Speech by

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EXIT CHALLENGES AND THE EU 2020 PROCESS

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Turning to exit strategies

The world economy appears to be on a still-fragile, but improved, recovery path. Implementation of exit strategies has begun. Needless to say that the economic downturn has been unprecedented, but it is also important to emphasise that the worst has been averted through bold policy action. Now the attention has turned to the proper policy mix to allow the nascent recovery to strengthen while avoiding risks of a double dip or fiscal instability.

Addressing financial system problems

We saw how gaps in financial regulation and poor supervision contributed to the crisis. In today's financial markets there is a clear possibility that loose monetary policies and excessive global liquidity produce, once again, asset price bubbles, sowing the seeds of future economic and financial instability. For this reason it is of utmost importance to address, as soon as possible, the fundamental weaknesses of the international financial system to prevent a repeat of past mistakes and reduce risks for the future. Regulatory tools should be used to address emerging risks independent of the overall fiscal or monetary stance or "leaning against the wind".

Early to tighten monetary policy

It would not be appropriate for me to comment on monetary policy issues. At any rate, it would be wrong to jump to the conclusion that monetary policy should be tightened immediately to address the aforementioned problems. While excess liquidity and the size of central bank balance sheets need to be reduced, the urge to respond to "speculative excesses" by raising interest rates is to be resisted in the context of a risk management framework. Milton Friedman would certainly agree that with today's low growth – or even year-on-year outright contraction – in monetary and credit aggregates in most economies (with the notable exception of China), the potential for an unexpected inflation jump is relatively small. Ample liquidity provided by central banks has not yet flowed into the real economy. However, if the recovery becomes more solid, liquidity could flow out quickly, increasing concerns about inflation risks. Striking a good balance between these two different issues is not easy, but, in my view, the risks are skewed towards the uncertain recovery.

No hurry on the fiscal side as well

Equally important would be for governments not to withdraw fiscal support too early, while, of course, keeping an eye on long-term fiscal sustainability. Policy makers need to be sufficiently sure that private demand will fill the gap once fiscal support is withdrawn. While it would be desirable to allow a gradual phasing out of sectoral incentives and temporary measures, policy support needs to be sustained for as long as it is needed.

We can draw fundamental lessons from past experiences, and not only from the Great Depression in 1929, but also from the severe downturn in 1937-38 in the United States and the more recent experience in Japan in the early 1990s. Premature tightening may easily result in unintended negative consequences for the economy.

A fresh drop into recession would be disastrous for the world economy in the current situation. This risk suggests caution in implementing exit strategies. The Council of the European Union stated in December that "it would be premature to initiate an exit from the support schemes at this point in time". The recent global recession was mainly due to excess leverage on the part of financial institutions and consumers alike in some countries. A debt recession necessarily requires a long healing process, even if there may well be a vigorous rebound in activity over the near term.

Shedding some light on the economy would help

Policy makers are walking a tightrope and a sense of balance needs to inform policy responses and their timing. There is understandable doubt regarding the ability of economists to look into the future as the deep recession was largely unexpected (although some vindication was provided by the successful policy response). Yet, shedding some light on the world to come – i.e. assessing expected cyclical and structural developments - is of paramount importance to maintain this sense of balance in policy responses and better fine tune exit strategies. The Ageing Working Group and the Output Gap Working Group, with the support of the EU Commission, as well as the OECD and the IMF, have already done a lot of work on this subject. But more needs to be done, especially by strengthening quantitative tools needed to support improved economic analysis. Any contribution in this regard from Bruegel would of course be very welcome.

Uncertainty needs to be factored in

In fact, there is a big question mark on the future path of economic growth. While it is reasonable to expect a period of above-par growth following the recent sizeable contraction, the outlook for GDP, both in terms of levels and pace of growth, remains subject to considerable uncertainty. We do not know how much damage has been done to long-term productive capacity. At the same time, we do not know if creative destruction has stimulated new responses by economic agents that may eventually lead to enhanced growth. This uncertainty needs to be factored in when deciding on exit strategies and policies to address structural issues. While we need to be bold in case of structural reforms, we need to be more cautious regarding a potential immediate stimulus withdrawal, given the uncertainty on potential growth and thus the cyclical position of our economies.

But a clear framework for exit strategies needs to be tabled anyway

Yet, economic agents and financial markets understandably call for a clear framework to anchor expectations as uncertainty on exit strategies could hamper investment decisions, the willingness of banks to extend credit and an orderly return to lower risk premia in financial markets, implying a lower cost of capital for companies. Thus, policymakers must make every effort to reduce the uncertainty that is in their direct control. In this context, effective communication of exit strategies is essential. The exit strategy should carefully combine ongoing near-term fiscal stimulus with credible plans to consolidate over the longer term.

Coordination may be beneficial

The global nature of the crisis calls for coordination of policies at global level, especially in the area of global imbalances. However, an explicit international coordination between fiscal and monetary policy on a worldwide scale is probably not feasible, and maybe not even desirable. Cyclical developments are not the same across countries and coordination may well be perceived as impinging on central banks' independence. Nonetheless, ex-ante coordination of fiscal policies within the Eurozone would likely be beneficial, given substantial macroeconomic and financial spillovers. Addressing the issue of fiscal sustainability over the long run, by allowing a gradual, but sufficiently effective, withdrawal of fiscal support, would allow monetary policy to remain accommodative for longer, thereby helping to prevent unwarranted potential strengthening of the euro exchange rate. A stronger euro would put an excessive burden on the Eurozone economy and jeopardise the current recovery. Coordination could be achieved by a "European Exit Strategy Plan", similar to the "European Economic Recovery Plan" that was introduced to respond to the crisis. Alternatively, there could be a lighter approach, with "Common Principles for a European Consolidation Plan", that would more explicitly take into account differences in the fiscal situation of individual EU countries. Some may even argue that the Stability and Growth Pact already provides the proper framework for fiscal exit. Where there are concerns over long-term fiscal sustainability, fiscal stimulus needs to be withdrawn more quickly and more emphasis should be placed on budget-neutral policies that can be beneficial to both economic activity and fiscal sustainability.

Lengthening the policy horizon

With the economy now on a recovery path, it is time to lengthen the policy horizon and refocus on long-term structural issues in terms of both employment and growth strategies and fiscal sustainability. The emphasis should be on those reform measures with limited financial impact that would complement the fiscal consolidation effort. Coupling a still-supportive fiscal stance with longer-term structural measures would put the economy on a stronger growth/lower debt-to-GDP trajectory, without resulting in premature policy tightening that would threaten the ongoing recovery.

EU 2020 to the fore

With all this is mind, Europe is preparing for a big re-launch of its employment and growth strategy–the rebranded EU 2020. The timing could not be better. This is indeed the proper moment to lengthen the policy horizon and tackle long-standing structural issues of the European economy. Here are the key issues at stake, in my view.

Key objectives

The three thematic objectives identified by the EU Commission consultation paper, i.e. creating value through knowledge, empowering people in inclusive societies and creating a competitive, connected and greener economy look adequate. Growth and employment should remain and be strengthened as the core objectives, while I would also support giving more emphasis to Green Growth and Social Cohesion in an economically sound manner. There is a need to streamline targets to a limited number of properly framed headline goals, while also spelling them out more clearly and thoroughly. National targets need to be aligned with EU-wide objectives in a transparent and agreed way, taking into account starting positions and structural differences. An agreed and reliable set of intermediate output indicators should be developed. They would form the basis for measurement of performance and comparison and support evidence-based policy making. Priorities should be spelled out more clearly and communicated in order to make policy action more effective and transparent.

Ownership and governance

The new strategy should be set and owned at the highest political level, while giving operational responsibilities to the appropriate bodies, i.e. relevant thematic Councils and Council formations. Also, there should be a greater role for the European Parliament. While a higher degree of coordination at the EU level is desirable, responsibility and ownership of the process should firmly remain at the national level, with allocation and management of resources in accordance with national priorities and subject to the constraints of national public finances. Responsibilities should be clearly allocated among policy actors.

Regional and external dimensions

The EU 2020 strategy, and especially its implementation, has a crucial regional dimension. We should consider ways in which this aspect could be included in the cohesion policy, especially with reference to the EU budget, which could be aligned better with policy priorities. This is a key issue for the success of the strategy. Moreover, the long-debated external dimension of the strategy should find a more prominent role. This would strengthen the role of the EU on the world stage.

Innovation and technological progress

Economic growth and, to a large extent, well being, depend on innovation and technological progress. Yet, not enough emphasis has been given in the past to this key driver of economic growth. Rather than focusing on input measures, such as R&D expenditure, more importance should be placed on output measures and framework conditions that are conducive to innovation and technological progress. Moreover, the strategy should strengthen market integration and enhance competition, especially in key productivity-enhancing industries and services.

EU 2020 vs. SGP

The role of multilateral surveillance on EU 2020 and its interplay with the Stability and Growth Pact need to be strengthened. While stronger governance is highly desirable, given the aim of making the process more effective, there are concerns that mixing up two different instruments may end up weakening both processes. These concerns need to be properly addressed.

Conclusions

To sum up, policy makers should design a policy mix that combines a cautious withdrawal of policy stimulus with structural reforms, with a view to reducing risks, and strengthening fiscal sustainability and the potential growth of the economy.