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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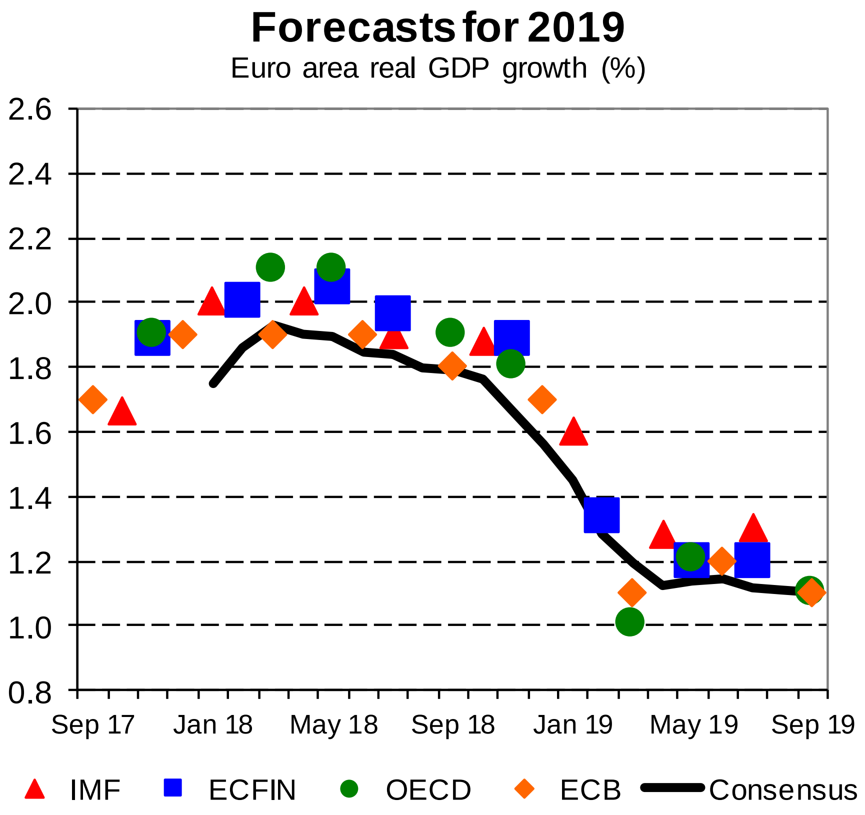
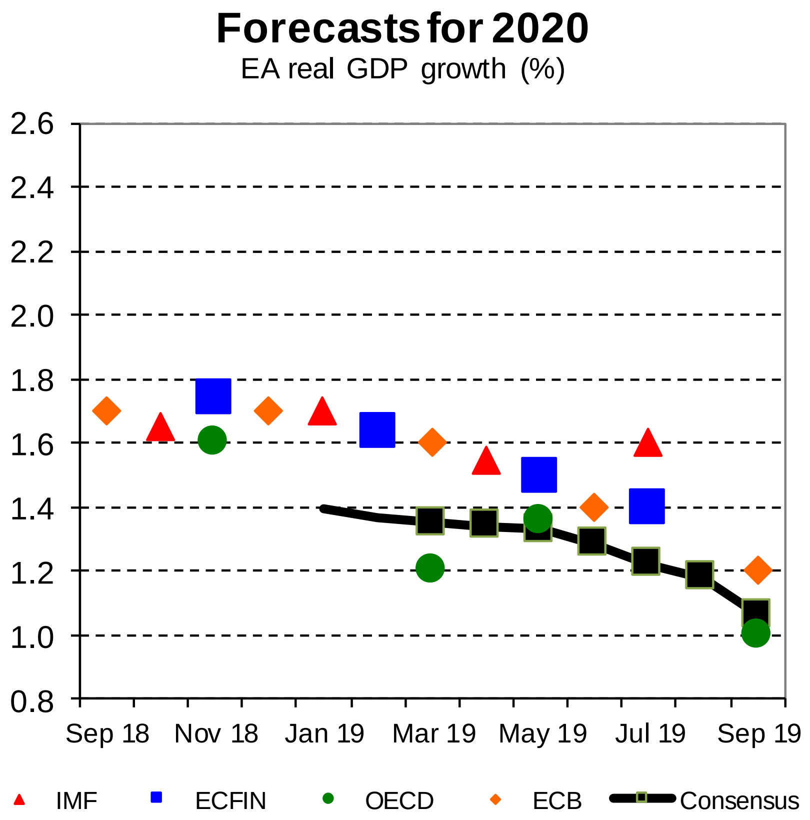
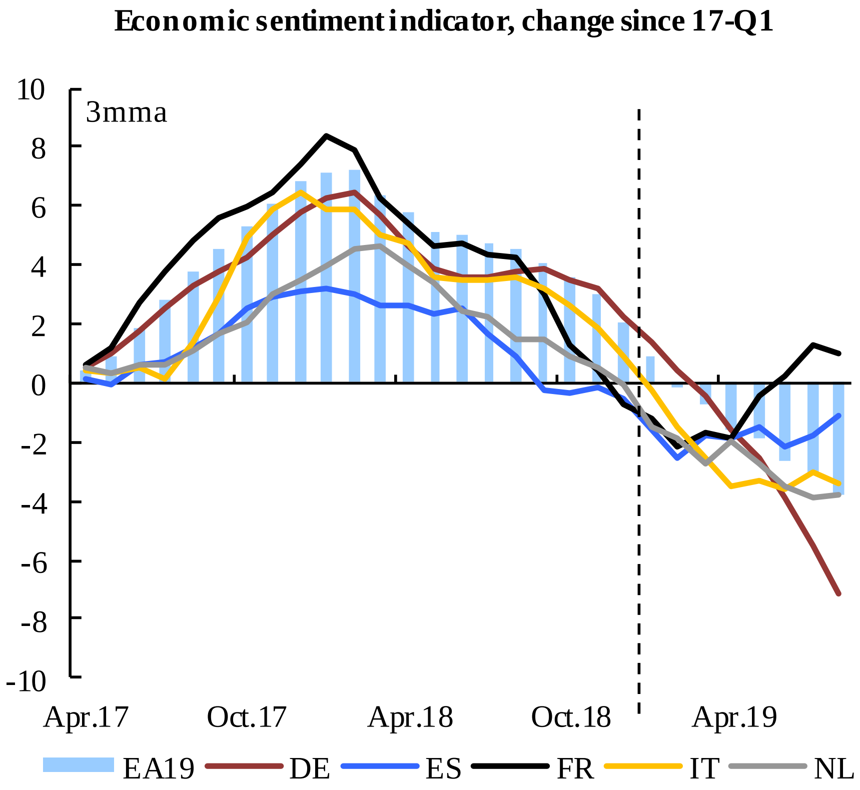
16 October 2019

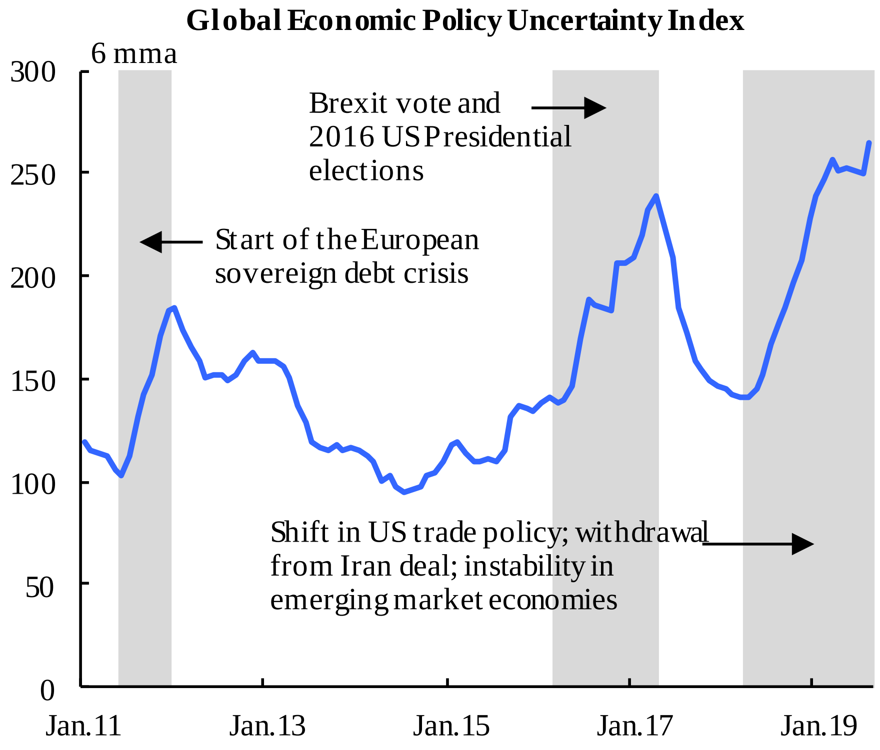
The euro area outlook is clouded…





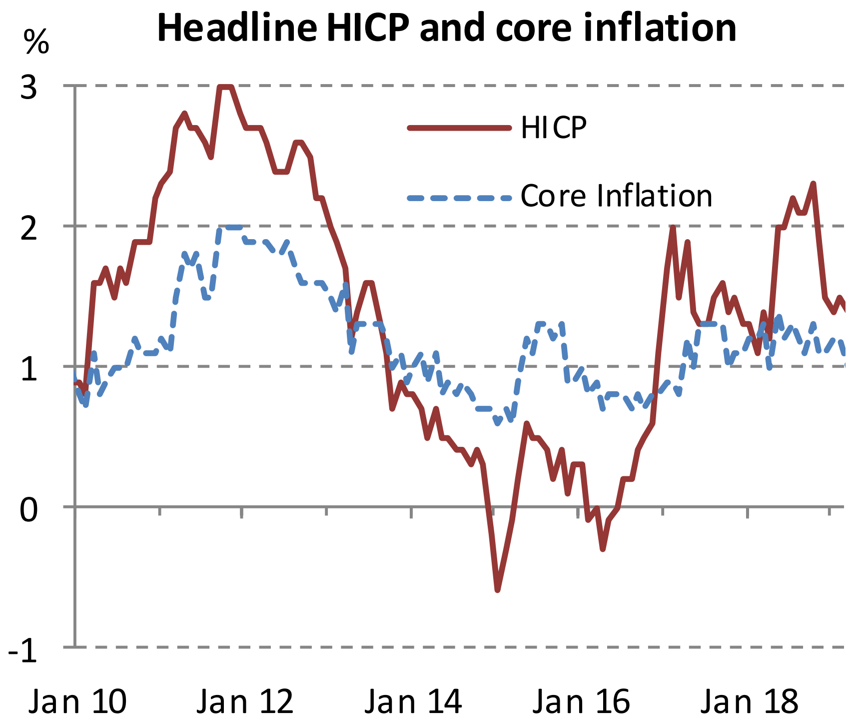
…and downside risks to growth remain prominent

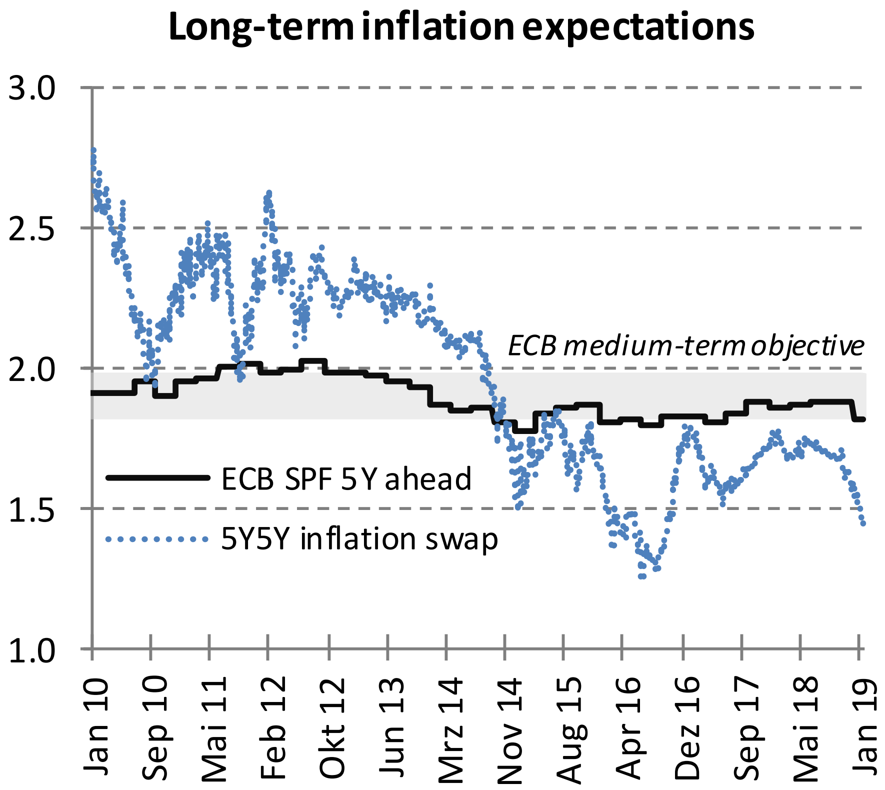




Source: www.policyuncertainty.com

Inflation remains subdued





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

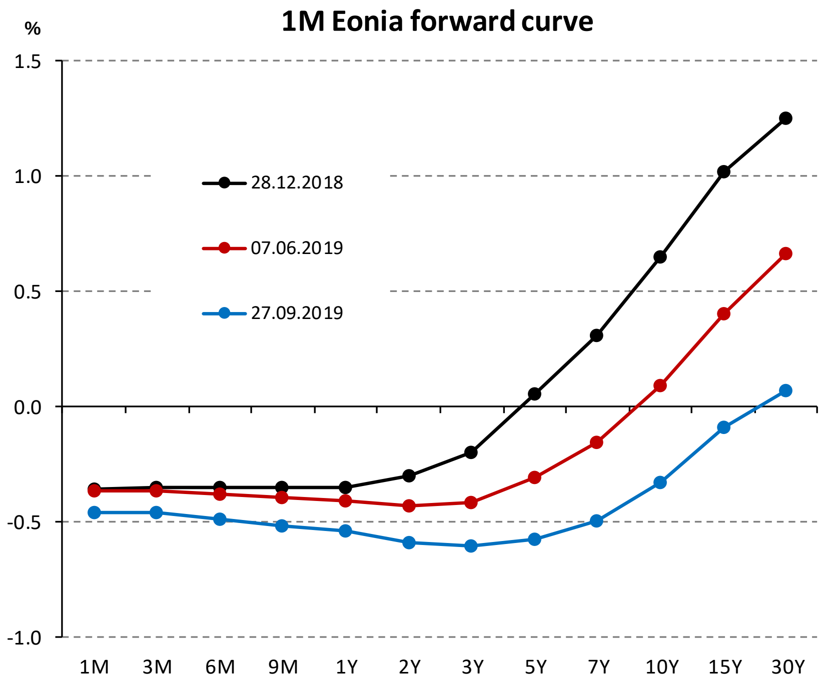
Diagnosis

- 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

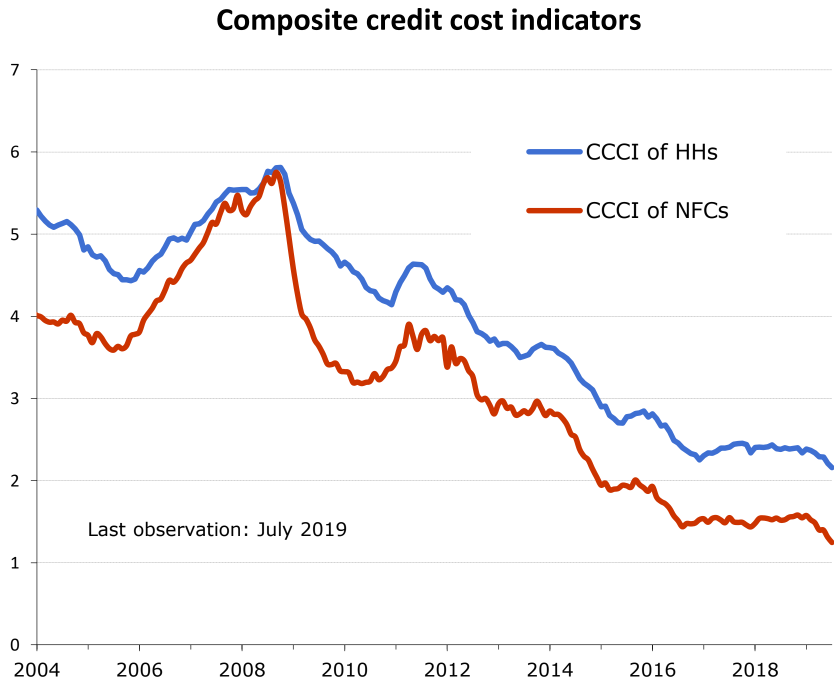
Policy prescription

➔ **Act now**

Monetary easing continues, but faces increasing constraints



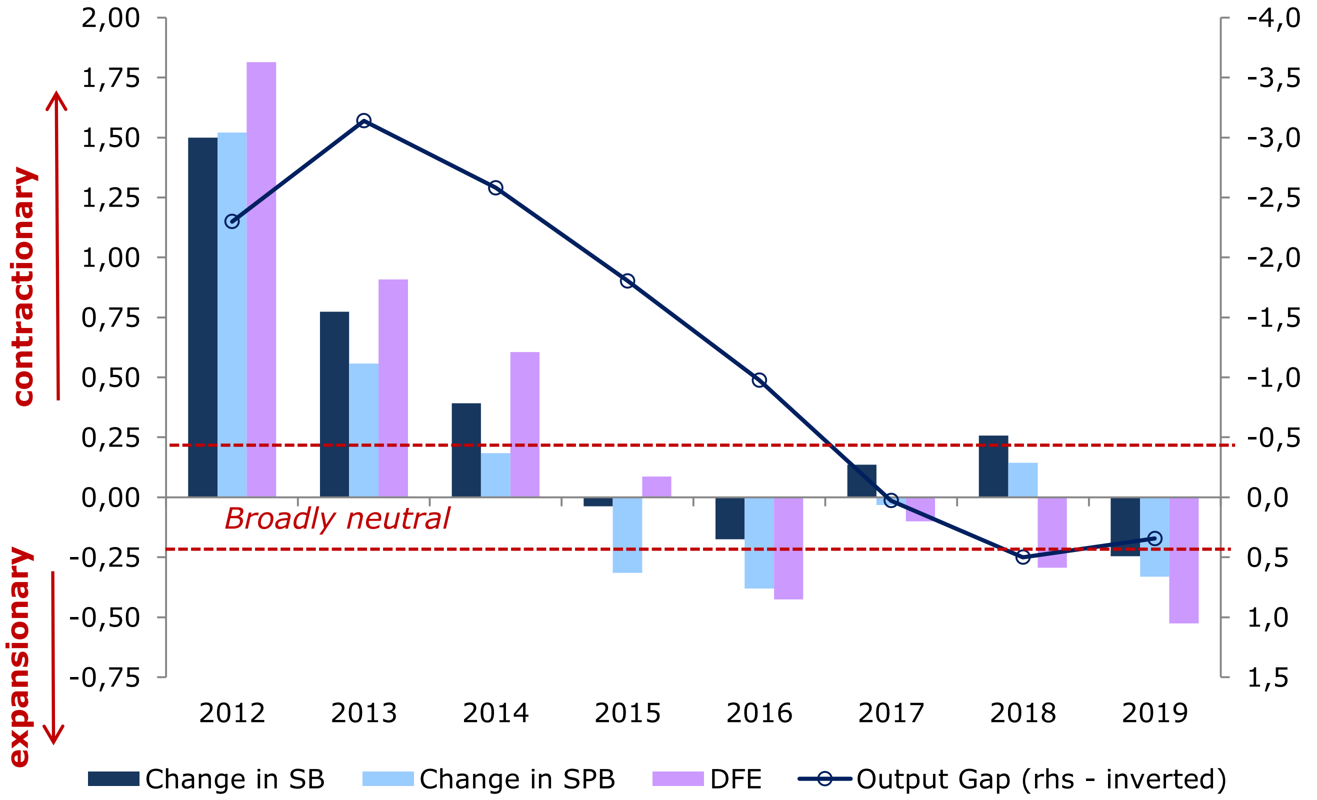
Source: Bloomberg



Sources: ECB, Bloomberg, Datastream, DG ECFIN calculations

Fiscal stance has been broadly neutral

Fiscal stance in the euro area



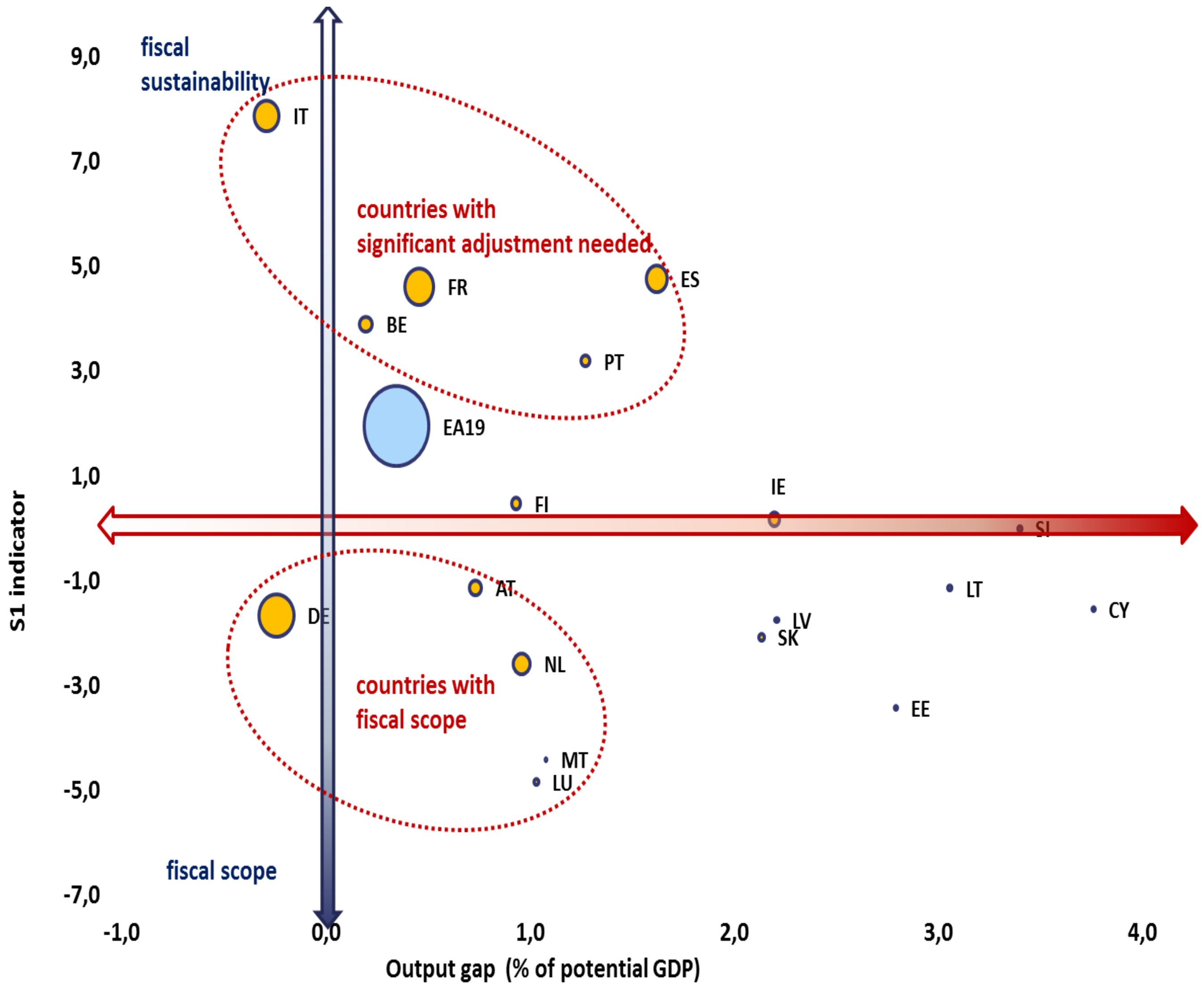
Development over years

- 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

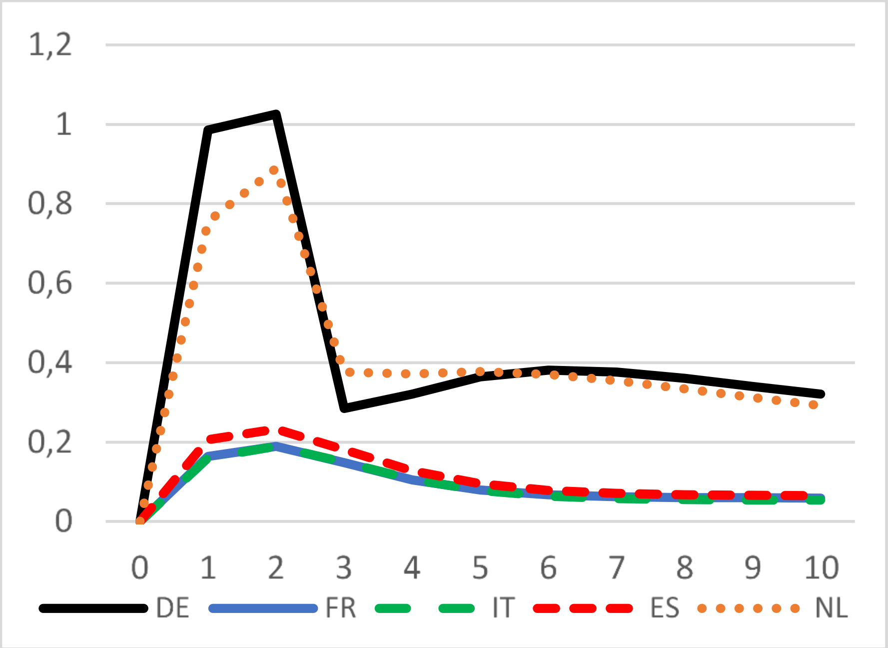


- Need for a **moderate fiscal expansion** to support ECB in fighting the slowdown
- But **differentiation across countries is key**
- Focus on **productive spending** for sustainable & green growth
- Need to convince some Member States

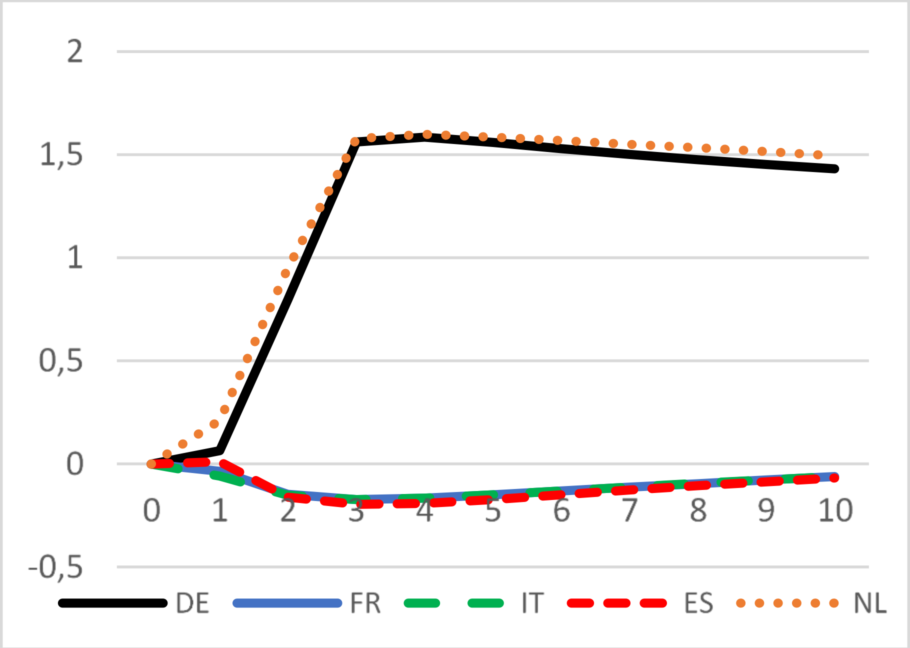
Fiscal stimulus: positive and lasting effects

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

GDP



Debt-to-GDP ratio



- r < g
- no monetary policy response for 2 years assumed (lower bound)

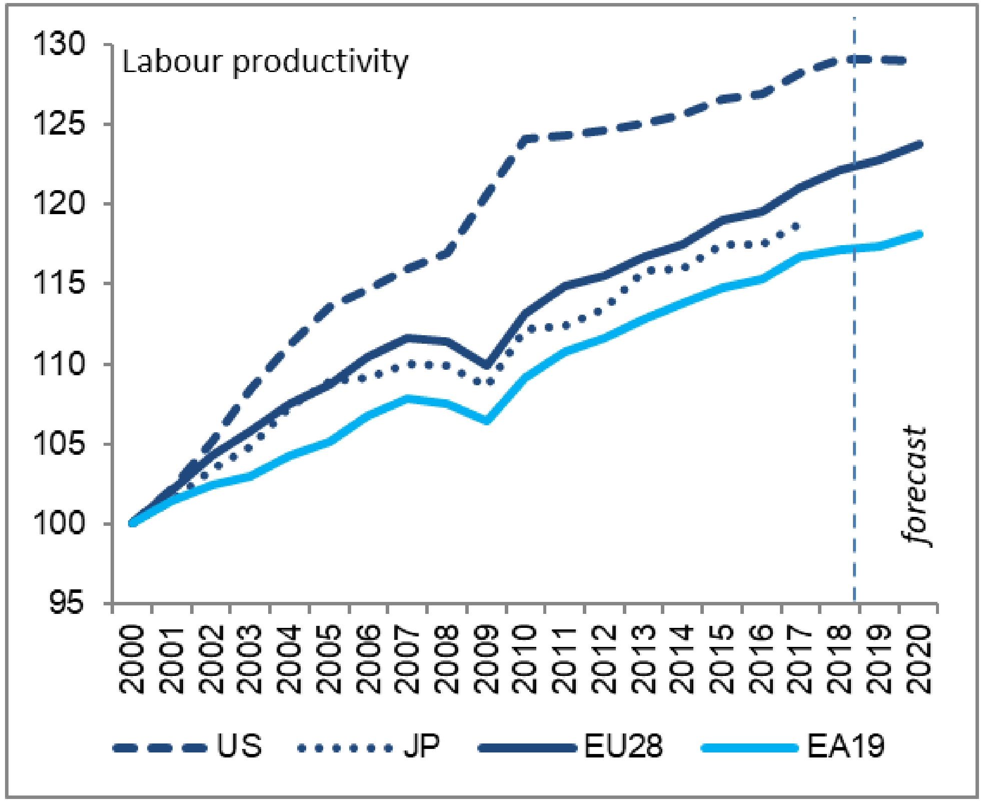
→ **Modest positive GDP spillovers** to other trading partners

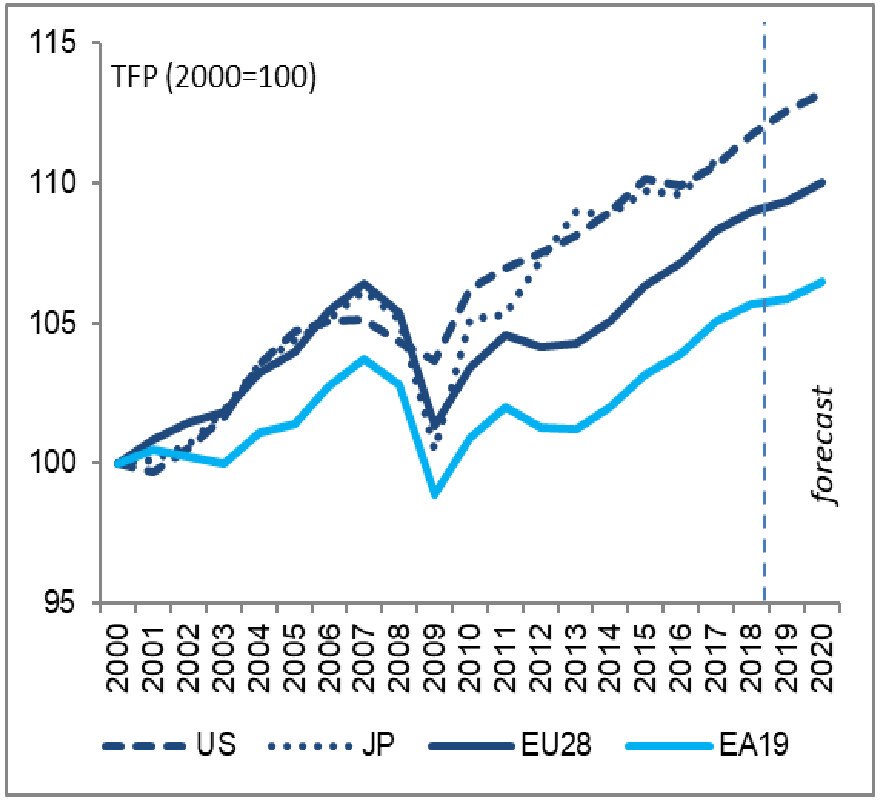
→ **Small improvement in government debt-to-GDP ratio** in trading partners

Structural challenges facing the EU economy

The productivity challenge…

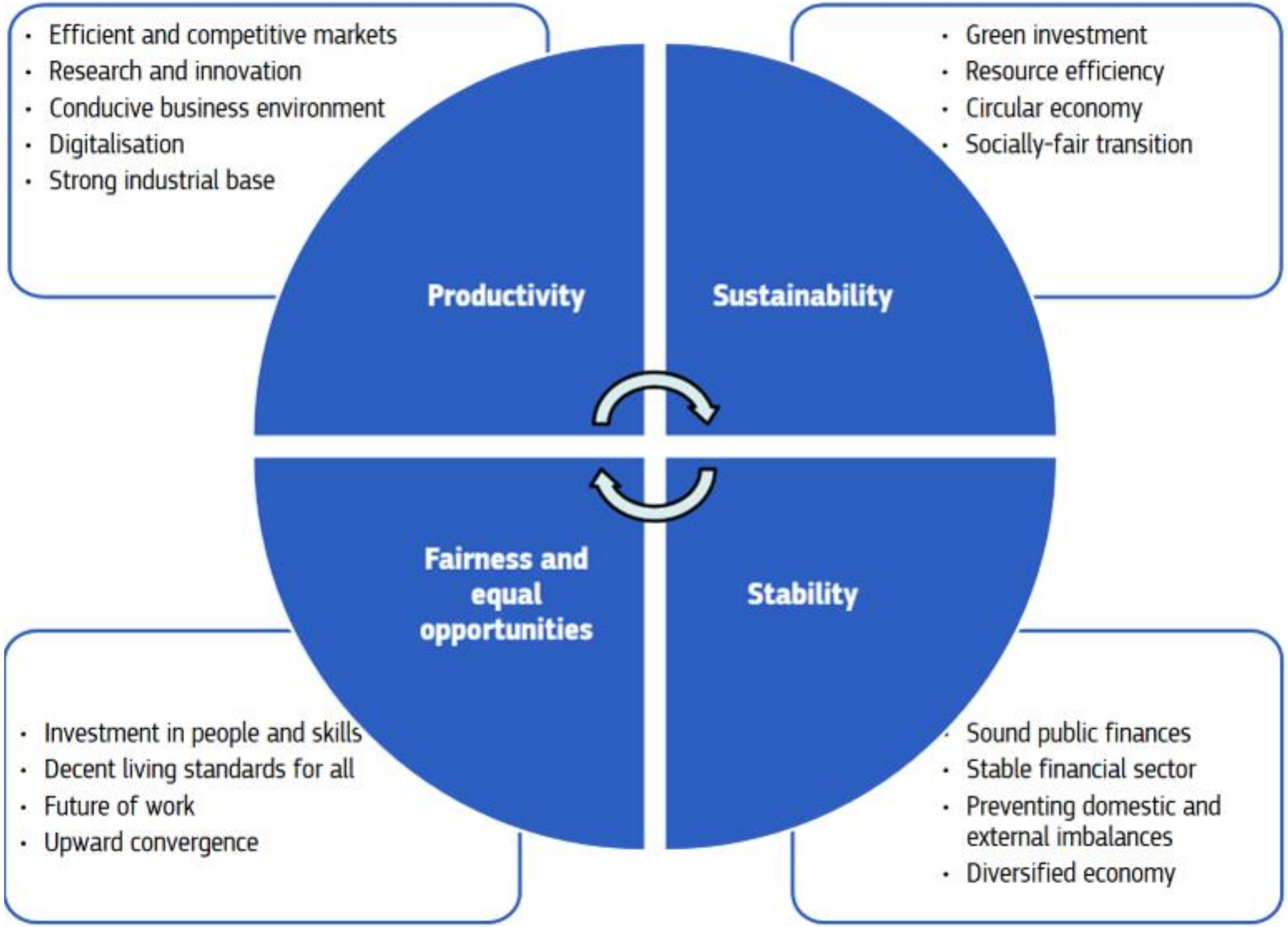
Labour productivity and TFP developments in euro area and EU28 compared to US and Japan





… and other challenges too: Climate change, Digitalisation, Inequality, Ageing

Structural policy responses



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

Monetary policy:

- Patient
- Persistent
- Prudent

a)

Fiscal policy:

- Timely
- Targeted
- Temporary?

b)

Adequate ST/LT policy mix

c)

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