MEF Dipartimento del Tesoro

The Right Incentives for Growth

Is there a way to combine the Fiscal Compact with flexibility for reforms?

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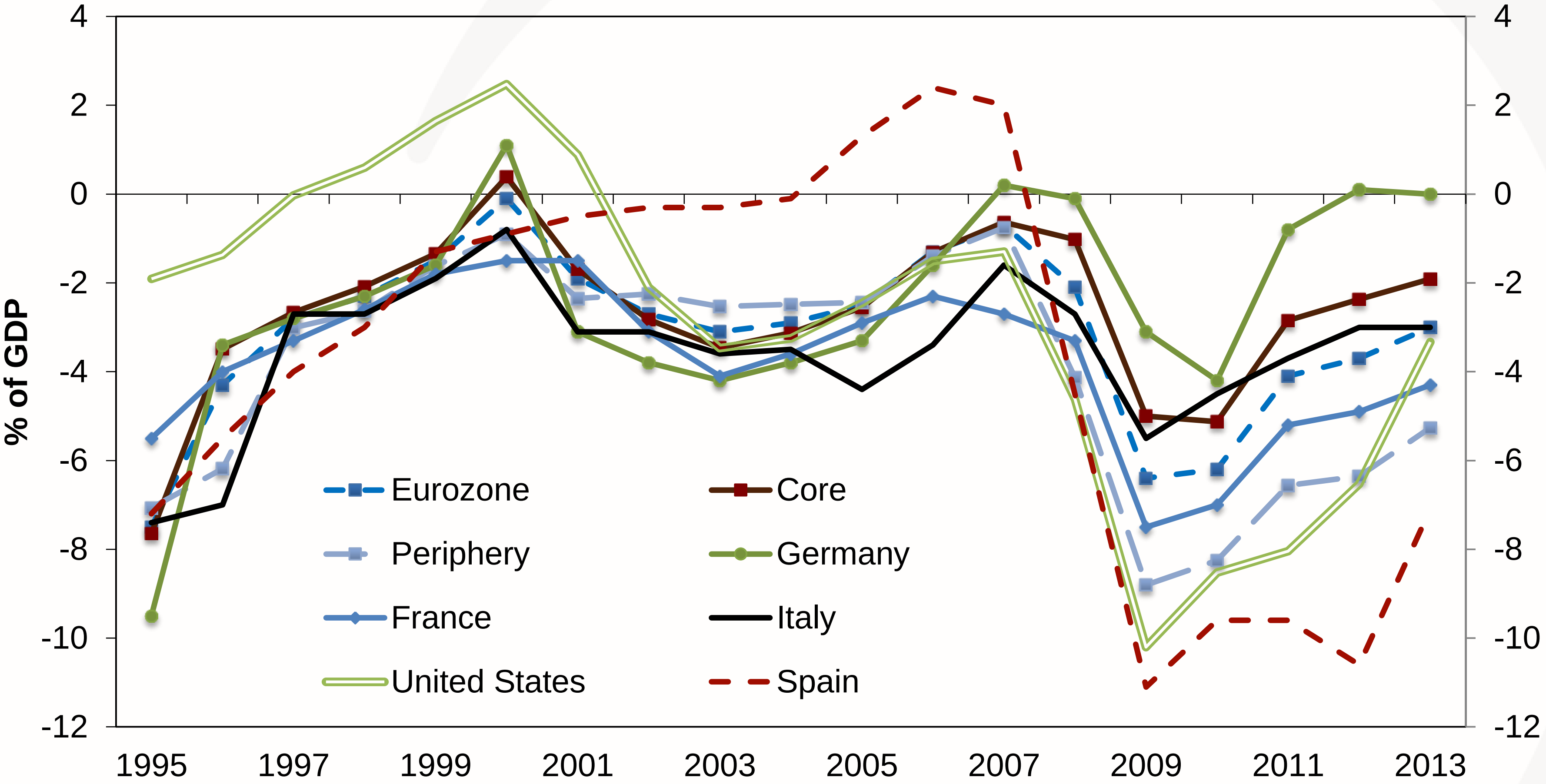
On the way to recovery?

- Many Euro area (EA) countries fell into triple dip in 2Q14: what is at the root of ongoing poor **economic performance**? Is **secular stagnation** for real? Can we reverse it in the EA?
- Can we have **growth-friendly fiscal consolidation**? How much/how quick should be public/private sector **deleveraging**?
- **ECB** commitment to address adverse shocks is in place and more stimulus measures are under way: is it going to be enough? Is the current policy mix the correct stance for the EA?
- What can be done to strengthen **supply-side reforms**? Is there a way to combine the Fiscal Compact with **flexibility for reforms**?

Have policies worked out 6 years into the crisis?

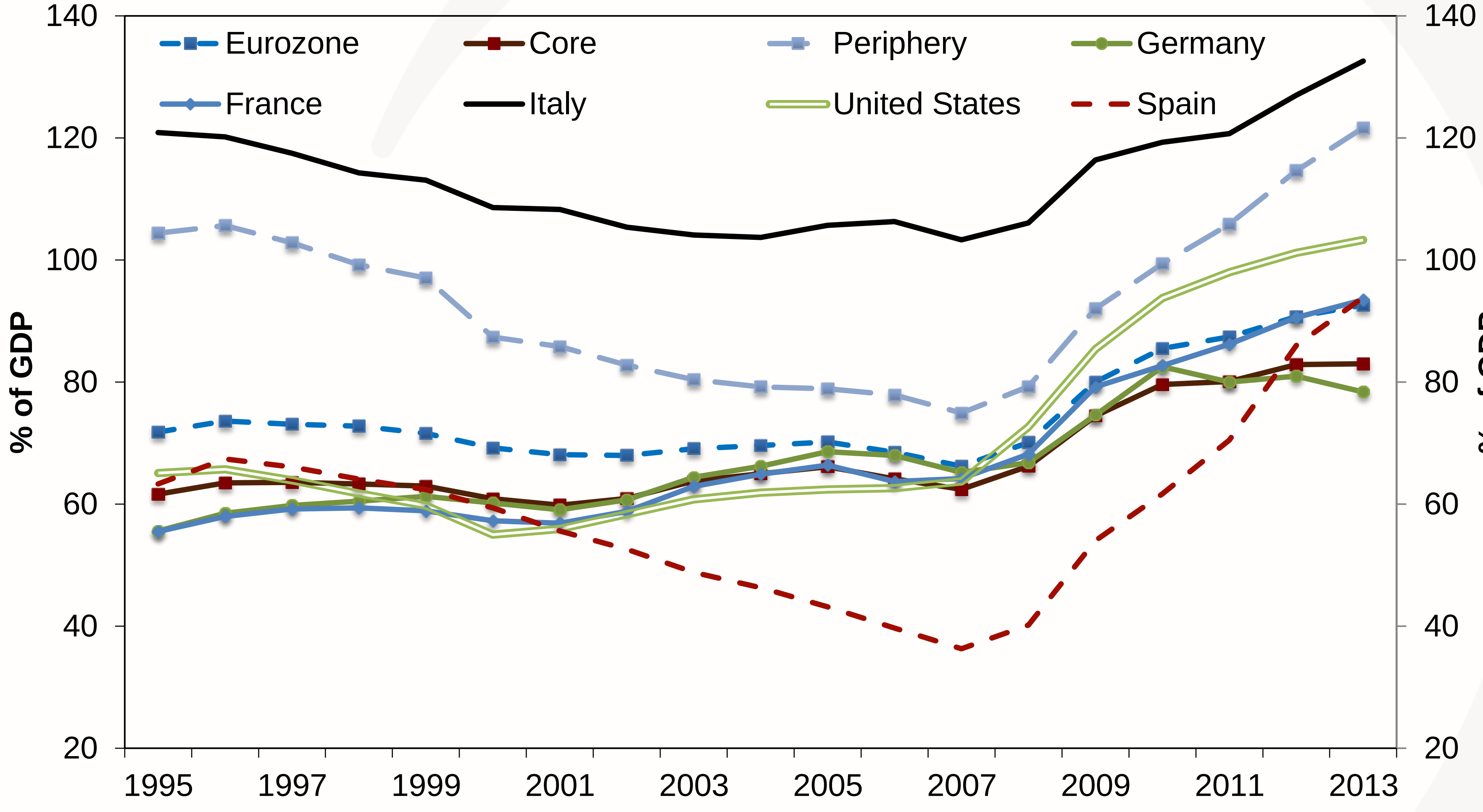
- Weakness in **investment activity**.
- Steady decline in **potential growth** almost everywhere.
- High **unemployment**, especially among the youth.
- Need to absorb **macroeconomic imbalances**.
- Increased **poverty** and reversal of progress towards **social inclusion** processes, with potential **political risks**.
- Continuing **disinflation** (and risks of de-anchoring expectations and triggering deflation).
- Euro strengthening and rising EA **current account surpluses**.

Additional fiscal consolidation is unavoidable



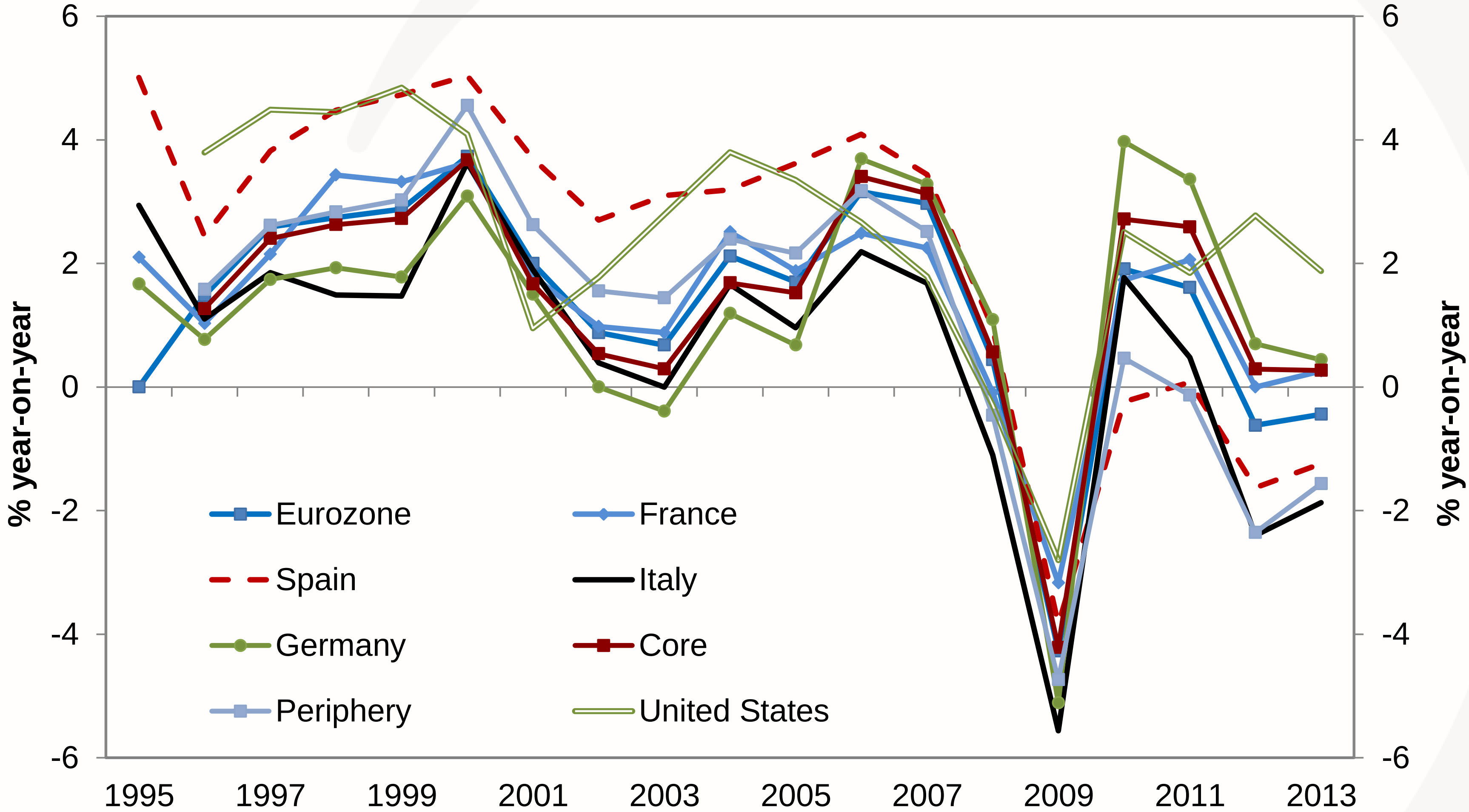
Note: Deficit data for Greece, included in Periphery, are not available for the period 1995-1999.
Source: Eurostat, US Department of the Treasury, Bureau of Economic Analysis

Public debt deleveraging has yet to start



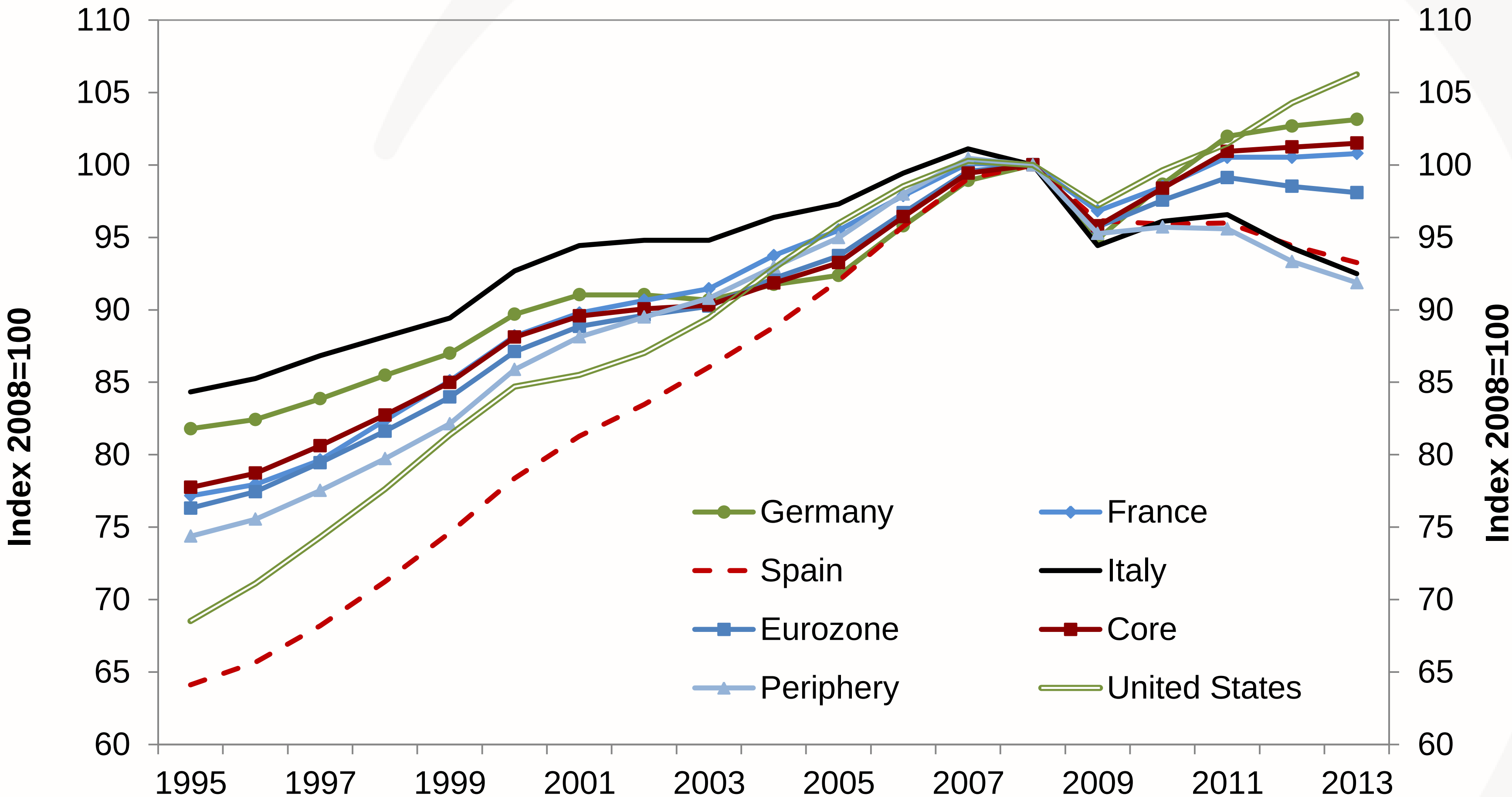
Source: Eurostat, US Department of the Treasury, Bureau of Economic Analysis

Is GDP growth going back to its pre-crisis potential?



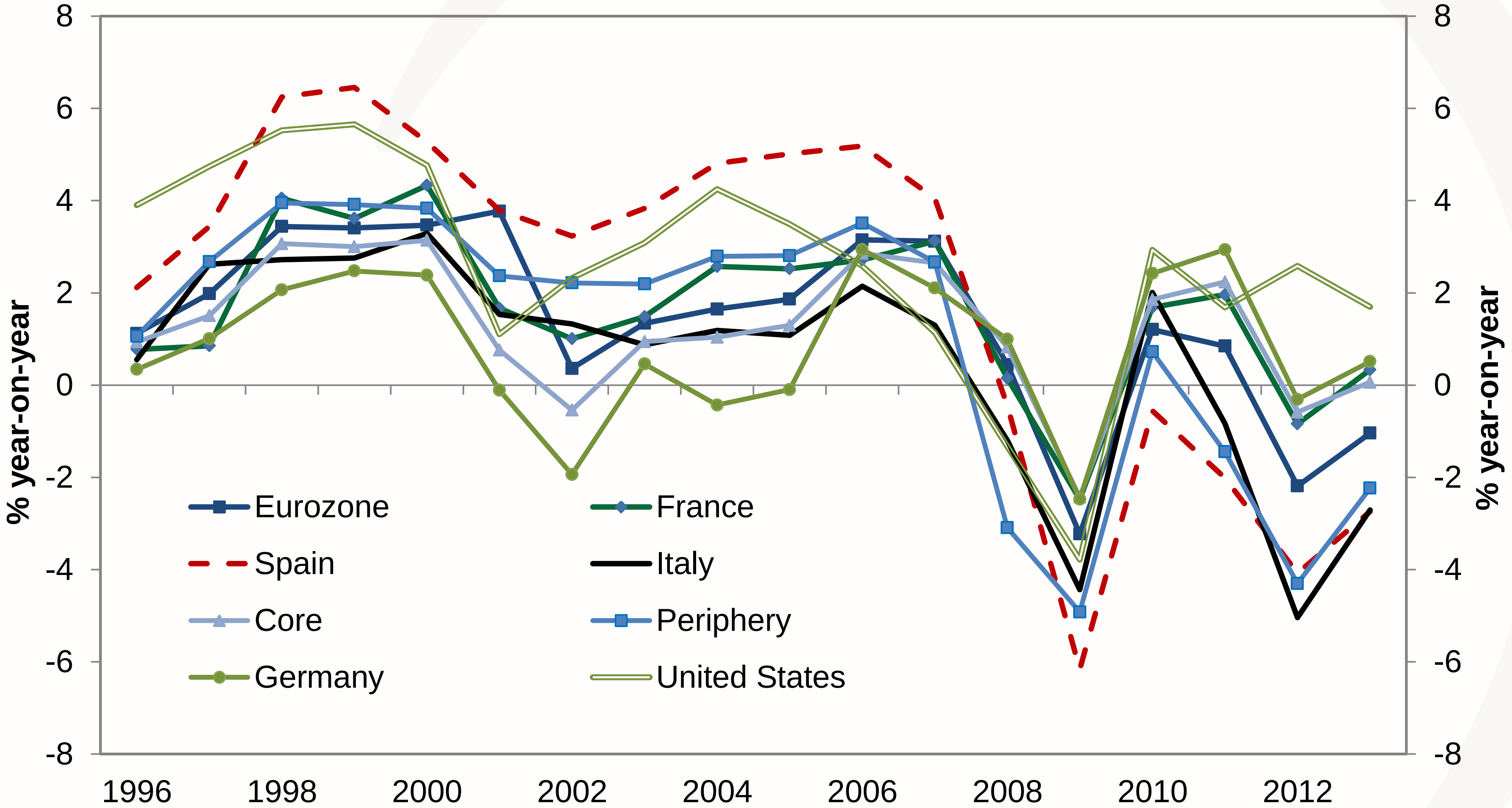
Source: Eurostat, BEA

Are GDP level losses going to be recovered?



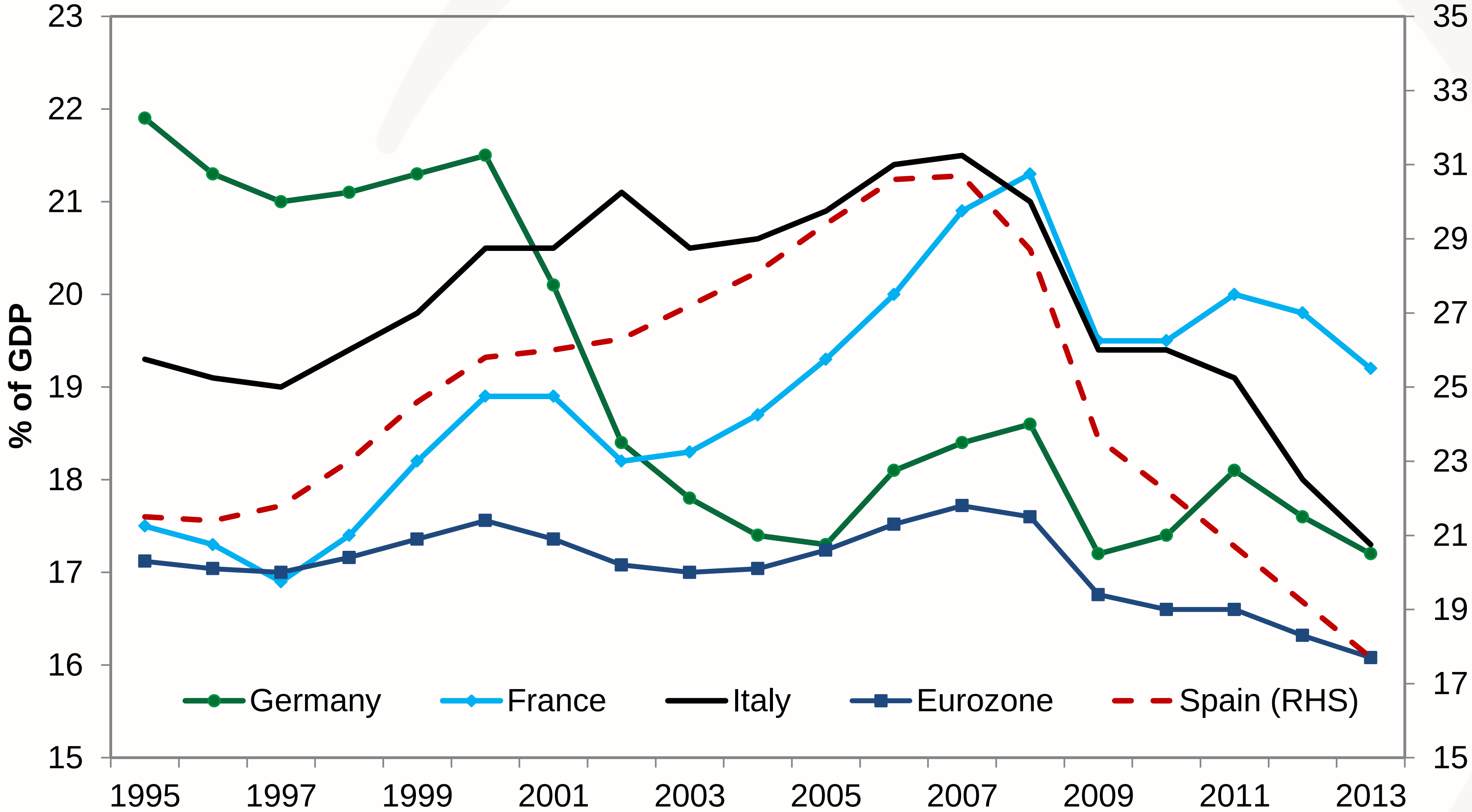
Source: Eurostat, BEA

Domestic demand improving slowly even in core EA countries



Source: Eurostat,Oxford Economics

Investments for growth: the challenge to reverse current trends



Source: Eurostat

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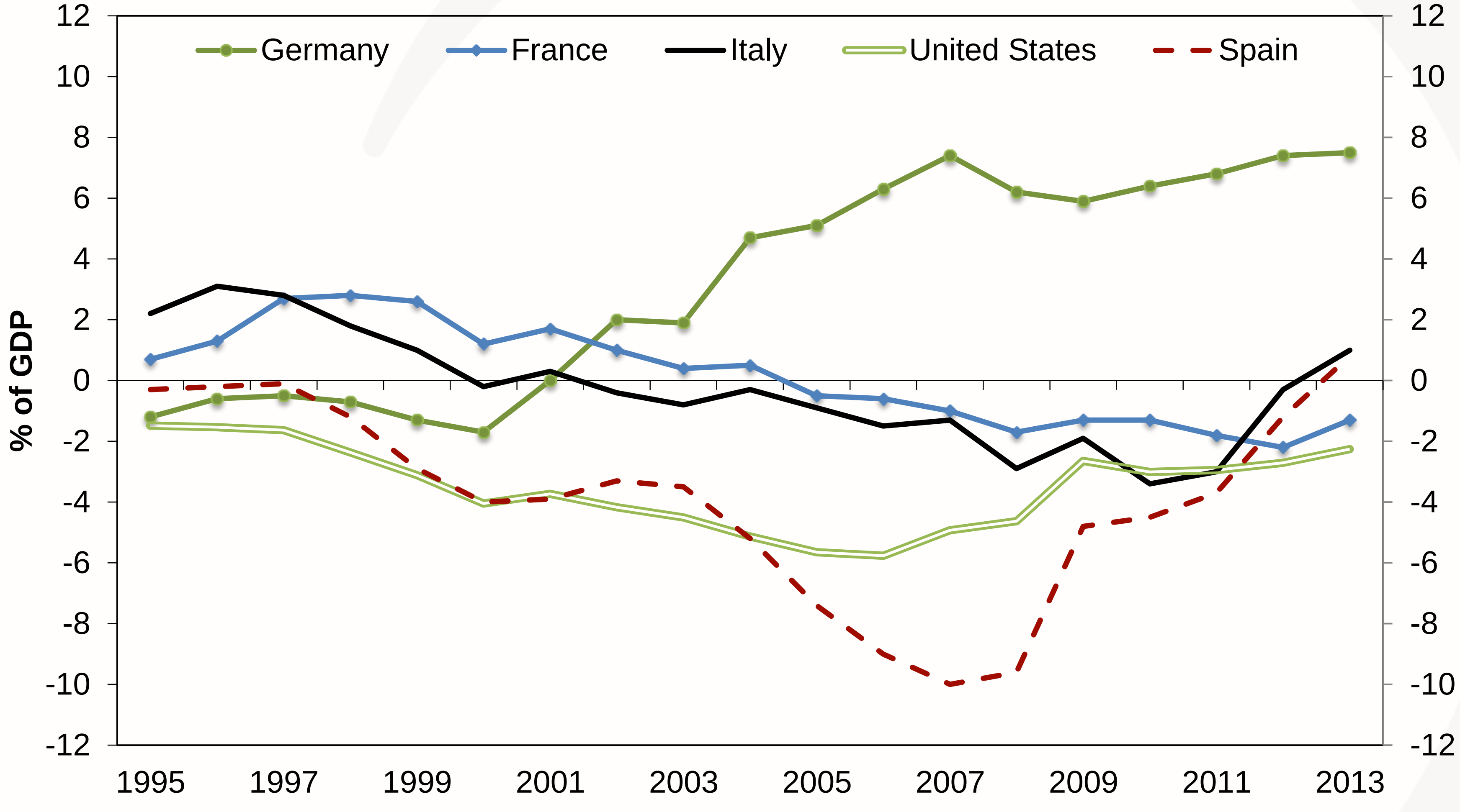
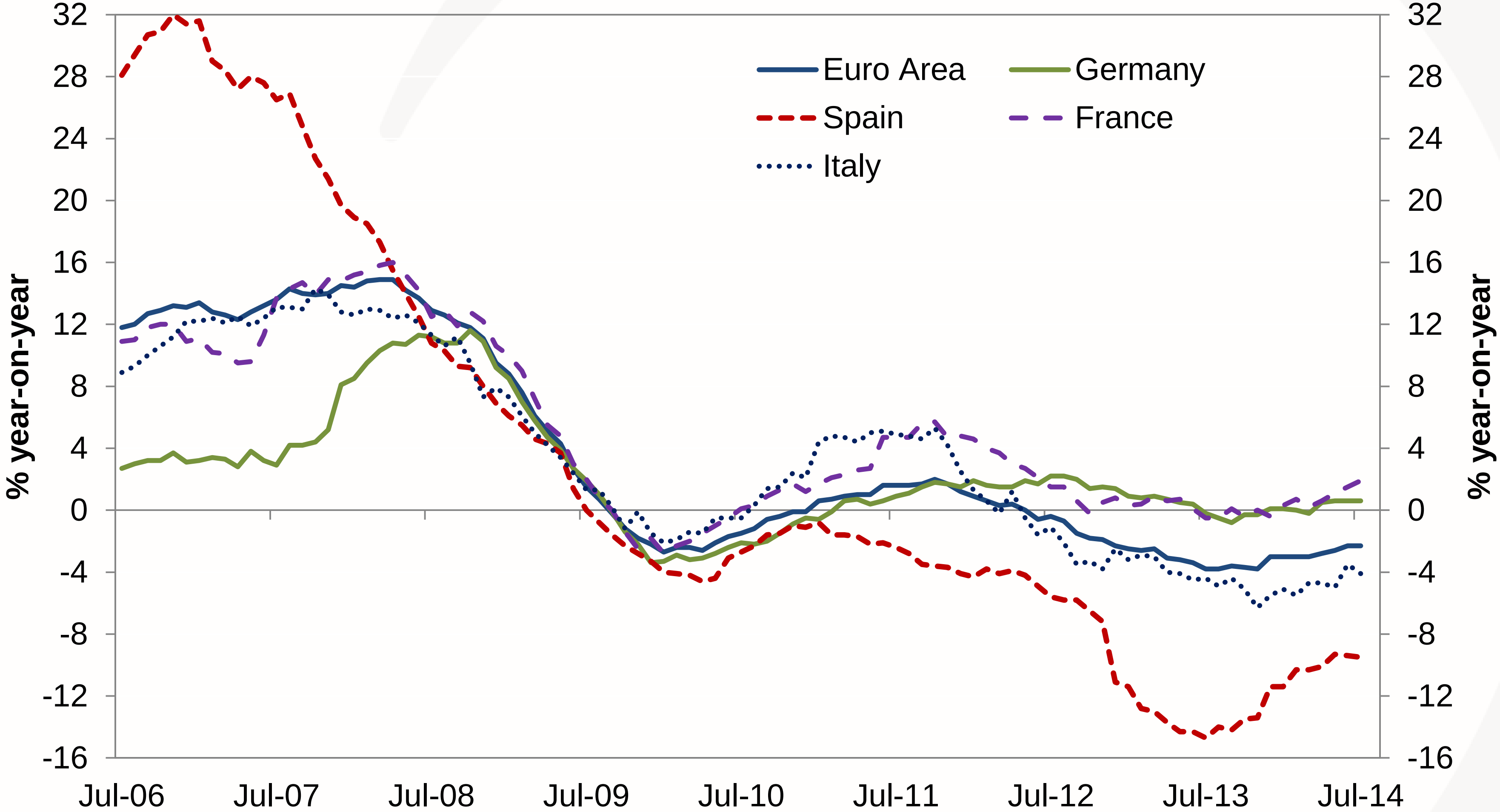
Policy mix leading to current account surpluses



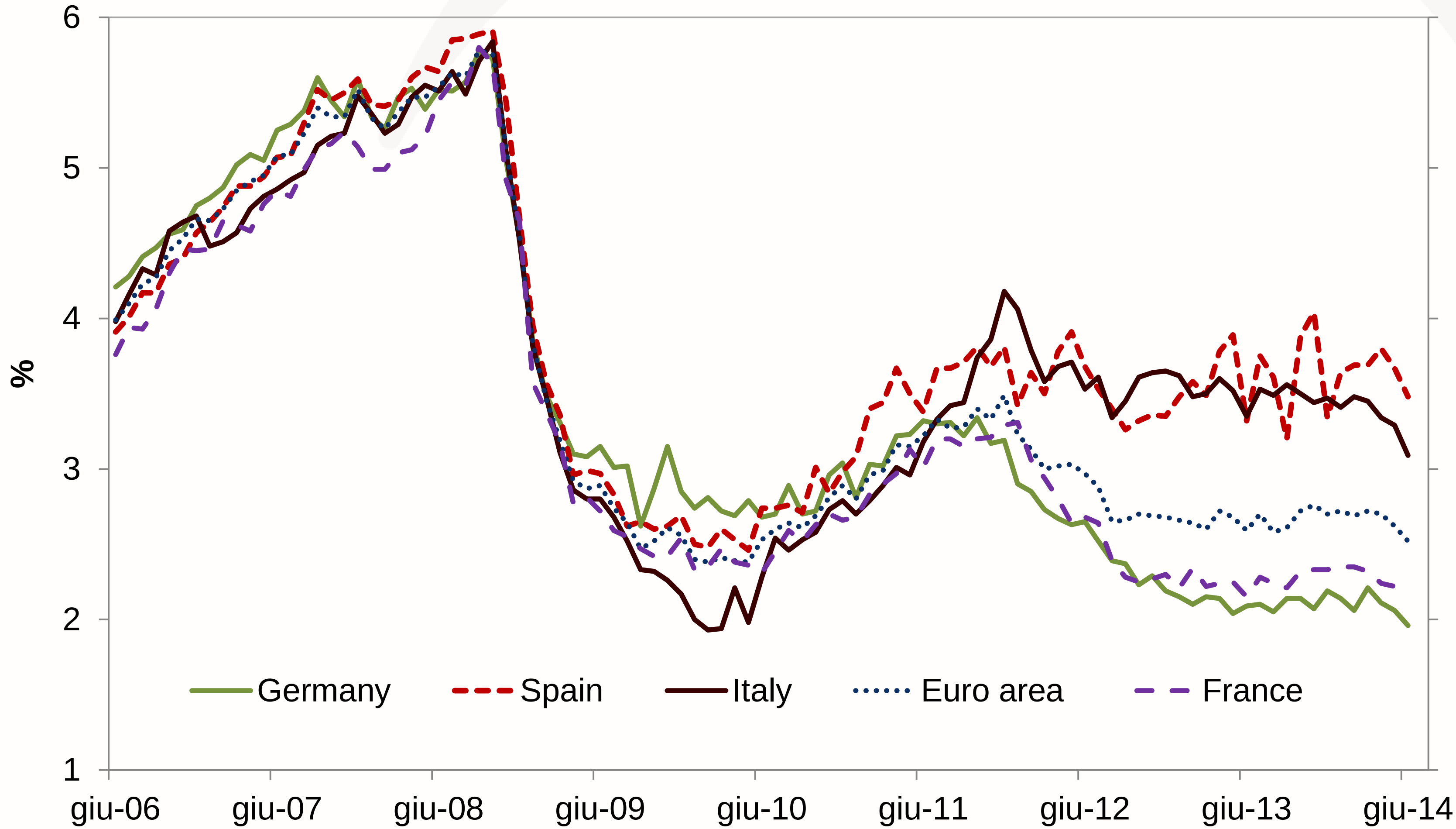
Source: Eurostat, ECB, IMF.

Contraction in credit: still no turning point



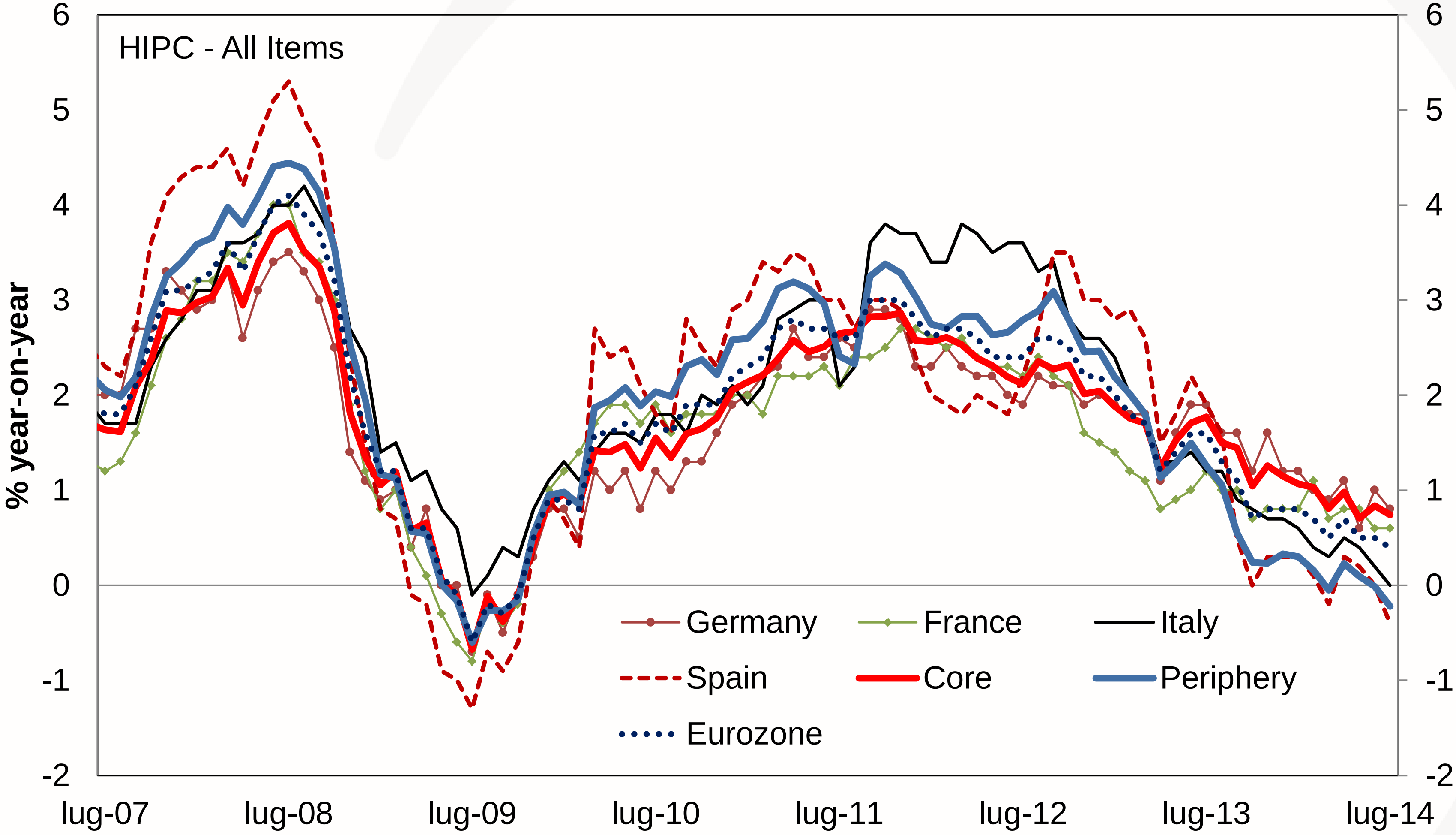
Source: ECB

Cost of credit: the gap among EA countries remains wide



Source: ECB

Disinflation continues (with non-negligible risk of deflation)



Source: ECB

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Supply-side economics is not enough

- **Debt recession**: need for private and public sector **deleveraging and balance sheet repair**. As a result, deeper recession and swallow recovery.
- Structural problems are at the root of the EA crisis: **structural reforms** must be the answer, combined with private and public investment programmes (link between supply and demand).
- But it is not enough over the near term. Need for a **better policy mix** to maintain decent growth in **aggregate demand, i.e. more forceful monetary action and fine tuning/flexibility in the fiscal consolidation efforts.**
- **Then … fiscal incentives for pro-growth reforms.**

Europe 2020 Strategy: an assessment

- In the March 2014 Communication "Taking Stock of Europe 2020", the EC notes the **"mixed progress"** in achieving the goals of Europe 2020.
- Protracted economic crisis has played a major role in hampering progress towards the Europe 2020 targets.
- Expected failure to reach the **employment, poverty and social exclusion** targets, decreasing resources dedicated to **research and innovation**.
- Only the **climate change and energy** targets likely to be reached given current efforts (partly because of lower economic activity).

Europe 2020 Strategy: need for a new governance

- **Methods and approach** to structural reforms relatively unchanged since the Lisbon strategy.
- **Incentives** for Member States have in some cases weakened.
- **Governance and means** for achieving the objectives not sufficient. Not enough attention to **positive spillovers**.
- Important potential drivers of growth and employment – notably **deepening of the Single Market, greater integration of Financial Markets, and Greening Growth** – not incorporated in the Strategy.
- Countries need to give up **sovereignty** on reforms.

Single Market + Finance for Growth: exploit unused potentials

- **EU Single Market:** significant benefits from deeper integration (Single Digital Market; Transport and Energy Networks; Professional and other services).
- Making product markets and services more **open and interconnected** would boost growth and facilitate greater integration of EU industries in global value chains.
- Need to eliminate **financial market fragmentation** and create favourable conditions for **long-term investments**.
- Increase efforts for the further development of non-bank finance and for ensuring availability of credit to firms, especially SMEs.

A new paradigm

- The pre-crisis paradigm was **unsustainable** economically, socially and environmentally. Recovery **must not be a return to pre-crisis normality**.
- Recovery must foster new sources of growth and competitiveness, based on knowledge-intensive activities and economic integration.
- The no-brainer solution: **further integration. Policymakers must take the lead.**
- **… but also proper incentives.**

Does it make sense to allow flexibility for structural reforms?

- Structural reforms increase **potential growth** over the medium-long run and thus lower the **structural part of the deficit**.
- Structural reforms often imply either near-term recessionary effects or need to compensate losers with impact on public accounts.
- If we agree that what really matters is **long-term sustainability of debt** (as opposed to deficits, CAB etc.), then supporting reforms makes sense also from a fiscal point of view.
- Otherwise risk of providing the **wrong incentives** to policymakers: if you do fiscal consolidation you are fine, if you do structural reforms you are punished.

IMF Art.IV EA: The SGP may reduce incentives for growth

- **"The SGP may reduce incentives to foster long-term growth:** Two issues features prominently in current discussions. The first is that the SGP may limit the space to finance structural reforms that entail sizeable short-term budgetary costs. Although the 2005 reform explicitly recognized that these costs should be accompanied, the present framework has so far only been applied to some types of pension reforms. Going beyond pension reforms is proving contentious. A second question is whether the MTO and, to a lesser extent, the 3 percent deficit cap, discourages public investment by limiting the capacity to borrow to fund projects that increase long-term growth potential."

How to measure structural reforms?

- Already a large body of **economic literature**. Methods to assess how much reforms add to economic growth over time.
- Work of the LIME WG attached top EPC and plenty of papers by the Commission.
- **Surveillance of structural reforms is already deep enough** to allow an evidence-based decision on flexibility for reforms.

Best policy for an indebted country in a severe recession?

- Balancing public finance objectives, support to the economy, respect of fiscal rules, and need to maintain credibility in financial markets.
- Structural reforms to boost confidence and change expectations of economic agents and investors.
- No magic wand! We live in exceptional times that need flexibility and less ruled-based assessments. We should not lose sight that the **ultimate goal must be economic growth and prosperity**.

IMF Art.IV EA: Rules are too complex and inconsistent

- Reforms of the SGP "have made the system increasingly complicated, creating risks of overlap and inconsistency between rules, as well as difficulties in public communication. […] Staff advised examining the complexity of the framework over the medium term, and looking into the possibility of reducing the number of rules (e.g., by **consolidating the preventive and corrective arms of the SGP and possibly focusing on some measure of the structural balance as the single operational target**)."
- Tradeoff between simplicity and "intelligence". Need to find simple ways to provide incentives for growth while maintaining fiscal sustainability.

What's the way out?

- During the crisis, policies focused on responding to short-term financial and fiscal challenges. Need for more integrated **common and country-specific structural policies to support long-term growth, employment and social cohesion.**
- EU Member States are engaged in **fiscal consolidation** and efforts to reduce **macroeconomic imbalances**, which inevitably have near-term negative effects on demand**: need for fine-tuning and flexibility linked to structural reforms.**
- The **transmission mechanism of monetary policy** is still not working properly. Recent measures seem to have limited positive effects. Need to bring **inflation back to target soon. Too much burden on the ECB…**

EA: a new policy approach for growth

- Need for a **better governance** of structural policies in the EA with better incentives and closer surveillance.
- Continuing **fiscal consolidation**, where possible at a pace consistent with decent growth in domestic demand.
- Strengthening integration in **financial and credit markets**, deepening of the **Single Market** and speeding-up **labour and product market reforms** to support growth and employment.
- Reviewing the **policy mix** to maintain anchored **inflation** expectations and avoid strengthening **external accounts**.