What role for fiscal vs monetary policy? Which has more scope left? How to combine them?

SUERF conference - Racing for Economic Leadership: EU and US Perspectives

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The euro area outlook is clouded...

Forecasts for 2019
Euro area real GDP growth (%)

Forecasts for 2020
EA real GDP growth (%)

- IMF
- ECFIN
- OECD
- ECB
- Consensus
...and downside risks to growth remain prominent
Inflation remains subdued

Headline HICP and core inflation

Long-term inflation expectations

ECB medium-term objective

ECB SPF 5Y ahead

5Y5Y inflation swap
Interpretation of the slowdown: two views

Cyclical slowdown

Diagnosis
- Unemployment reaching record low, wage inflation before the slowdown
- Decreasing interest rates and flat yield curve due to monetary accommodation
- Monetary policy with enough space to act; fiscal policy less effective

Policy prescription ➔ Go slow

Secular stagnation

Diagnosis
- Wage inflation stubbornly low: Phillips curve rather flat, risk of inflation trap
- Structurally low interest rates and flat yield curve reflect low r*
- Monetary policy increasingly constrained; fiscal policy more effective

Policy prescription ➔ Act now
Monetary easing continues, but faces increasing constraints

Source: Bloomberg

Composite credit cost indicators

Sources: ECB, Bloomberg, Datastream, DG ECFIN calculations
Fiscal stance has been broadly neutral

Development over years
- Contractionary and pro-cyclical in 2011-2014
- Broadly neutral in 2015-2017
- Turning mildly expansionary since 2018 / 2019

→ Change in fiscal stance has helped economic recovery in the euro area since 2015

→ Time to shift to a more supportive stance?
Fiscal policy: differentiation is key

- Need for a **moderate fiscal expansion** to support ECB in fighting the slowdown
- But **differentiation across countries is key**
- Focus on **productive spending** for sustainable & green growth
- Need to convince some Member States
Fiscal stimulus: positive and lasting effects

Temporary 2 year fiscal stimulus in Germany and Netherlands
Debt-financed 1% of GDP increase in productive public investment

- $r < g$
- no monetary policy response for 2 years assumed (lower bound)
  → Modest positive GDP spillovers to other trading partners
  → Small improvement in government debt-to-GDP ratio in trading partners
Structural challenges facing the EU economy

The productivity challenge...
Labour productivity and TFP developments in euro area and EU28 compared to US and Japan

... and other challenges too: Climate change, Digitalisation, Inequality, Ageing
Structural policy responses

- Efficient and competitive markets
  - Research and innovation
  - Conducive business environment
  - Digitalisation
  - Strong industrial base

- Green investment
  - Resource efficiency
  - Circular economy
  - Socially-fair transition

Productivity

- Investment in people and skills
  - Decent living standards for all
  - Future of work
  - Upward convergence

Fairness and equal opportunities

- Sound public finances
  - Stable financial sector
  - Preventing domestic and external imbalances
  - Diversified economy

Stability
Policy choices in autumn to address both short-term and long-term challenges

Monetary policy:
- Patient
- Persistent
- Prudent

Fiscal policy:
- Timely
- Targeted
- Temporary?

Adequate ST/LT policy mix

Structural reforms:
- Feasible
- Forward-looking
- Fair

Questions:
- a) Can monetary policy achieve internal and external equilibrium alone?
- b) Time to shift from a neutral to expansionary fiscal stance?
- c) What positive incentives for structural reforms?
THANK YOU