Exit strategies for the short, medium and long term

Conference on growth and jobs
Aarhus University, Institute for Economics, 2nd March 2010

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Fiscal policies in the euro area and the EU
DG Economic and Financial Affairs
European Commission
The economic crisis
Deepest recession since the inception of the EU
Monetary could not do the job alone
'Taylor rule' suggests that interest rates should have been negative

Taylor rule (headline inflation)
(Jan99 - Jun11, from Oct 2009 on: based on EC autumn forecast)

Minimum bid rate
A massive fiscal policy intervention

Fiscal stance and debt developments in the EU and Euro Area
Macroeconomic policies avoided a repeat of the Great Depression

The crisis is undermining growth Europe’s growth potential

Annual growth (%)  Average annual potential growth in the EU
## Exit - policy strategy matrix

<table>
<thead>
<tr>
<th>Exit policies</th>
<th>Impact on exit objective</th>
<th>Implementation lag</th>
<th>Impact on potential growth</th>
<th>Cross country spillovers</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Output stabilisation</td>
<td>Financial stability</td>
<td>Fiscal sustainability</td>
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<tr>
<td>Budgetary consolidation</td>
<td>-</td>
<td>-</td>
<td>+</td>
<td>m.t.</td>
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<tr>
<td>Monetary normalisation</td>
<td>-</td>
<td>- / +</td>
<td>-</td>
<td>s.t.</td>
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<tr>
<td>Withdrawal of extraordinary liquidity support</td>
<td>-</td>
<td>-</td>
<td>+</td>
<td>s.t.</td>
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<tr>
<td>End of guarantees/asset relief schemes</td>
<td>-</td>
<td>-</td>
<td>+</td>
<td>s.t.</td>
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<tr>
<td>End of short-term working schemes</td>
<td>-</td>
<td>~ 0</td>
<td>+</td>
<td>s.t.</td>
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<tr>
<td>End of sectoral support</td>
<td>-</td>
<td>~ 0</td>
<td>+</td>
<td>s.t.</td>
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<tr>
<td>Bank recapitalisation &amp; restructuring</td>
<td>+</td>
<td>+</td>
<td>- / +</td>
<td>m.t.</td>
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<tr>
<td>Structural policies</td>
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<tr>
<td>Macroprudential surveillance</td>
<td>~ 0</td>
<td>+</td>
<td>+</td>
<td>m.t.</td>
</tr>
<tr>
<td>Labour market reform</td>
<td>- / +</td>
<td>~ 0</td>
<td>+</td>
<td>l.t.</td>
</tr>
<tr>
<td>Product market reform</td>
<td>+</td>
<td>+</td>
<td>+</td>
<td>l.t.</td>
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</table>
Fiscal sustainability is a constraint

Debt is on-track to reach 120% of GDP by 2020 in the absence of consolidation.
Ageing is a concern that adds to sustainability worries. If growth is even weaker, sustainability problems are larger.

Euro area

Non-euro area
Exiting from the fiscal stimulus
Could be undertaken in stages

Fiscal exit in 2 phases

✓ Current fiscal trends are unsustainable even factoring in:
  ▪ temporary character of extraordinary support measures;
  ▪ recovery of economy and tax bases.

✓ Useful distinction between two phases of the fiscal exit strategy:
  ▪ Withdrawal of stimulus measures;
    ✓ follows quasi-automatically from temporary character of measures agreed under the EERP;
    ✓ Full implementation of the packages should imply stimulus withdrawal beginning from 2010 and fading out in 2011;
    ✓ Still, overall fiscal stance supportive in the euro area and the EU in 2010.
  ▪ From 2011: generalised consolidation going beyond stimulus withdrawal aiming at halting and then reversing unsustainable debt trends.
Exiting from the fiscal stimulus
What about monetary policy?

✓ Monetary financing prohibited by Article 123 of the Lisbon Treaty

✓ Inflation not a solution
  - Initially: inflation reduces stock of debt as most debt is medium to long-term, non-indexed and in domestic currency.
  - Blanchard (IMF) suggests 4% inflation target. Even if it were as high as 6% IMF itself (Cottarelli and Vinals) suggests that it would take at most 8-9pp of GDP of advanced economies’ debt levels.
  - High risk of destabilising expectations resulting in large increases in long-term rates and the cost of re-financing, with monetary policy losing traction.

✓ Stable monetary environment important
  - For resource allocation, growth, internal and external monetary stability.
  - Stable currency (in terms of prices and exchange rate) also helps government to borrow without additional premia.

✓ Importance of monetary authorities being able and willing to accommodate fiscal consolidation and structural reforms
  - Timely fiscal consolidation can prevent cyclical price pressures, gives monetary policy the possibility to remain accommodative longer than otherwise.
  - Pro-growth structural reforms increase the speed limit for non-inflationary growth; rebuilding the growth potential is a crucial element of the “exit strategy”.
EU fiscal surveillance - Coordinating fiscal exit strategies
The excessive deficit procedure

- Deadlines and fiscal effort modulated in line with fiscal space
  - external imbalances, financial sector contingent liabilities, risk premia on sovereign debt and the projected increase in age-related expenditure also considered
  - debt given renewed focus

- Important flanking policies to the fiscal exit:
  - strengthened national budgetary framework
  - measures to support long-term sustainability.

- SCPs currently being assessed have new elements
  - SCPs contain a chapter dealing with the EDP recommendations
    - Include section on dealing with unsustainable debt levels and trend
    - Present budgetary measures and consolidation plans in a multi-annual framework
  - Specific consolidation measures to be updated in subsequent versions of SCPs
  - SCPs give prominence to structural reforms with a direct bearing on fiscal outcomes and long-term sustainability
    - quality of public finances and fiscal governance changes relating to budgetary frameworks and measures to improve expenditure control to be flagged
The long term: the ageing challenge

Government debt if no measures are taken
Impact of the crisis on potential growth

- Critical challenges for the EU are to prevent reductions in potential growth from:
  - Lower or unproductive investment due to risk aversion, credit constraints or government intervention
  - Permanent rebalancing of internal demand
  - Labour market hysterisis

- Past crises (e.g. SE and FI) show that policy responses matter

- Different scenarios are possible i.e. a full return to earlier path, a permanent loss in level terms only or a permanent loss on growth rates

The medium term: possible trajectories for growth

Case No 1: Full return to earlier path

Case No 2: Permanent loss in GDP level

Case No 3: Permanent loss on growth rates

The medium term: possible trajectories for growth

Impact of the crisis on potential growth

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EU2020
A sustainable social market economy which is smarter and greener

Integrated EU2020 Guidelines (treaty based anchor)
Headline political targets for the EU27 and by MS to be reached by 2020

Country surveillance
(leading to recommendations to Member States)

Thematic priority agendas
- Empowering people in inclusive societies
- Creating a competitive, connected and green economy
- Creating value by basing growth on knowledge

Political ownership
European Council: steers EU2020 strategy and provides political impulse
ECOFIN: responsible for country surveillance and establishing macro/fiscal constraint
Other Councils: develop and implement priority thematic agendas
European Parliament: provide guidances and opinions
New impetus to the Single Market needed

- Single Market has delivered significant gains: some € 500 per head and 2.75 million jobs

- But untapped potential exists in some sectors due to unfinished regulatory agenda, e.g. Services Directive (0.6 to 1.5% increase in GDP) or further opening of energy sector (0.6 to 0.8% increase in GDP)

- In other sectors, Single Market is legal reality, but not economic reality: high price dispersion and big differences in sectoral productivity levels

→ Regulation, competition policies and proper functioning of markets at least as important as “legal” integration to fully tap the potential of the Single Market
Creating value by basing growth on knowledge

- Little progress on R&D: EU particularly lagging in terms of private R&D spending
- Sectoral composition explains ½ of the total gap with the US (R&D investment in US is driven by high-tech sectors but the number of firms in high-tech sectors in the EU is much lower)
- It is framework conditions (e.g. entry barriers) and lack of young and innovative companies that are behind the R&D/innovation gap
- It is not public spending that causes underperformance of the EU R&D
- Need to carefully review the 3% R&D expenditure rate target
- It is framework conditions (e.g. entry barriers) and lack of young and innovative companies that are behind the R&D/innovation gap
Seizing opportunities in education

- EU spends significantly less on education than main competitors
- Shares of tertiary graduates are low and there is little private expenditure on tertiary education
- It is framework conditions (e.g. entry barriers) and lack of young and innovative companies that are behind the R&D/innovation gap

→ Need to increase overall spending on education
→ Investment in pre-primary education has high social returns
→ Private financing should play a bigger role in tertiary education as private returns are high, i.e. a wide-spread use of tuition fees
Developing a greener economy

Climate change damages in % of global final output

- Climate and energy policy inaction would lead to high GDP losses
- Targeted and technology neutral support for green R&D can bring down the costs of green policies and boost productivity and innovation economy wide
  - Need to “get the prices right” and phase out environmentally harmful subsidies
  - Efficient support to green R&D may reap and multiply the benefits of a greener economy

Source: Grimaud et al. (2009)
Conclusions

- Macroeconomic policies have played a central role in averting a depression, but the policies adopted to address the crisis cannot be maintained without increasingly negative effects and are ultimately unsustainable.

- In particular, sustained budgetary consolidation is needed to halt and reverse the increase in public debt, also in the light of the looming fiscal burden from ageing populations.

- Implementation of exit needs careful preparation: there are trade-offs between different objectives and interactions across different policy areas.

- Going forward the key issue is growth: without growth restoring public finance and maintaining living and social standards will be impossible.

- The EU2020 focus is firmly on growth and jobs: making the best of the single market, growing the knowledge economy and greening growth are key.
Thank you