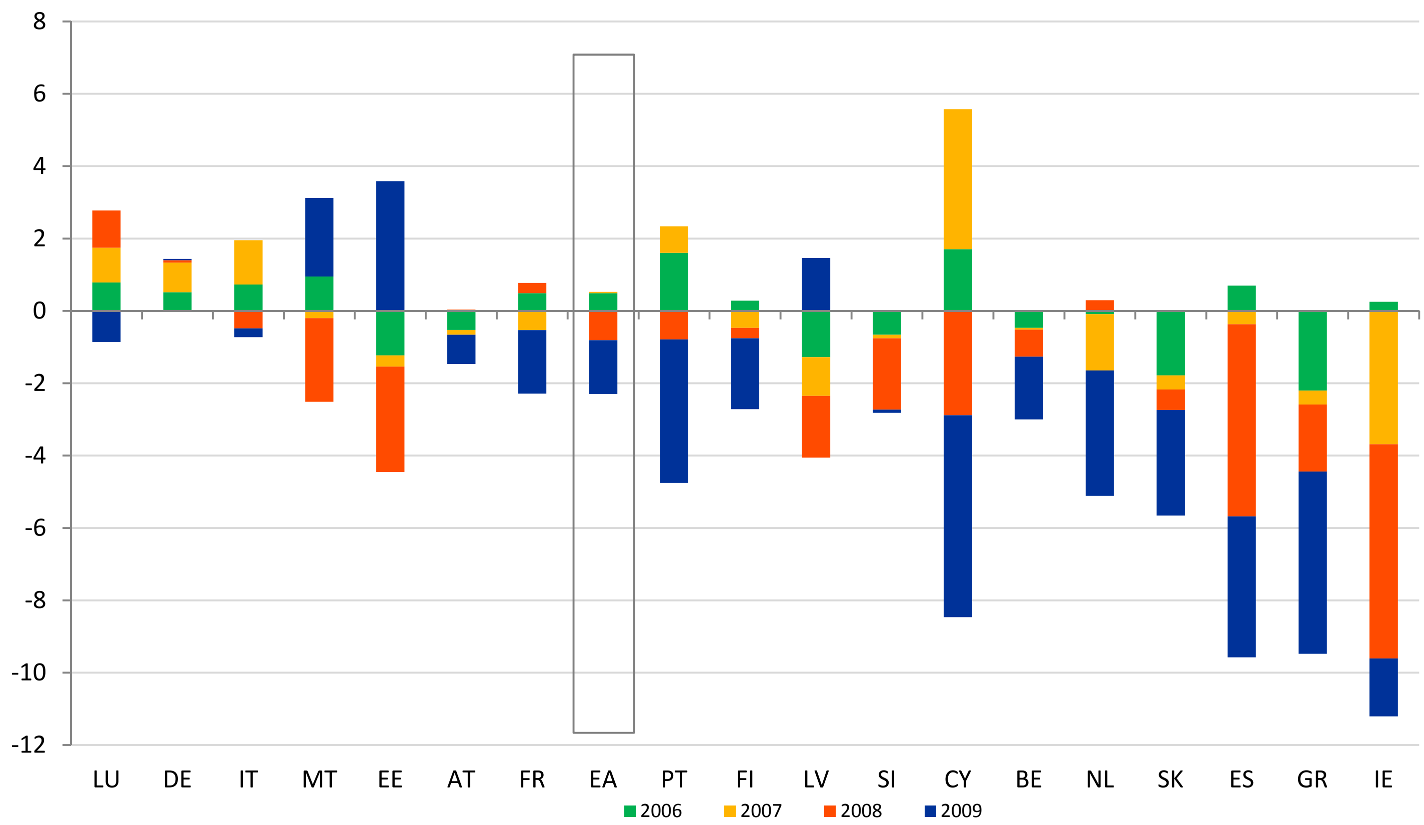
Fiscal expansion in EA countries
(change in structural balance)



Data source: European Commission spring forecast 2018

Sizeable consolidation has been achieved ....

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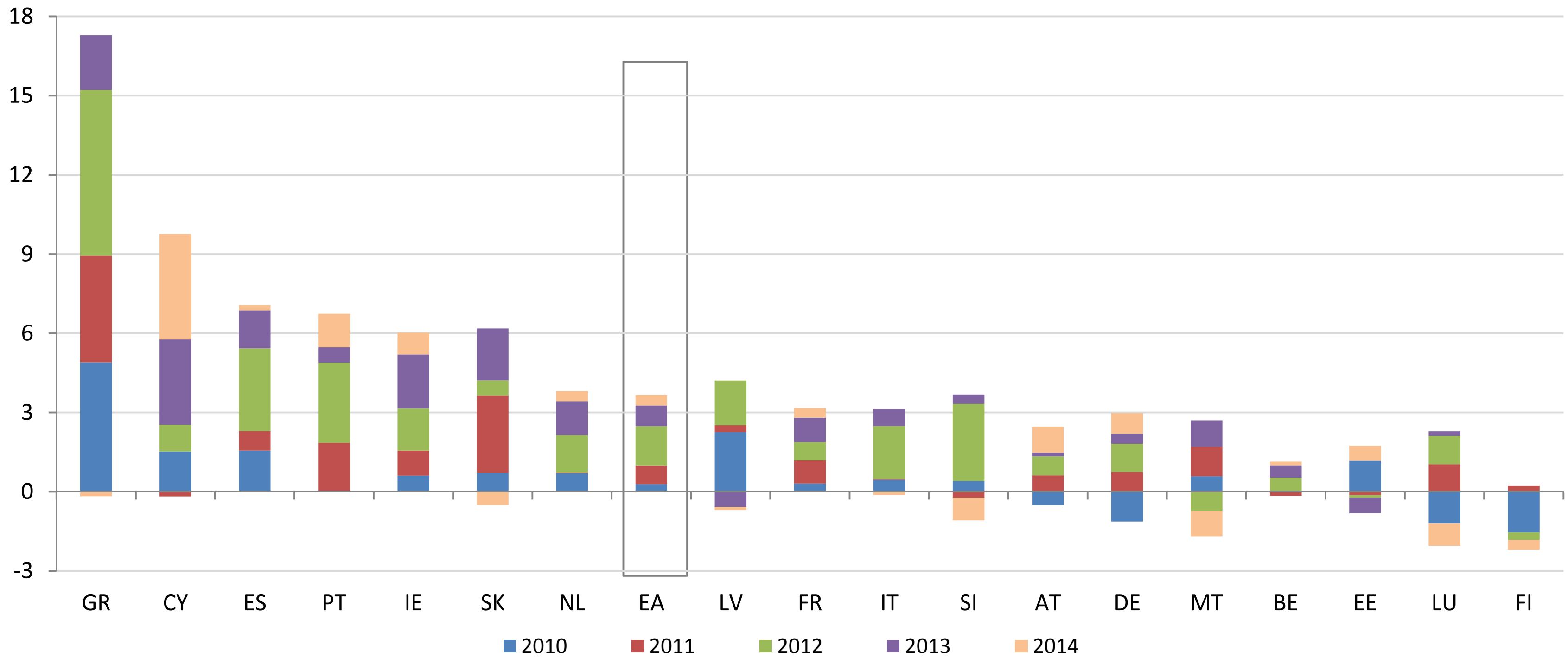
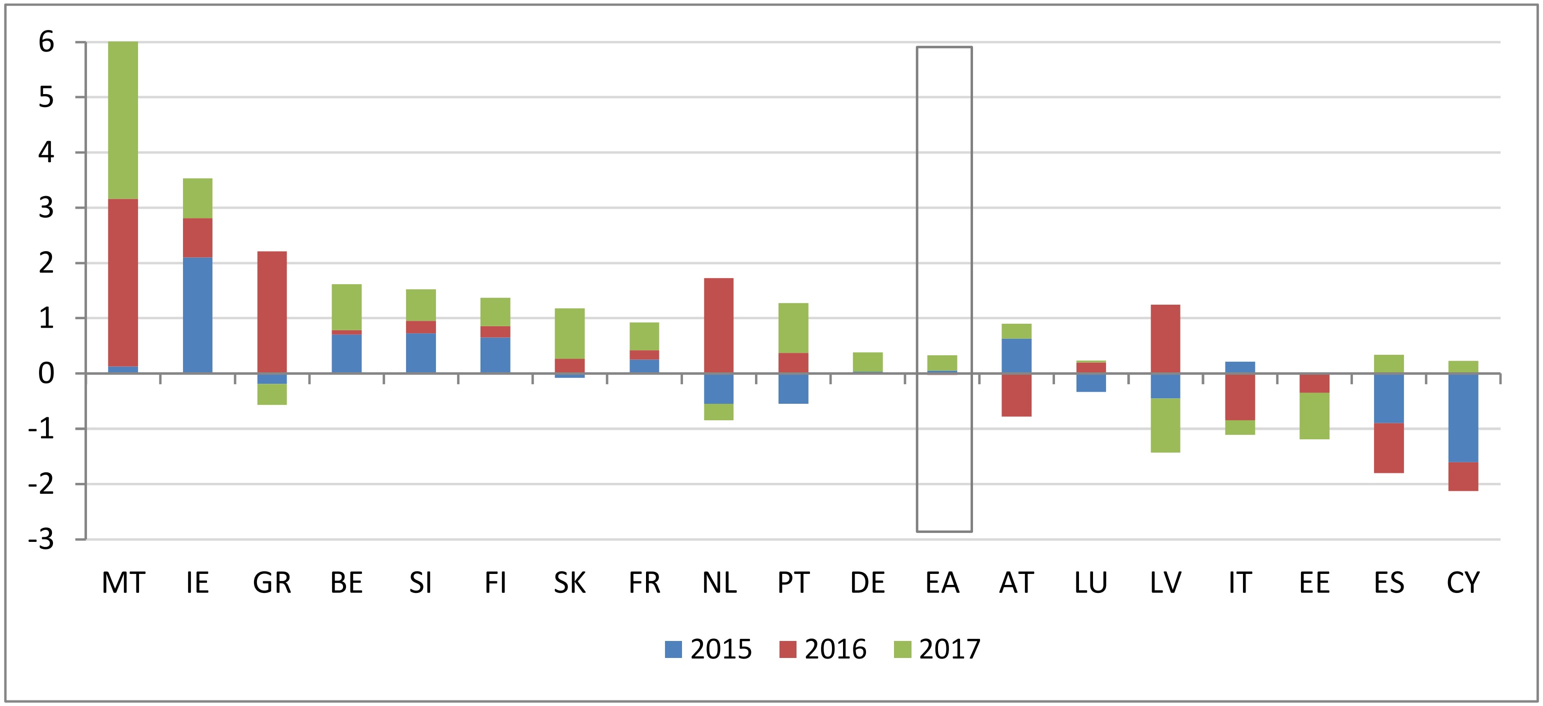
Consolidation in EA countries
(change in structural balance)



Data source: European Commission spring forecast 2018

… but efforts are slowing down and turning expansionary

Consolidation in EA countries
(change in structural balance)



Data source: European Commission spring forecast 2018

Note: The structural effort for IE could be affected by the GDP revision in 2015

Overview

Building blocks of EMU fiscal policy framework in the Treaty

- Article 126: Excessive Deficit Procedure (EDP)
- Protocol on the EDP: 3% and 60% reference values
- Further relevant provisions
    - Article 121: Co-ordination of economic policies
    - Article 122: Union financial assistance in exceptional circumstances
    - Article 123: no monetary ECB financing of governments
    - Article 124: no privileged government access to financial institutions
    - Article 125: no bail out clause

Treaty needs to be made operational: Stability and Growth Pact

The two arms of the Stability and Growth Pact

Stability and Growth Pact

Preventive arm

1. Definition of country-specific budgetary objectives (MTO)
2. Surveillance of compliance with MTO/adjustment path
3. Decision on significant deviation from adjustment path
4. Recommendation for correction
5. Decision on effective action
6. Decision on sanctions (interest bearing deposit)

Corrective arm

1. Deficit and debt reporting by MS, checked by Eurostat
2. Surveillance of compliance with deficit/ debt criteria
3. Decision on excessive deficit and/or debt
4. Recommendation for deficit reduction
5. Decision on effective action
6. Decisions on financial sanctions (fines)

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The preventive arm of the SGP

- Member States commit to reach a country-specific "medium-term objective" (MTO), of a structural balance "close to balance or in surplus":
  - a safety margin with respect to 3% of GDP reference value
  - to ensure rapid progress towards sustainable public finances
  - accounting for implicit liabilities (ageing)
- Assessment of progress towards sound fiscal positions :
  - benchmark: annual structural adjustment of 0.5% of GDP
  - SGP flexibility clauses (accounting for cyclical position/debt level, public investment, structural reforms)
  - expenditure growth needs to be in line with medium-term potential GDP growth ("expenditure benchmark")
- The ECOFIN Council can issue early warnings; ultimately possibility of financial sanction (interest bearing deposit)

- Identification of excessive deficits or excessive debt
  - 3% of GDP deficit and 60% of GDP debt threshold
  - 1/20 debt rule for debt reduction
  - based on data submitted by national governments & checked by EUROSTAT
  - consideration of escape clauses
- Recommendations for the correction of excessive deficits
  - speed of adjustment at least 0.5% of GDP in structural terms per year
  - annual nominal deficit targets
  - deadline for correction one year after excessive deficit is diagnosed (as a rule); but multi-annual EDP deadlines possible
  - EDP deadline extension possible in case of unexpected adverse developments and provided that effective action has been taken
- If no effective action: escalation of procedure and possibility to impose sanctions (non interest-bearing deposit, fines)

Poor compliance with the preventive …

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Structural budget balance (% of GDP)

		Structural net lending (+) / net borrowing (-) (in % of GDP)													
	MTO 2017	*2004*	*2005*	*2006*	*2007*	*2008*	*2009*	*2010*	*2011*	*2012*	*2013*	*2014*	*2015*	*2016*	2017
Belgium	**0.0**	-1.4	-0.9	-1.4	-1.4	-2.2	-3.9	-3.9	-4.0	-3.5	-3.1	-2.9	-2.2	-2.1	-1.3
Germany	**-0.5**	-2.9	-2.2	-1.7	-0.8	-0.8	-0.7	-1.9	-1.1	-0.1	0.3	1.1	1.1	1.1	1.5
Estonia	**-0.5**	1.4	-0.1	-1.3	-1.6	-4.5	-1.0	0.2	0.1	0.0	-0.6	0.0	0.0	-0.4	-1.2
Ireland	**-0.5**	1.7	1.3	1.6	-2.1	-8.0	-9.6	-9.0	-8.1	-6.5	-4.4	-3.6	-1.5	-0.8	-0.1
Greece	**0.0**	-7.7	-5.2	-7.4	-7.8	-9.7	-14.7	-9.8	-5.8	0.5	2.6	2.4	2.2	4.4	4.0
Spain	**0.0**	-0.1	0.3	1.0	0.6	-4.7	-8.6	-7.0	-6.3	-3.1	-1.7	-1.5	-2.4	-3.3	-3.0
France	**-0.4**	-4.8	-4.7	-4.2	-4.7	-4.4	-6.2	-5.9	-5.0	-4.3	-3.4	-3.0	-2.7	-2.6	-2.1
Italy	**0.0**	-5.3	-5.0	-4.3	-3.1	-3.6	-3.8	-3.3	-3.3	-1.3	-0.7	-0.8	-0.6	-1.4	-1.7
Cyprus	**0.0**	-5.1	-3.4	-1.7	2.2	-0.7	-6.3	-4.8	-4.9	-3.9	-0.7	3.3	1.7	1.2	1.4
Latvia	**-1.0**	-1.8	-2.0	-3.3	-4.3	-6.0	-4.6	-2.3	-2.1	-0.4	-0.9	-1.1	-1.5	-0.3	-1.2
Lithuania	**-1.0**	-2.3	-1.9	-2.3	-3.2	-5.3	-6.9	-3.1	-3.3	-2.3	-1.9	-1.4	-0.7	-0.3	-0.6
Luxembourg	**-0.5**	-0.9	-0.2	0.6	1.5	2.6	1.7	0.5	1.6	2.6	2.8	1.9	1.6	1.8	1.8
Malta	**0.0**	-6.1	-4.2	-3.3	-3.5	-5.8	-3.6	-3.1	-1.9	-2.7	-1.7	-2.6	-2.5	0.5	3.5
Netherlands	**-0.5**	-0.8	0.6	0.5	-1.0	-0.7	-4.2	-3.5	-3.4	-2.0	-0.7	-0.4	-0.9	0.8	0.5
Austria	**-0.5**	-0.7	-1.3	-1.8	-1.9	-1.9	-2.7	-3.2	-2.6	-1.9	-1.7	-0.7	-0.1	-0.9	-0.6
Portugal	**0.3**	-5.9	-6.1	-4.5	-3.8	-4.6	-8.5	-8.5	-6.7	-3.6	-3.1	-1.8	-2.3	-2.0	-1.1
Slovenia	**0.3**	-2.5	-1.9	-2.5	-2.6	-4.6	-4.7	-4.3	-4.5	-1.6	-1.2	-2.1	-1.3	-1.1	-0.6
Slovakia	**-0.5**	-2.1	-2.2	-4.0	-4.3	-4.9	-7.8	-7.1	-4.2	-3.6	-1.6	-2.1	-2.2	-2.0	-1.0
Finland	**-0.5**	2.6	2.9	3.2	2.7	2.4	0.5	-1.1	-0.8	-1.1	-1.1	-1.5	-0.9	-0.7	-0.1
Euro area *	**-0.3**	-3.1	-2.8	-2.3	-2.2	-3.0	-4.5	-4.2	-3.5	-2.0	-1.3	-0.9	-0.8	-0.8	-0.6

Sources: European Commission's spring 2018 economic forecast, figures prior to 2010 are from Spring 2014 vintage of forecasts
(*) Euro area implied MTO

… and the corrective arm of the Stability and Growth Pact

Budget balance (% of GDP)

	Net lending (+) / net borrowing (-) (in % of GDP)													
	2004	*2005*	*2006*	*2007*	*2008*	*2009*	*2010*	*2011*	*2012*	*2013*	*2014*	*2015*	*2016*	2017
Belgium	-0.2	-2.8	0.2	0.1	-1.1	-5.4	-4.0	-4.1	-4.2	-3.1	-3.1	-2.5	-2.5	-1.0
Germany	-3.7	-3.4	-1.7	0.2	-0.2	-3.2	-4.2	-1.0	0.0	-0.1	0.5	0.8	1.0	1.3
Estonia	2.4	1.1	2.9	2.7	-2.7	-2.2	0.2	1.2	-0.3	-0.2	0.7	0.1	-0.3	-0.3
Ireland	1.3	1.6	2.8	0.3	-7.0	-13.8	-32.1	-12.7	-8.0	-6.1	-3.6	-1.9	-0.5	-0.3
Greece	-8.8	-6.2	-5.9	-6.7	-10.2	-15.1	-11.2	-10.3	-8.9	-13.2	-3.6	-5.7	0.6	0.8
Spain	0.0	1.2	2.2	1.9	-4.4	-11.0	-9.4	-9.6	-10.5	-7.0	-6.0	-5.3	-4.5	-3.1
France	-3.6	-3.3	-2.4	-2.6	-3.3	-7.2	-6.9	-5.2	-5.0	-4.1	-3.9	-3.6	-3.4	-2.6
Italy	-3.5	-4.1	-3.5	-1.5	-2.6	-5.2	-4.2	-3.7	-2.9	-2.9	-3.0	-2.6	-2.5	-2.3
Cyprus	-3.7	-2.2	-1.0	3.2	0.9	-5.4	-4.7	-5.7	-5.6	-5.1	-9.0	-1.3	0.3	1.8
Latvia	-0.9	-0.4	-0.5	-0.5	-4.2	-9.1	-8.7	-4.3	-1.2	-1.2	-1.5	-1.4	0.1	-0.5
Lithuania	-1.4	-0.3	-0.3	-0.8	-3.1	-9.1	-6.9	-8.9	-3.1	-2.6	-0.6	-0.2	0.3	0.5
Luxembourg	-1.3	0.1	1.9	4.2	3.3	-0.7	-0.7	0.5	0.3	1.0	1.3	1.4	1.6	1.5
Malta	-4.3	-2.6	-2.5	-2.1	-4.2	-3.2	-2.4	-2.4	-3.5	-2.4	-1.8	-1.1	1.0	3.9
Netherlands	-1.7	-0.3	0.2	0.2	0.2	-5.4	-5.0	-4.3	-3.9	-2.4	-2.3	-2.1	0.4	1.1
Austria	-4.8	-2.5	-2.5	-1.4	-1.5	-5.3	-4.4	-2.6	-2.2	-2.0	-2.7	-1.0	-1.6	-0.7
Portugal	-6.2	-6.2	-4.3	-3.0	-3.8	-9.8	-11.2	-7.4	-5.7	-4.8	-7.2	-4.4	-2.0	-3.0
Slovenia	-2.0	-1.3	-1.2	-0.1	-1.4	-5.8	-5.6	-6.7	-4.0	-14.7	-5.5	-2.9	-1.9	0.0
Slovakia	-2.3	-2.9	-3.6	-1.9	-2.4	-7.8	-7.5	-4.3	-4.3	-2.7	-2.7	-2.7	-2.2	-1.0
Finland	2.2	2.6	3.9	5.1	4.2	-2.5	-2.6	-1.0	-2.2	-2.6	-3.2	-2.8	-1.8	-0.6
Euro area	-3.0	-2.6	-1.5	-0.7	-2.2	-6.3	-6.2	-4.2	-3.7	-3.0	-2.5	-2.0	-1.5	-0.9

Sources: European Commission's spring 2018 economic forecast

Poor debt rule compliance in a few cases

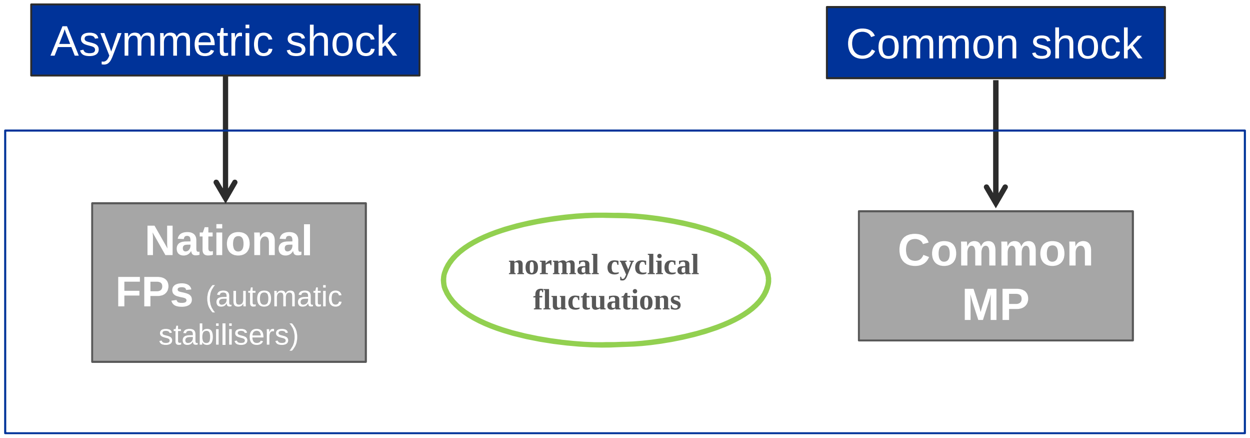
- The Commission has issued Article 126(3) reports for Italy and Belgium in which compliance with the debt rule is assessed.
- No-debt based EDP launched for BE and IT despite gaps to debt reduction benchmark once relevant factors have been taken into account.

ITALY: Gap to debt reduction benchmark (p.p. of GDP)	2016	2017	2018	2019
Article 126(3) report for Italy 18.5.2016	5.6	4.7		
Article 126(3) report for Italy 22.2.2017	7.4	7.1		
Article 126(3) report for Italy 23.5.2018	5.9	5.1	5.1	5.1

BELGIUM : Gap to debt reduction benchmark (p.p. of GDP)	2016	2017	2018	2019
Article 126(3) report 18.5.2016		2.3		
Article 126(3) report 22.5.2017		2.7	2.1	
Article 126(3) report 23.5.2018		0.9	0.9	0.9

Overview

Requirements for a well-functioning EMU



- **The pre-crisis consensus - a clear separation of tasks:**
  - **National fiscal policies to smooth idiosyncratic shocks** through the operation of automatic stabilisers
  - **Monetary policy to stabilise euro-area wide shocks**
- **Experience with the Great Recession:**
  - **Large and persistent shocks (and pro-cyclical policy in good times) may exhaust fiscal buffers** at the national level, hindering automatic stabilisers.
  - **Monetary policy may be constrained or more difficult when reaching the effective lower bound**, creating rational for fiscal stabilisation of major area wide recessions.

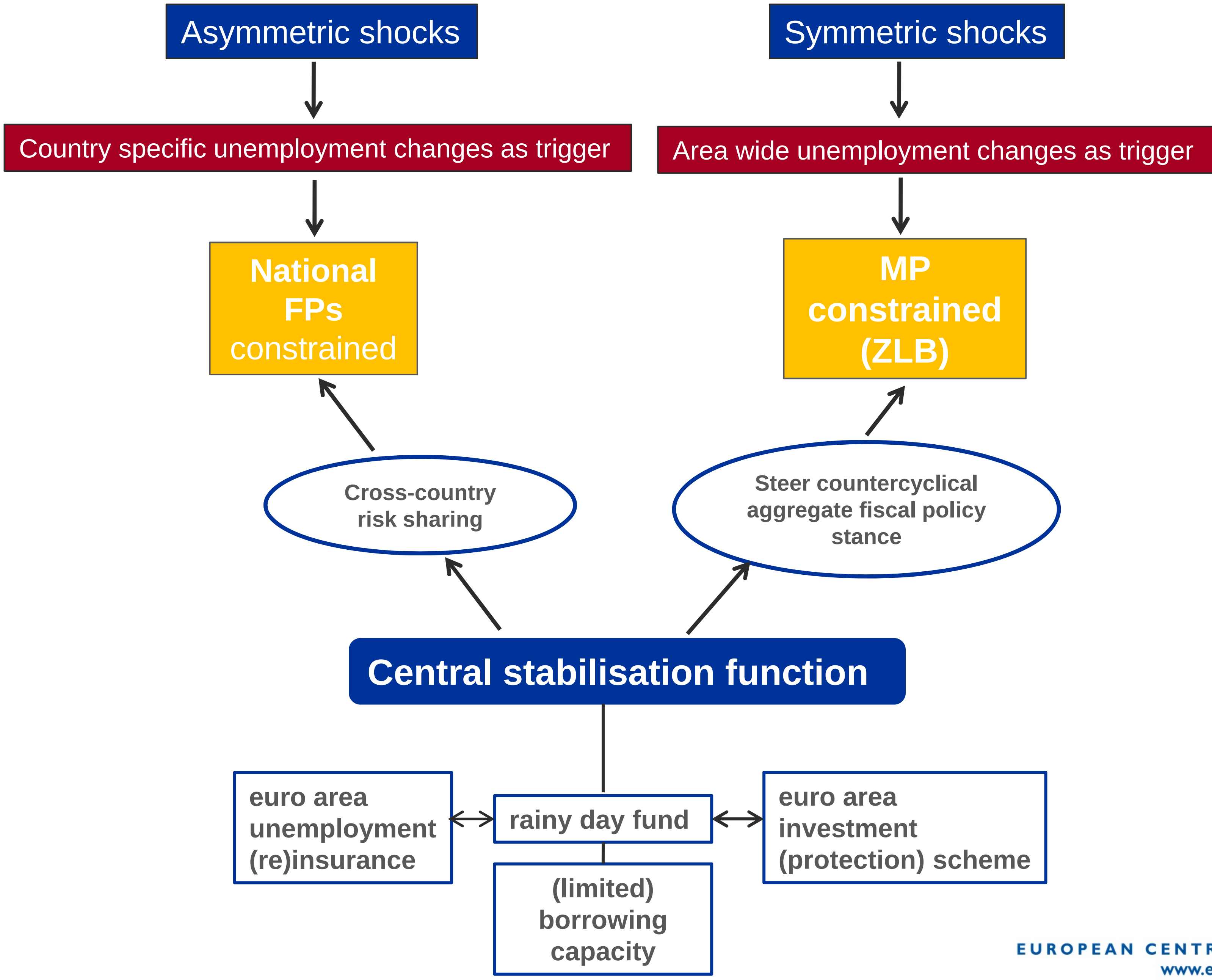
How much private or public risk-sharing in the EMU?

- The architecture of the EMU has been severely challenged during the recent period. Common view: lack of appropriate risk-sharing mechanisms at the euro area level.
- Five President Report: euro area countries have to take steps, both individually and collectively, to compensate for the national adjustment tools they gave up on entry in the EMU.
- When a country-specific economic shock occurs:
  - Each country should be able to respond effectively at the domestic level.
  - Member states may also smooth the impact of shocks through private or public risk sharing within the EMU.

Options for a euro area fiscal capacity

- **Central fiscal stabilisation instrument standard feature of monetary unions**
  - EA fiscal capacity core proposal on EMU deepening agenda (5PR, COM EMU reflection paper) to:
    - complement national fiscal stabilisers / allow smoother aggregate fiscal policies for the euro area in unusual circumstances …
    - … while avoiding permanent transfers and minimising moral hazard
- **Existing governance framework cannot substitute for euro area stabilisation tool**
  - SGP is asymmetric: designed to ensure fiscal discipline, no obligation to use fiscal space
  - Fiscal expansion in Member States with fiscal space may not be equivalent to centrally operated expansion (uncertainties regarding spill-overs)

Options for a euro area fiscal capacity



Can the current framework be further improved to facilitate better reform implementation?

A. Main avenues proposed in the *"Five Presidents' Report"* (2015):

- **More traction of MIP**: as a rule apply the EIP when imbalances are excessive;
- Create **National Productivity Boards** that raise awareness for reform needs;
- Contemplate on **financial incentives for structural reforms**
- Initiate a "**binding convergence process towards more resilient economic structures"**, among others by identifying best practice structural reforms

B. Various proposals published recently take up some of those suggestions:

- e.g. European Commission's May 2018 package, e.g. on a "reform delivery tool"

Conclusions and the way ahead (I)

ECB - Public

- **Macroeconomic imbalances** (e.g. current account balances, labour costs, or credit growth) **have adjusted** since the beginning of the crisis**.**

- **But vulnerabilities remain high** (debt, unemployment, remaining rigidities, partly weak framework conditions/institutions), **limiting resilience to shocks and growth potential**

- **Significant reform progress achieved by vulnerable EA countries during programme,** but it has weakened over the past years.

- Credible and decisive **structural reforms remain crucial** to improve resilience to shocks and increase growth potential.

Conclusions and the way ahead (II)

- **Fiscal rules are key in a monetary union, but effective implementation is crucial.**
- **Need to build fiscal buffers in good times.**
- To the extent that **central fiscal capacity** implies risk sharing, features that minimise moral hazard are important.
- **Importance of cross-border private sector financial risk sharing**

Thank you for your attention!