



MACROECONOMIC POLICIES IN EUROPE: QUO VADIS ?

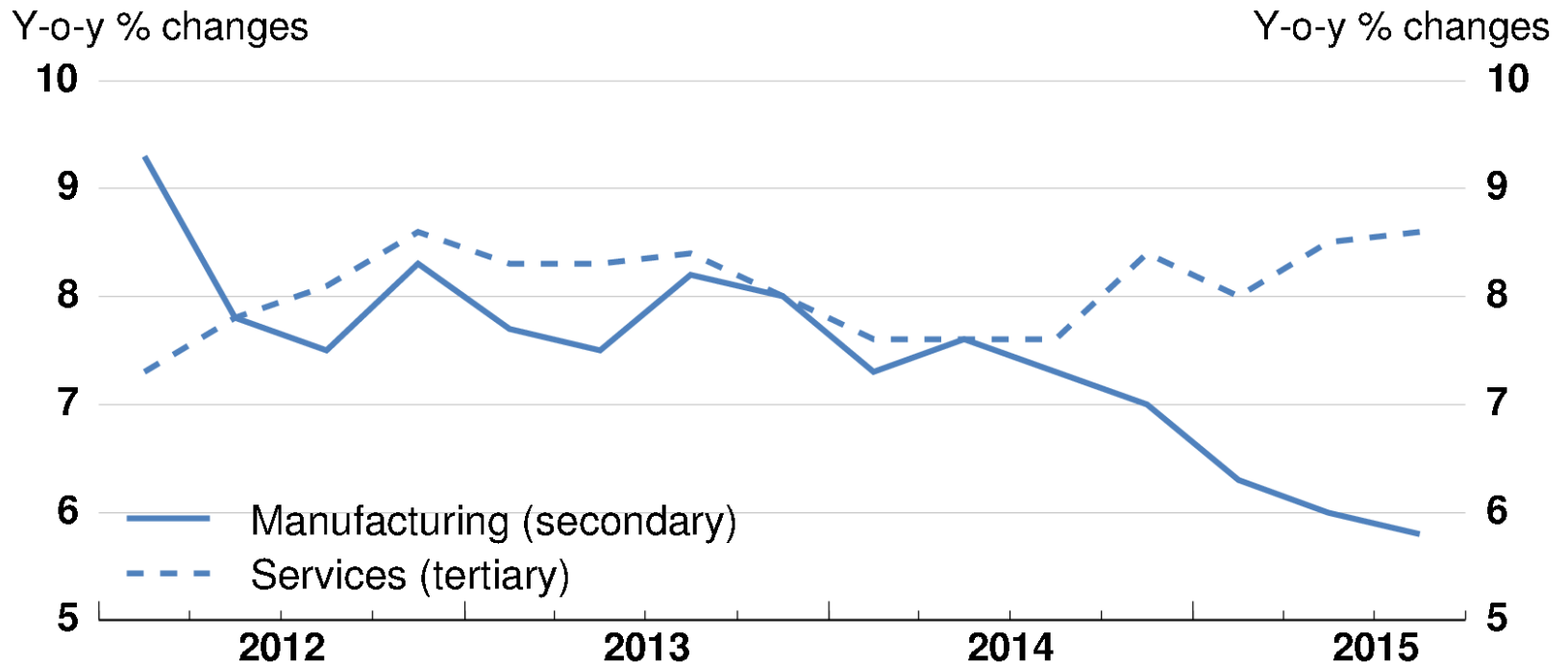
Christian KASTROP
Director, Policy Studies Branch
Economics Department, OECD

Joint Vienna Institute, Friday 12th February 2016



Rebalancing is happening in China

Macro forecasts - World

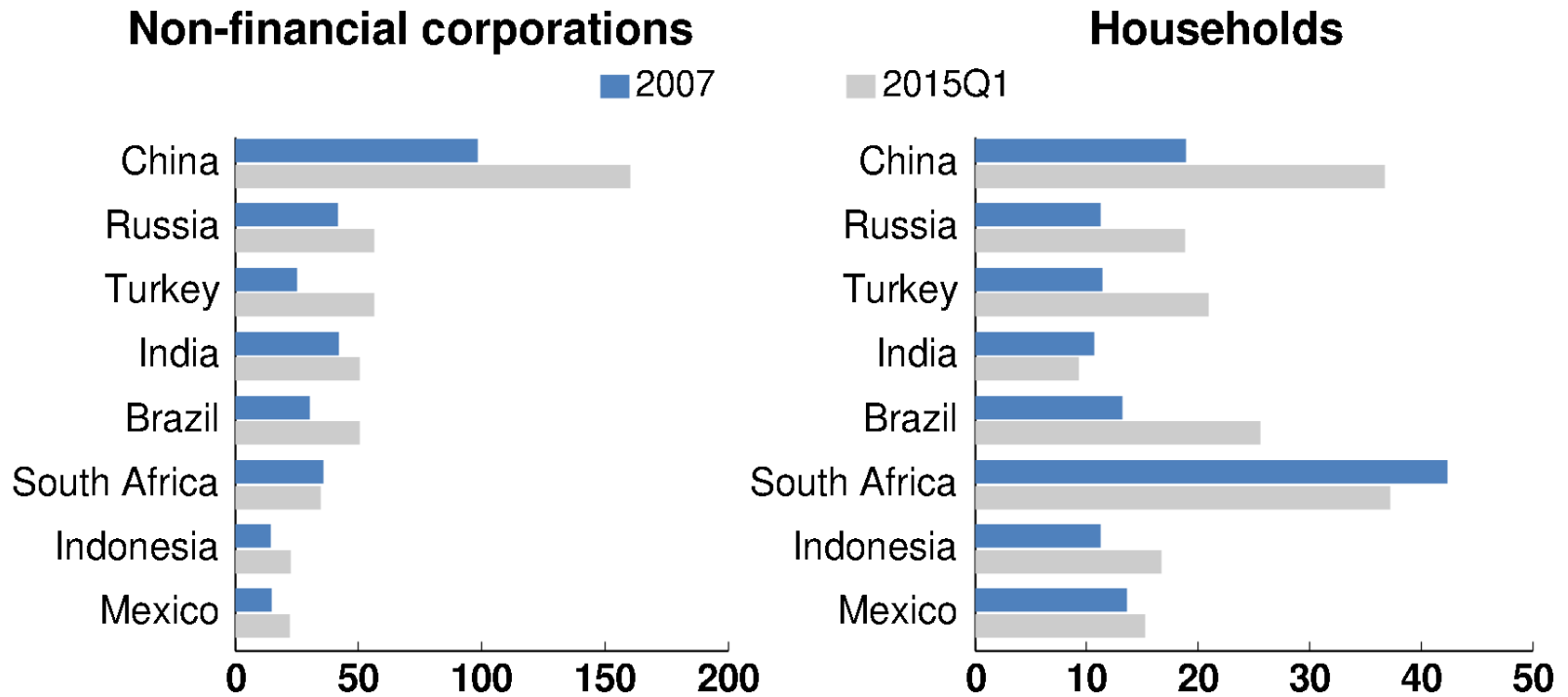


Source: OECD Economic Outlook.



Financial exposures have increased in EMEs

Increase in debt levels
End- period stock, % of GDP

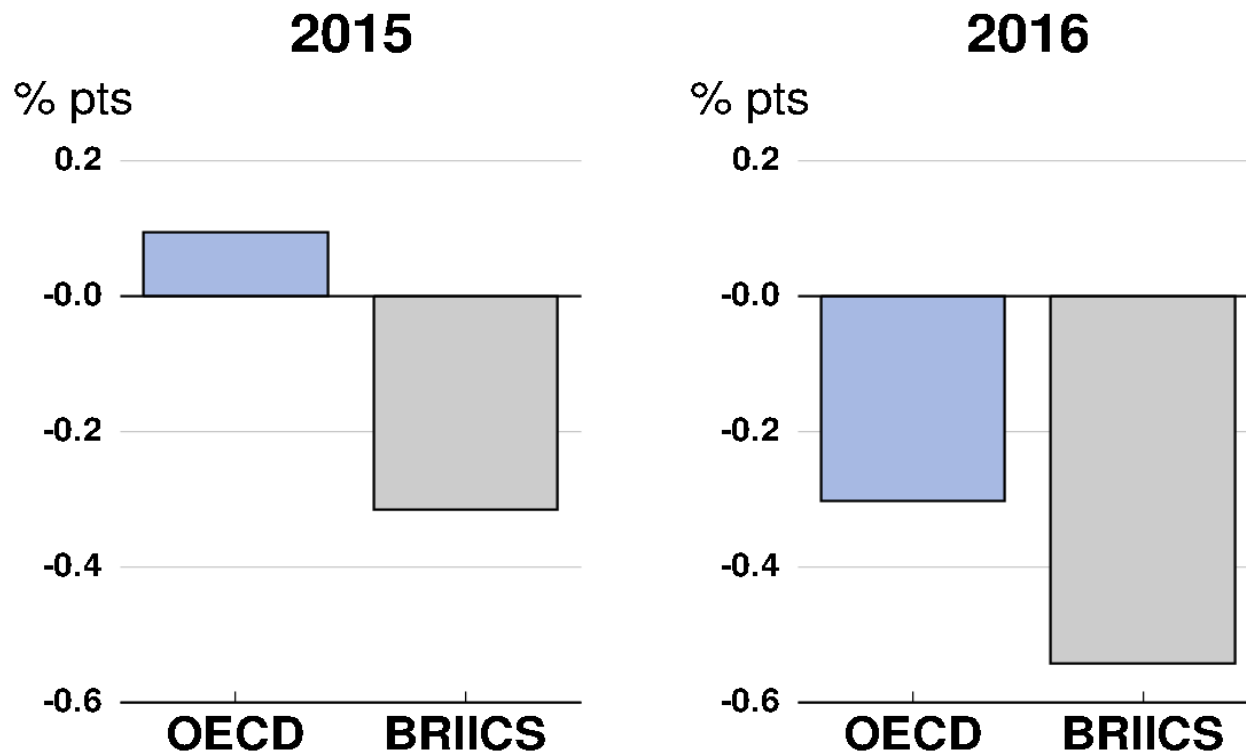


Source: OECD Economic Outlook.



Advanced economies have been resilient

Revisions to OECD Economic Outlook projections between June and November 2015

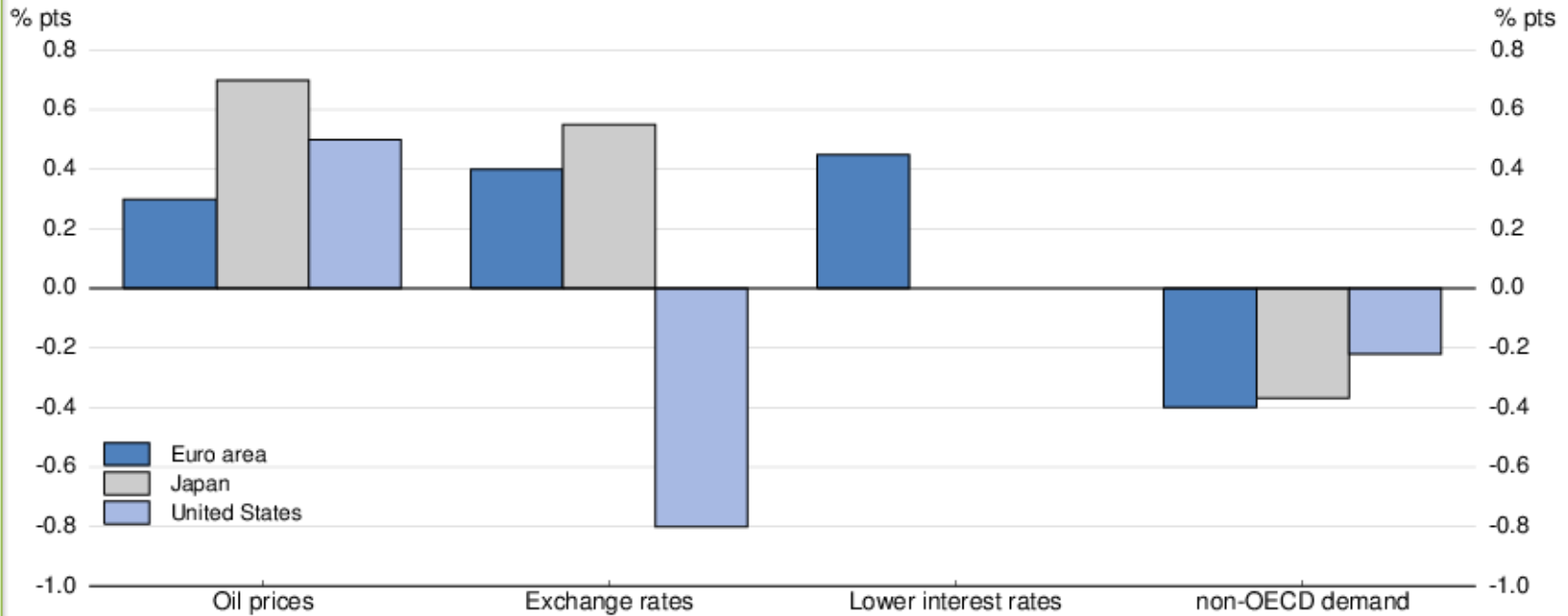




But there were growth shortfalls in the euro area

The estimated impact on GDP growth in 2015 of changes in forces acting since June 2014

Difference from baseline, percentage points

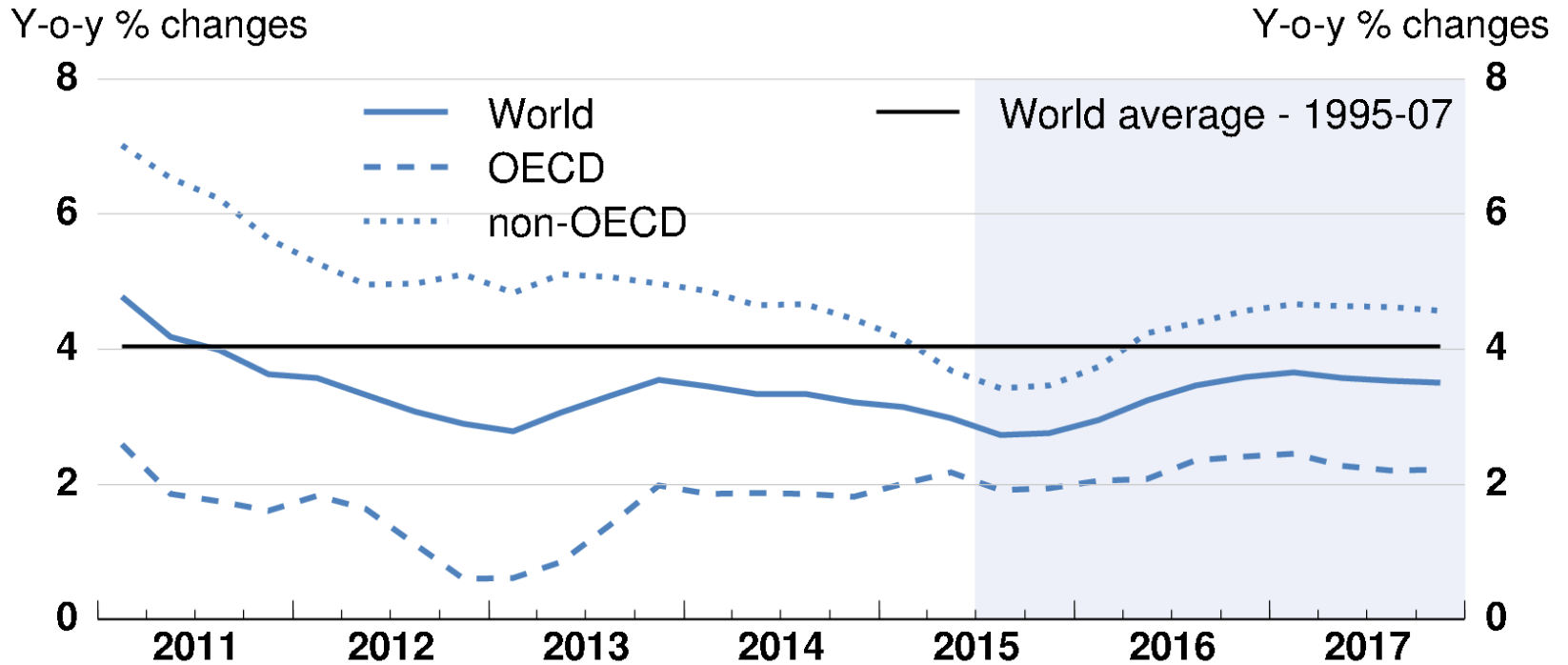




Growth is expected to softly recover

Macro forecasts - World

Global GDP growth



Source: OECD Economic Outlook.



The recovery in the euro area would be mild

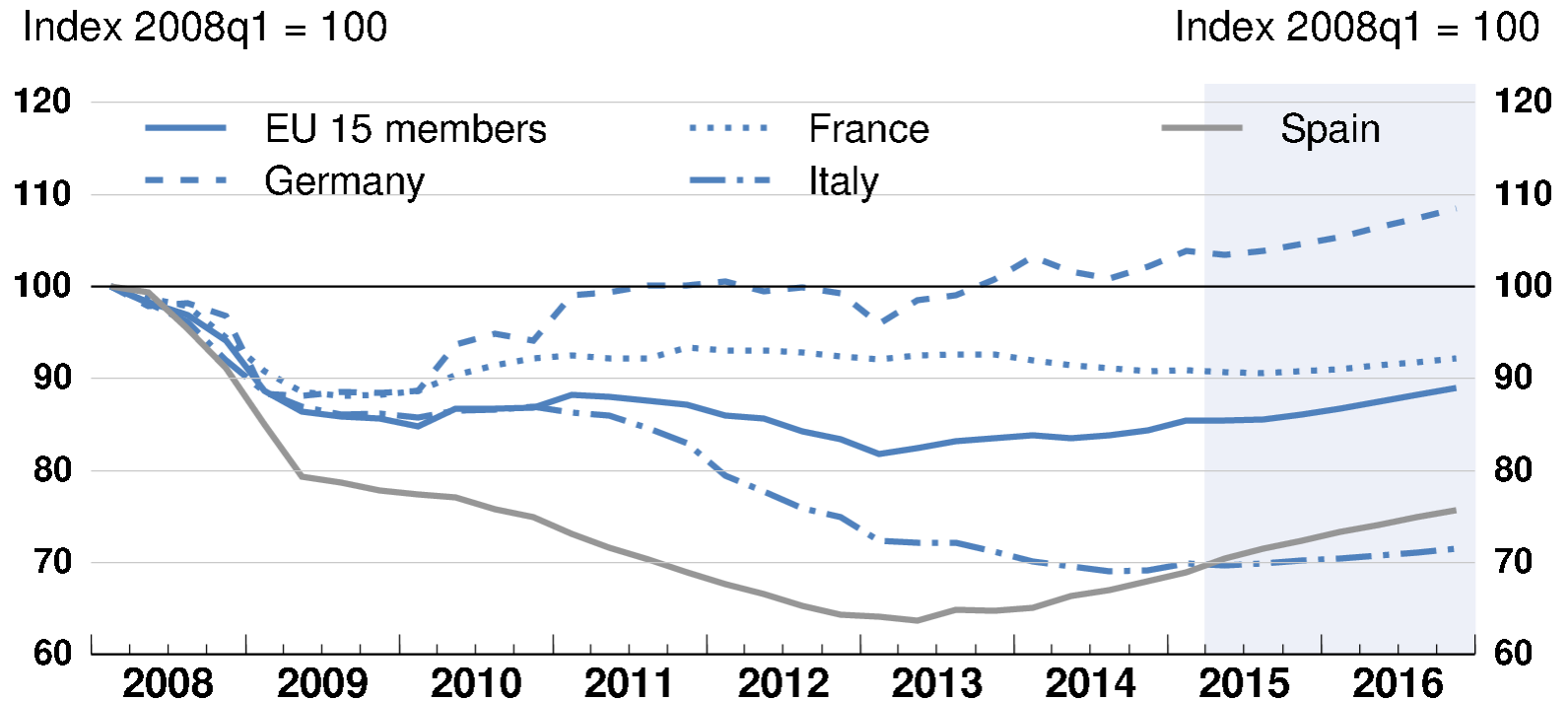
Real GDP growth
Percentage change

	2014	2015	2016	2017
World	3.3	2.9	3.3	3.6
United States	2.4	2.4	2.5	2.4
Euro area	0.9	1.5	1.8	1.9
Japan	-0.1	0.6	0.9	0.5
China	7.3	6.7	6.5	6.2
India	7.3	7.2	7.3	7.4
Brazil	0.2	-3.1	-1.2	1.8



Investment is expected to pick up, but to a varying degree

Total investment

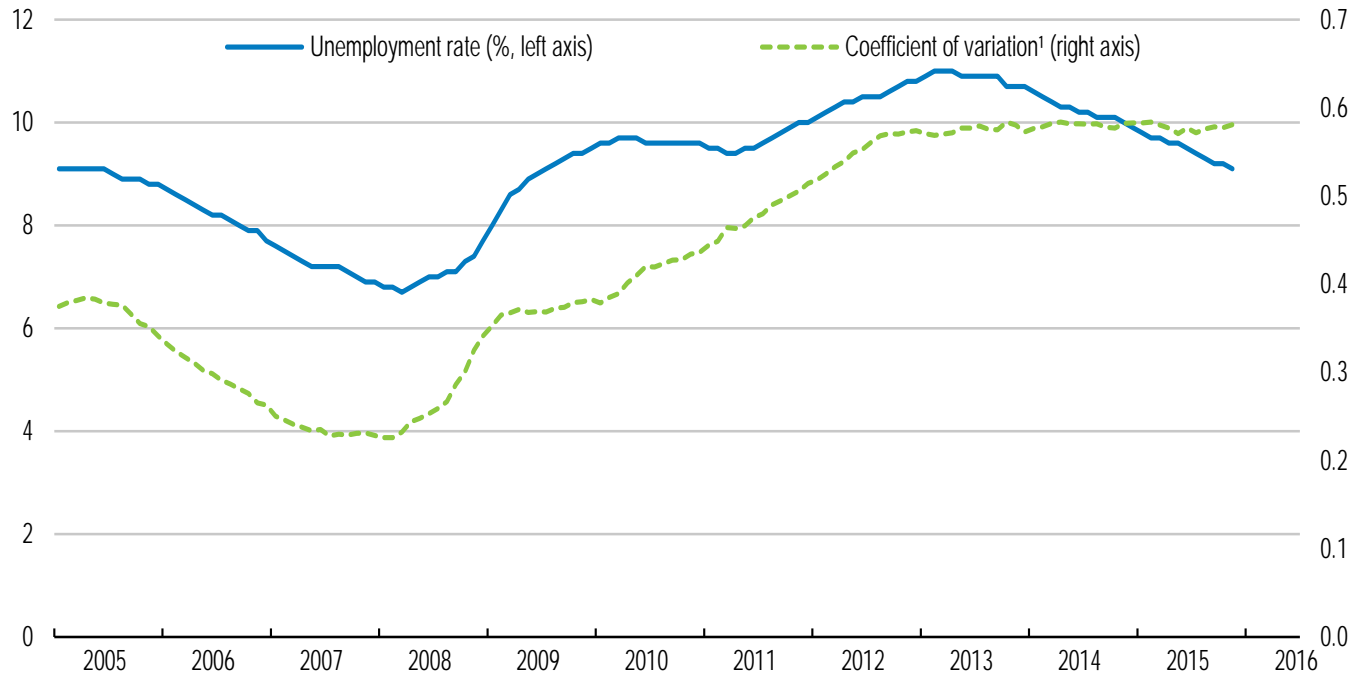


Source: OECD Economic Outlook.



Unemployment rate would slowly go down

Unemployment dispersion in the European Union



1. Weighted standard deviation of unemployment rate observations for European Union (28) countries divided by the average EU unemployment rate.

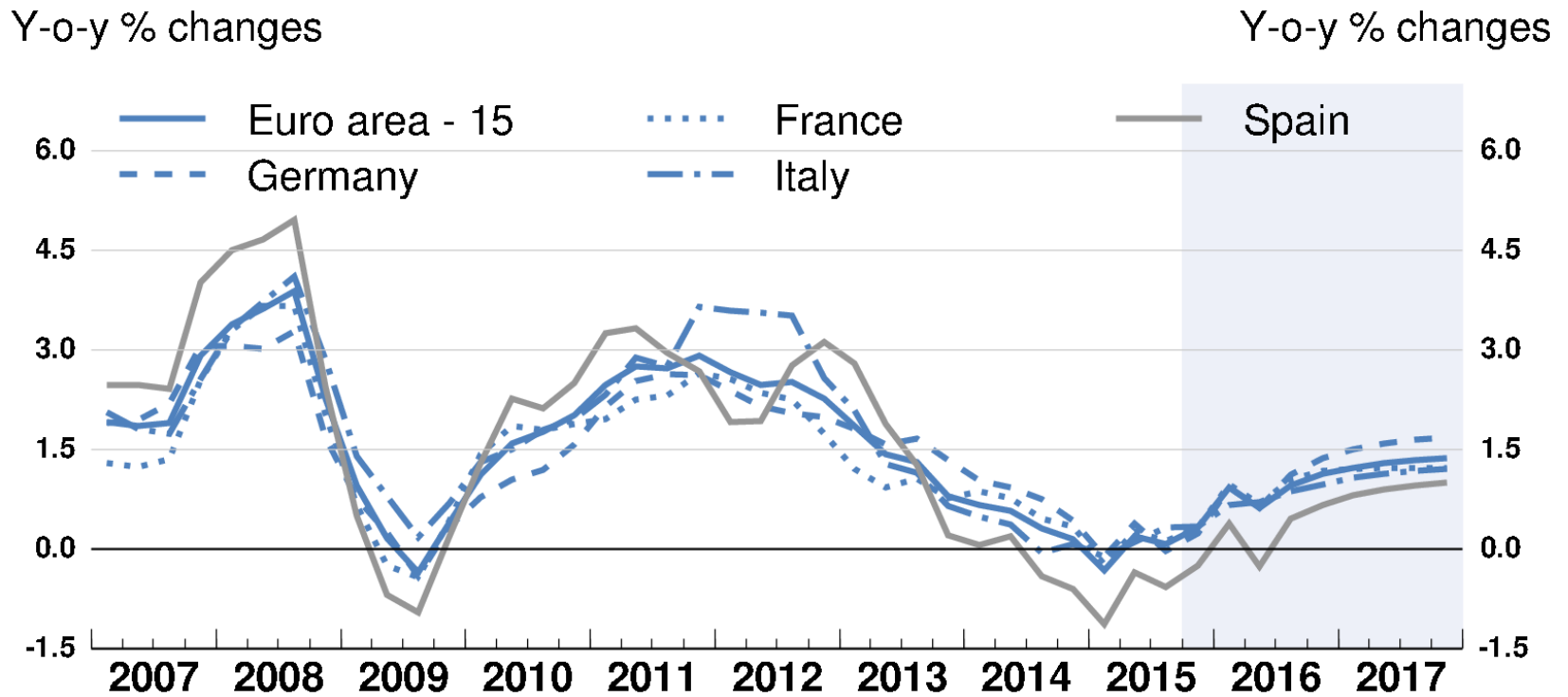
Source: Calculations based on Eurostat (2016), "Employment and unemployment (LFS)", Eurostat Database.



Inflation is projected to remain below the target

Macro forecasts - Europe

Harmonised index of consumer prices

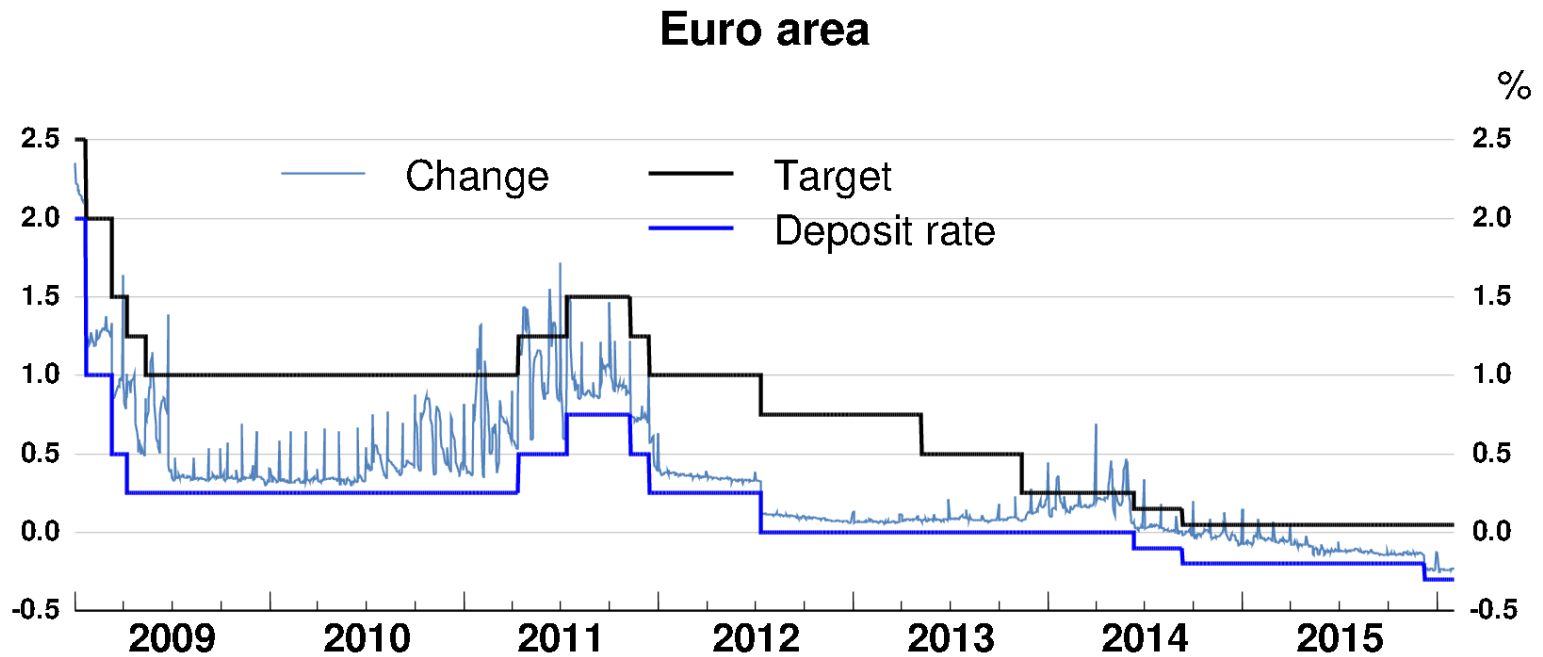


Source: OECD Economic Outlook.



Interest rates are low

Policy determined and money market interest rates

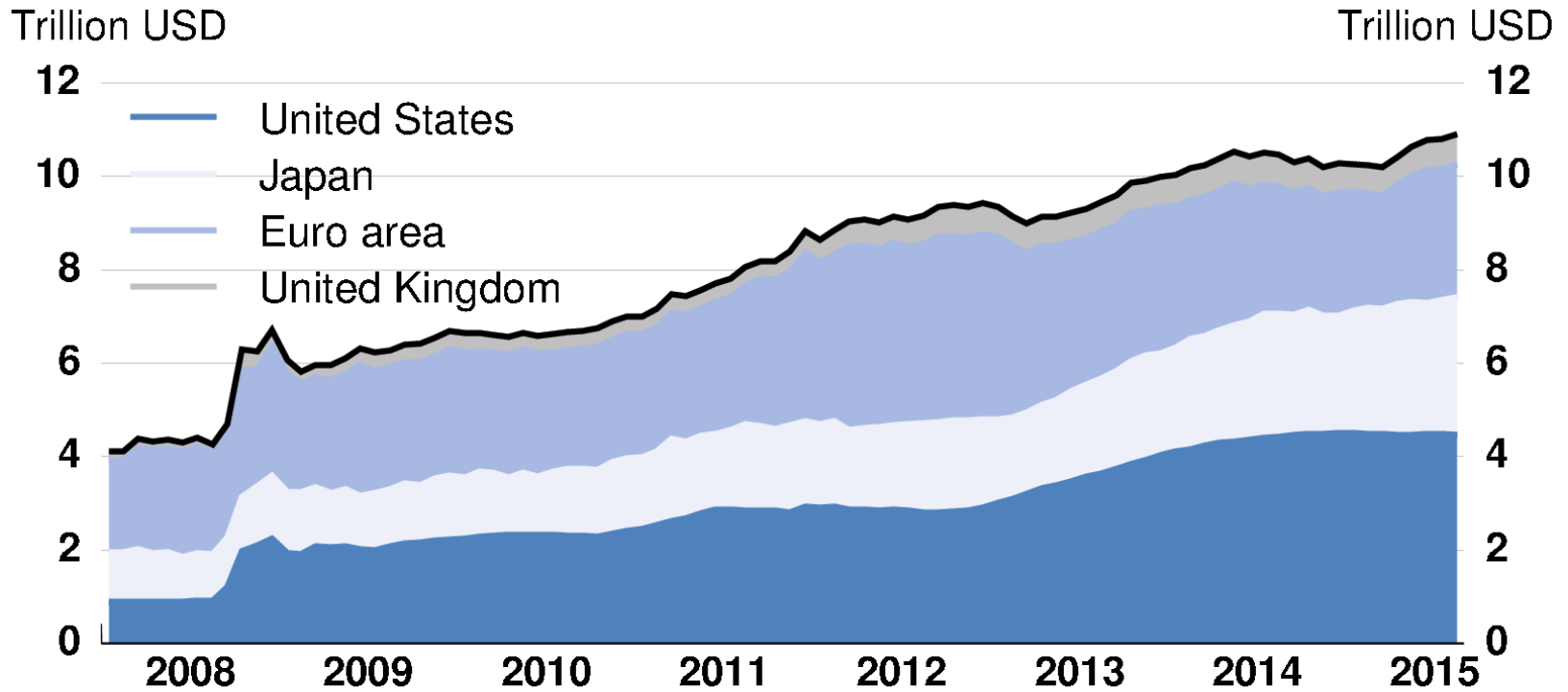


Last observation: 1-Feb-16.



Central bank assets expanded

Monetary policy

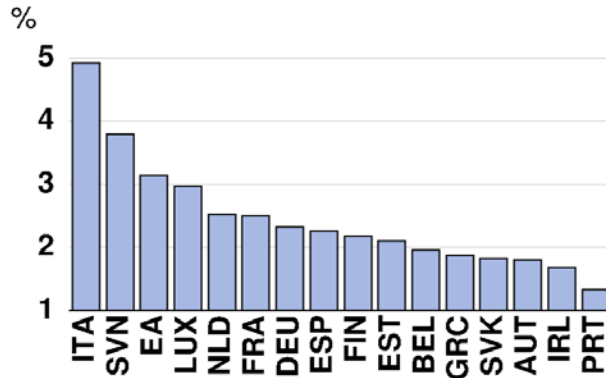


Source: Board of Governors of the Federal Reserve System, European Central Bank, Bank of Japan, and Bank of England; and OECD calculations.

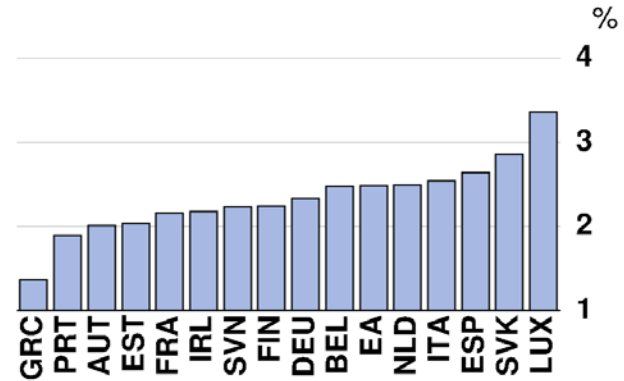


Financial markets fragmentation persists

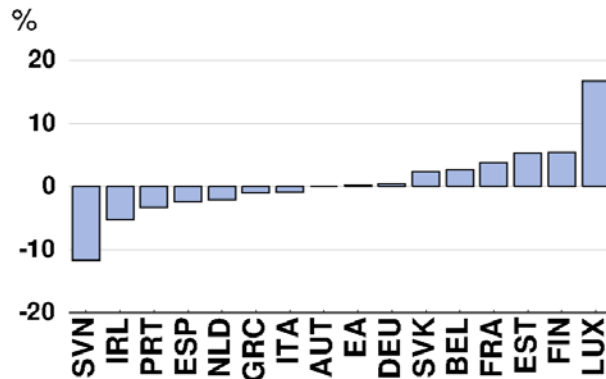
A. Interest rate on loans to non-financial corporations



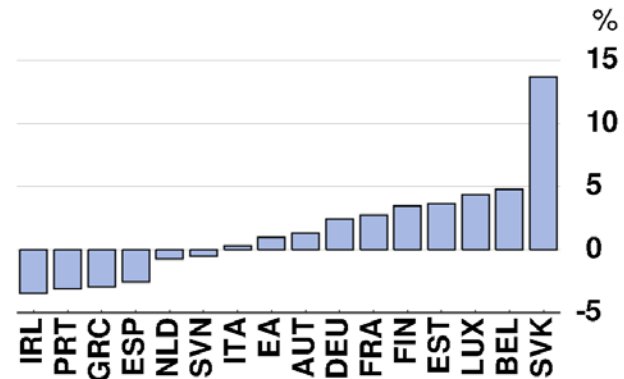
B. Interest rate for house purchase



C. Growth in credit to non-financial corporations



D. Growth in credit to households

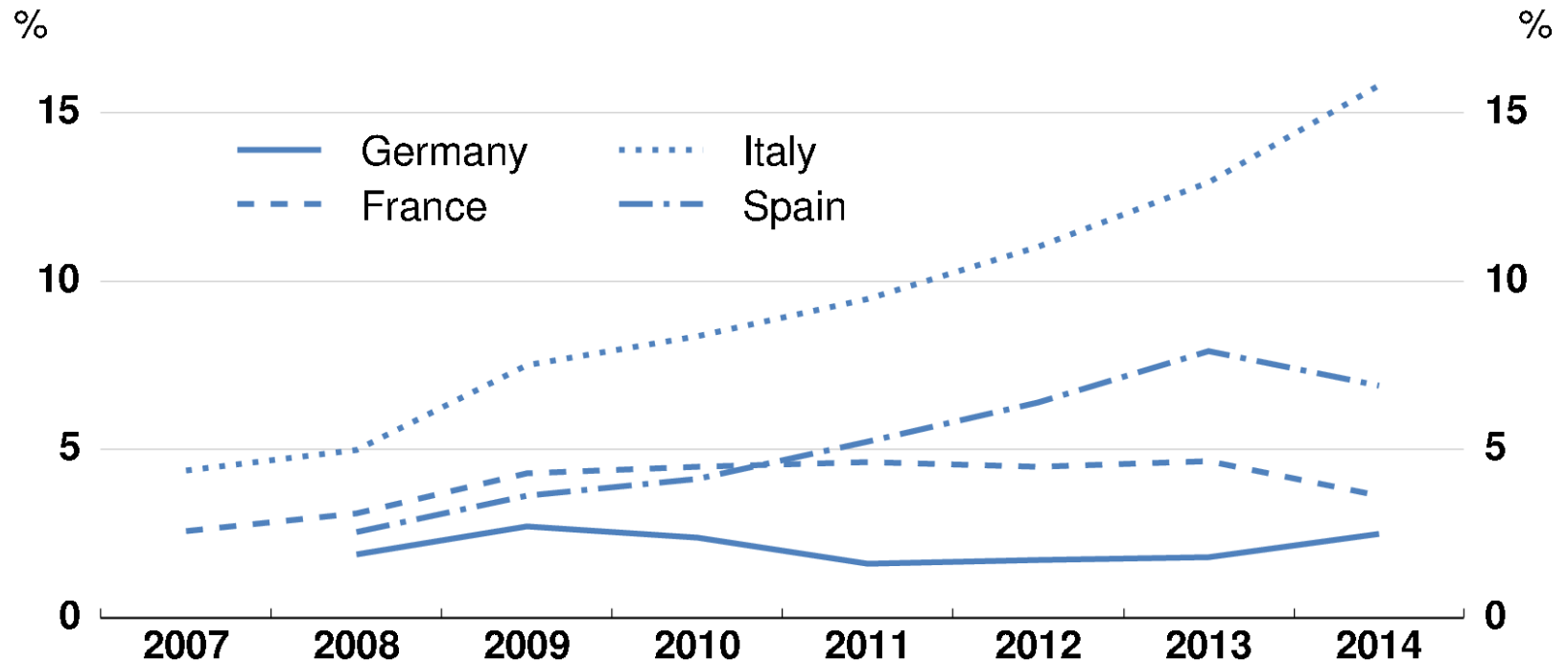


Source: OECD Economic Outlook.



Non-performing loans have been coming down, but only in some countries

As a percentage of gross debt instruments



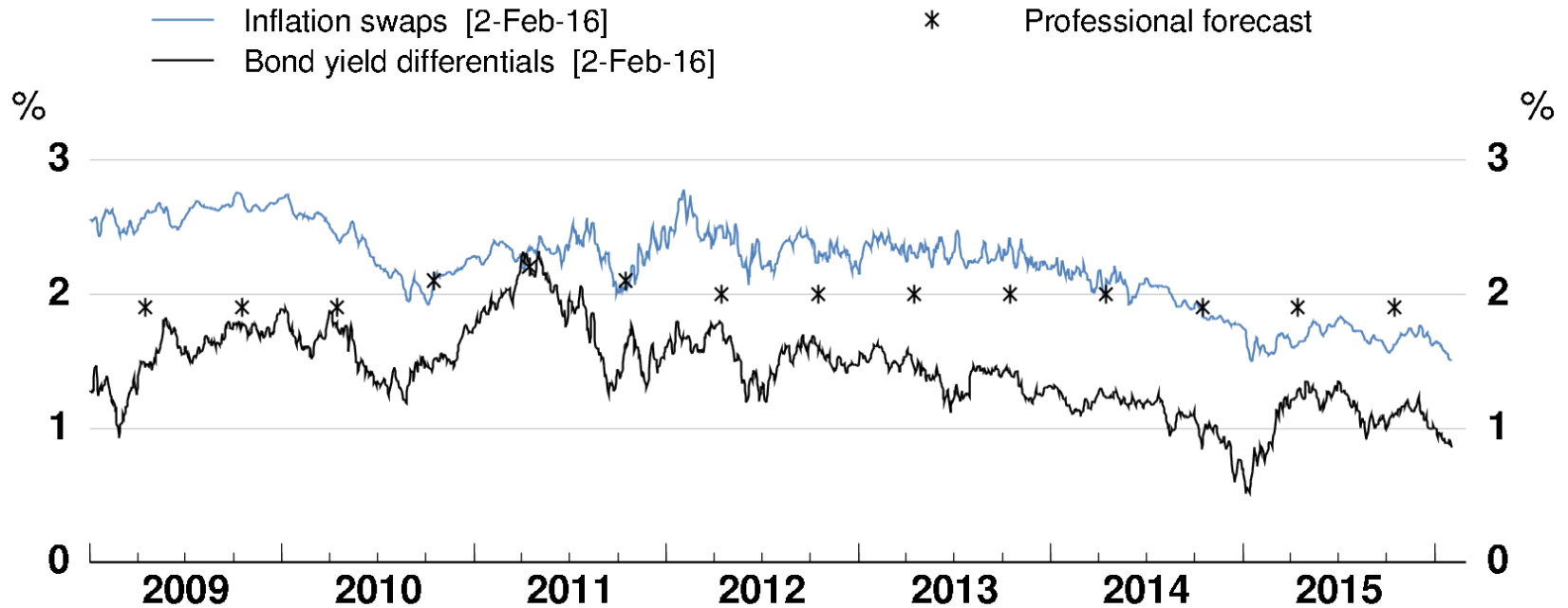
Source: OECD Economic Outlook.



Inflation expectations have been low

Monetary policy

Proxies for long-term expected inflation
Euro area

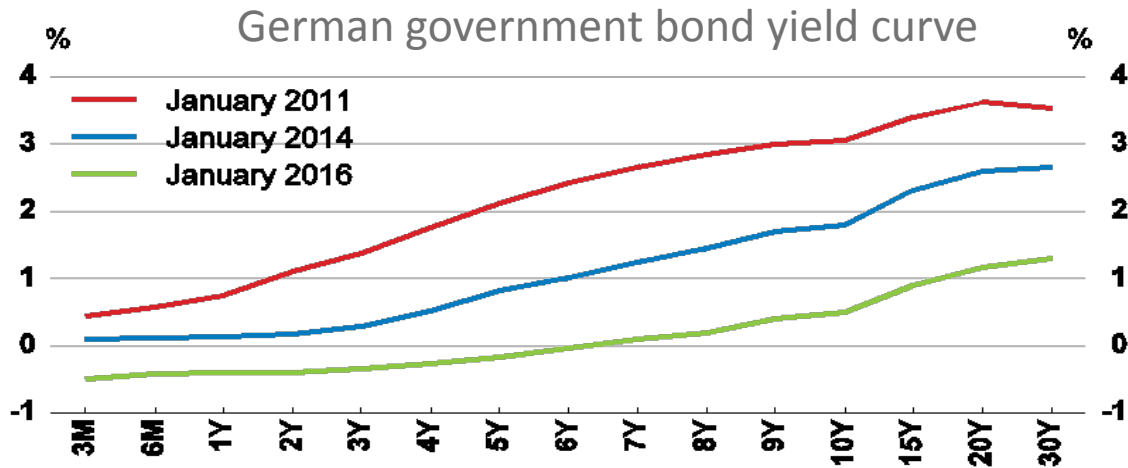
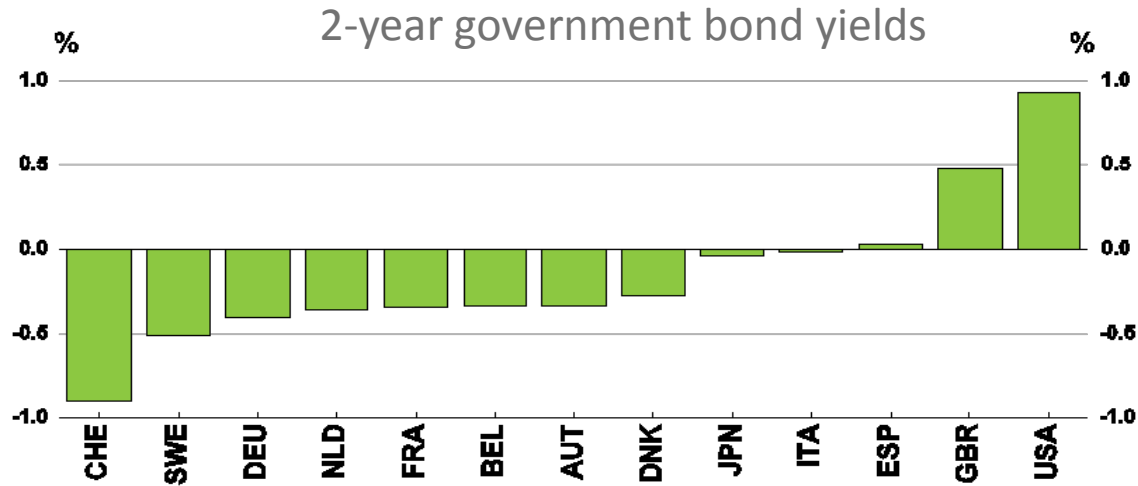


Source: Thomson Reuters; and Consensus Economics.
Last observation: 2-Feb-16.



Interest rates have turned negative

Monetary policy



Source: Thomson Reuters.



Deposit interest rates have become negative

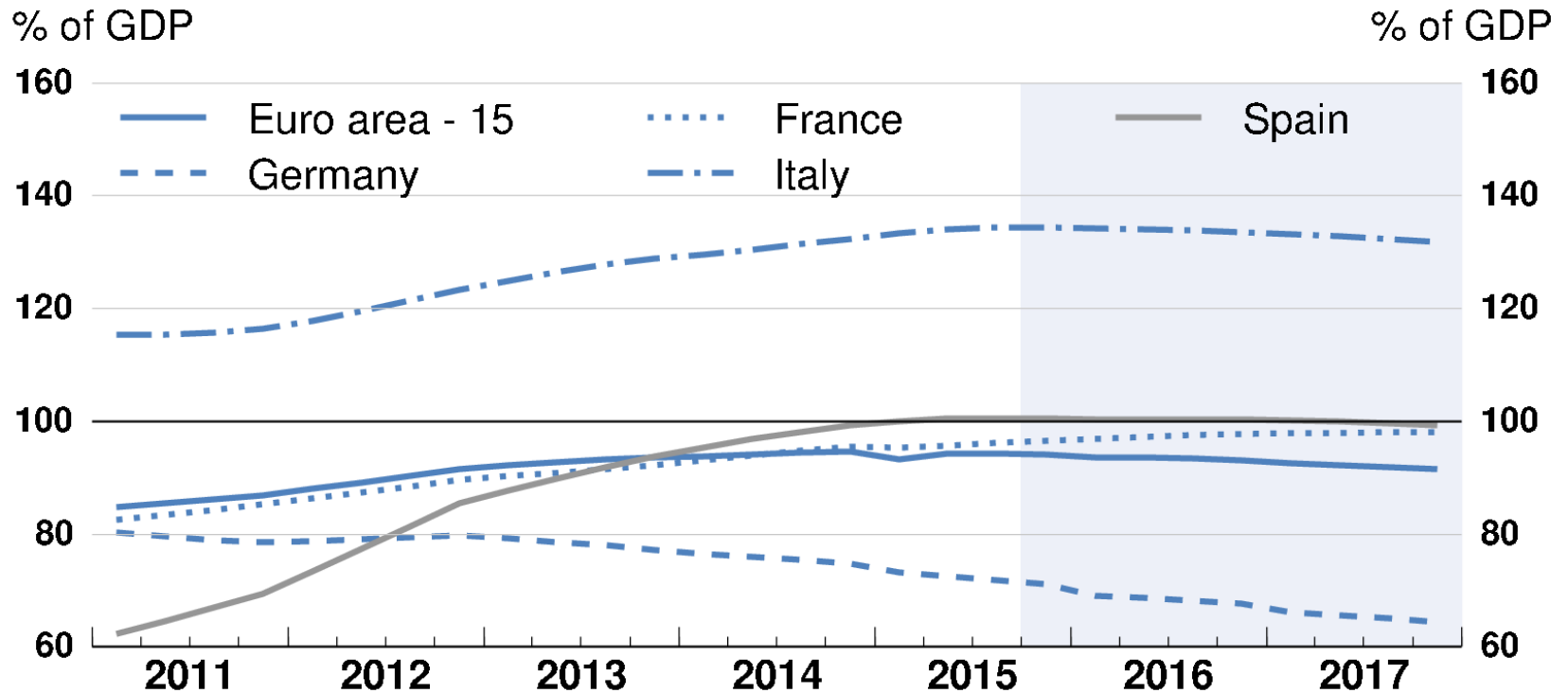
- Negative central bank deposit interest rates should serve to limit borrowing costs and, where credit growth is weak, encourage banks to lend money to households and firms. They also signal the commitment of central banks to maintain price stability and, in some cases, may have contributed to downward pressures on the exchange rate.
- However, they also decrease bank profitability, with banks reluctant to impose negative interest rates on depositors. And the costs of negative deposit interest rates may be ultimately passed to banks' customers via higher-fees or an increased-cost of credit.
- Overall, the effectiveness of such a policy appears to be uncertain in the short term.
- Questions also remain about the period of time in which interest rates can be kept below zero, as this entails risks of becoming dependent on public debt management policy and of financial instability in the longer term.



Fiscal space is limited in many euro area countries

Fiscal policy

Debt-to-GDP ratio
Maastricht definition



Source: OECD Economic Outlook.

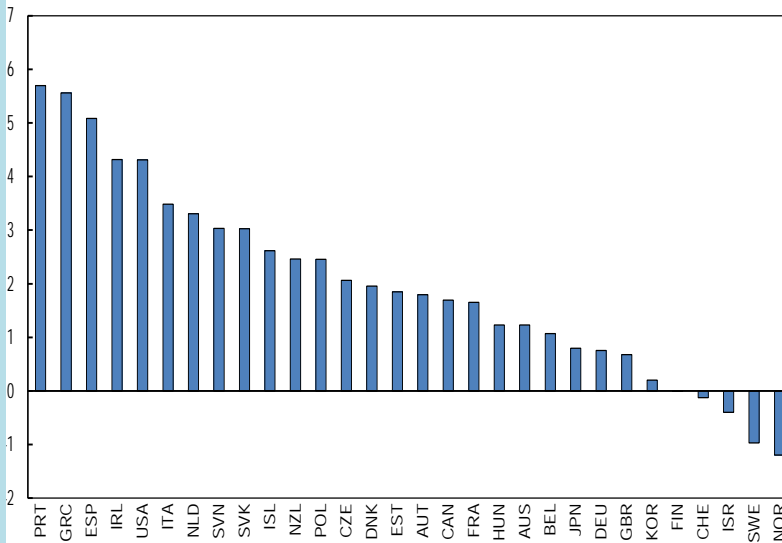


Recent and planned consolidation

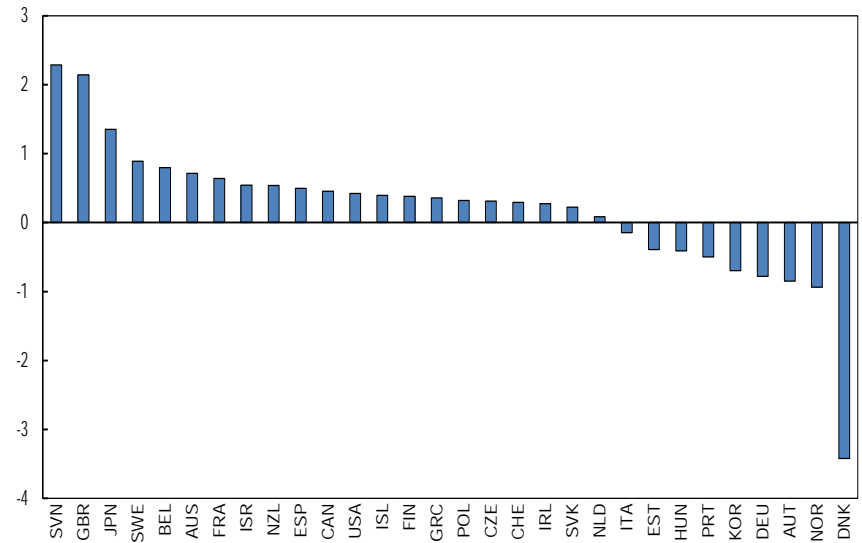
Fiscal policy

Change in the underlying primary balance

2011 - 2014



2014 - 2016



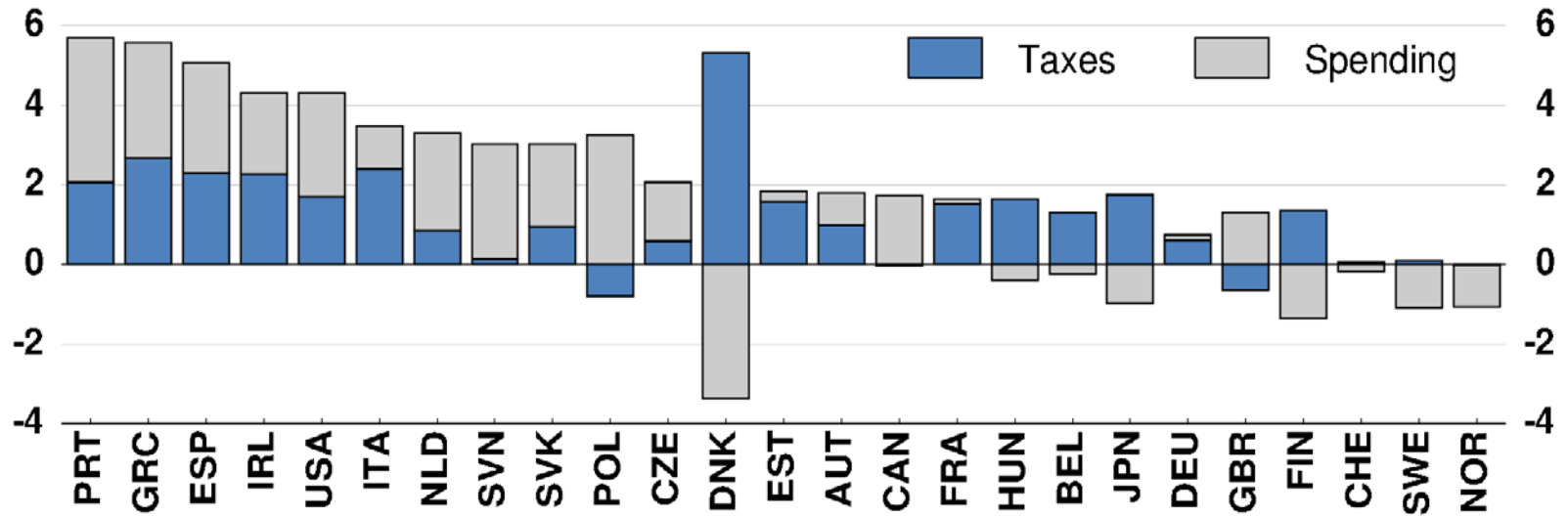
Source: OECD Economic Outlook.



Consolidation relied to a large extent on tax increases up to 2014

Change in key components of the primary balance

2011-14, in per cent of potential GDP



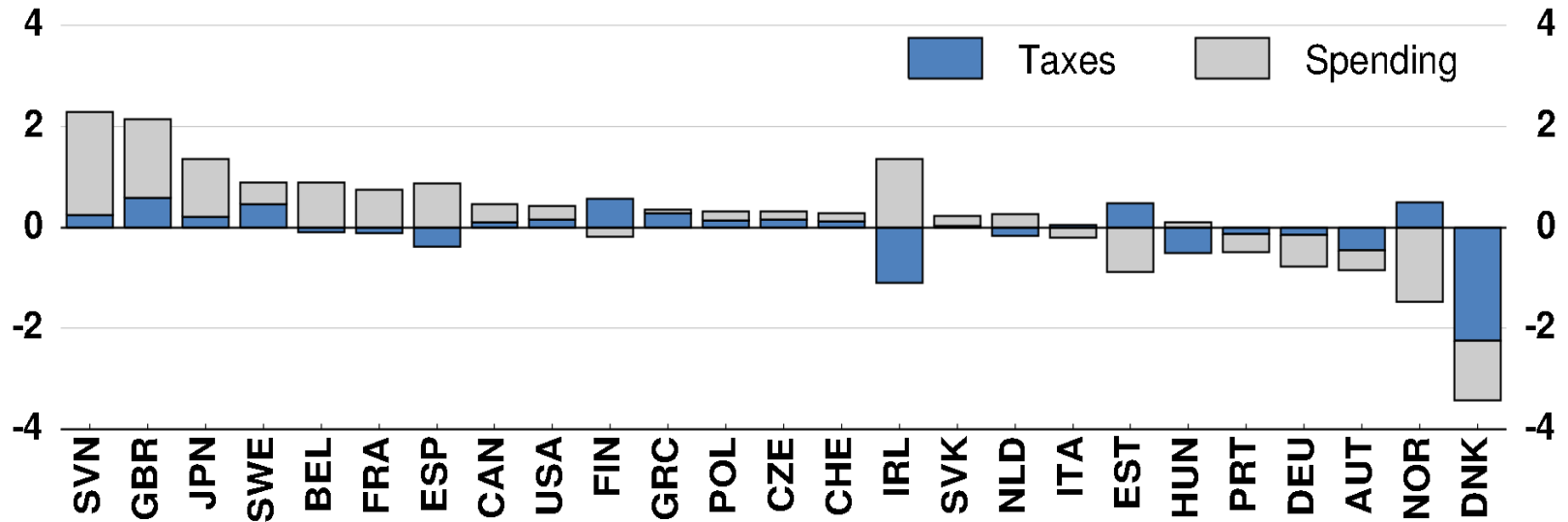
Source: OECD Economic Outlook.



In the coming years, the focus is going to be expenditure restraints

Change in key components of the primary balance

2014-16, in per cent of potential GDP

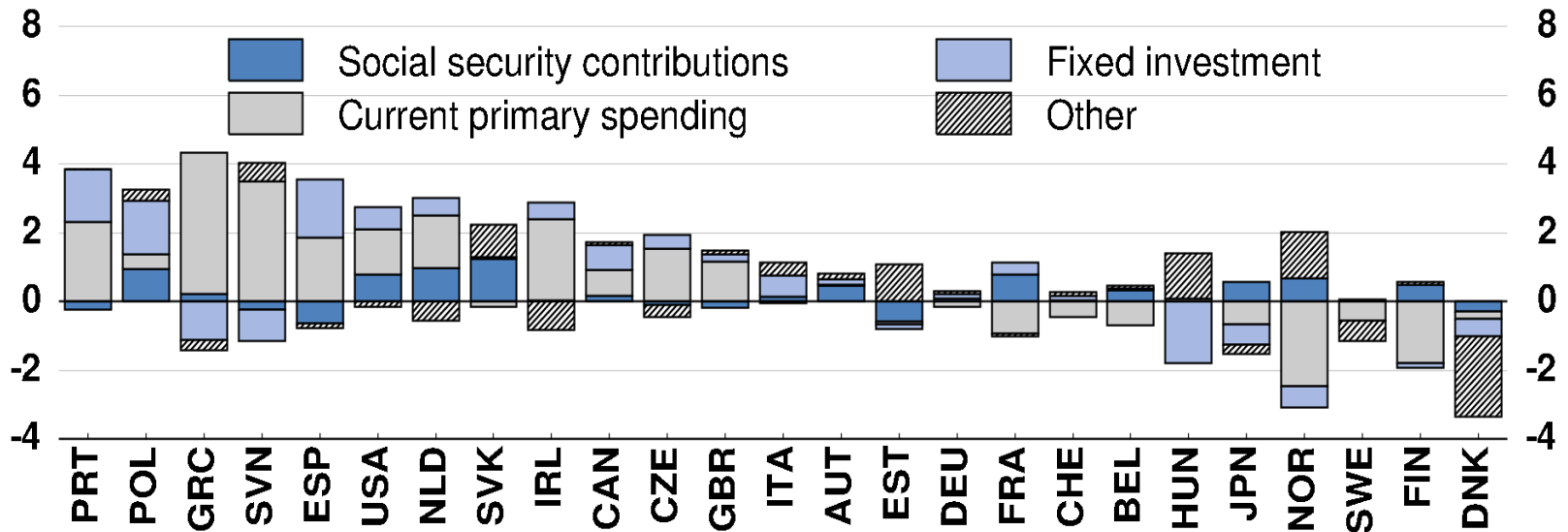


Source: OECD Economic Outlook.



In the past, some countries have adjusted public investment

Change in key components of the primary balance
2011-14, in per cent of potential GDP





Fiscal multipliers depend:

- On whether the measures are temporary or permanent;
- On the structure of the economy: openness, exchange-rate regime, fiscal space, structure of spending and tax, size of automatic stabilisers;
- On the position in the business cycle, monetary policy reaction;
- On the choice of instruments.



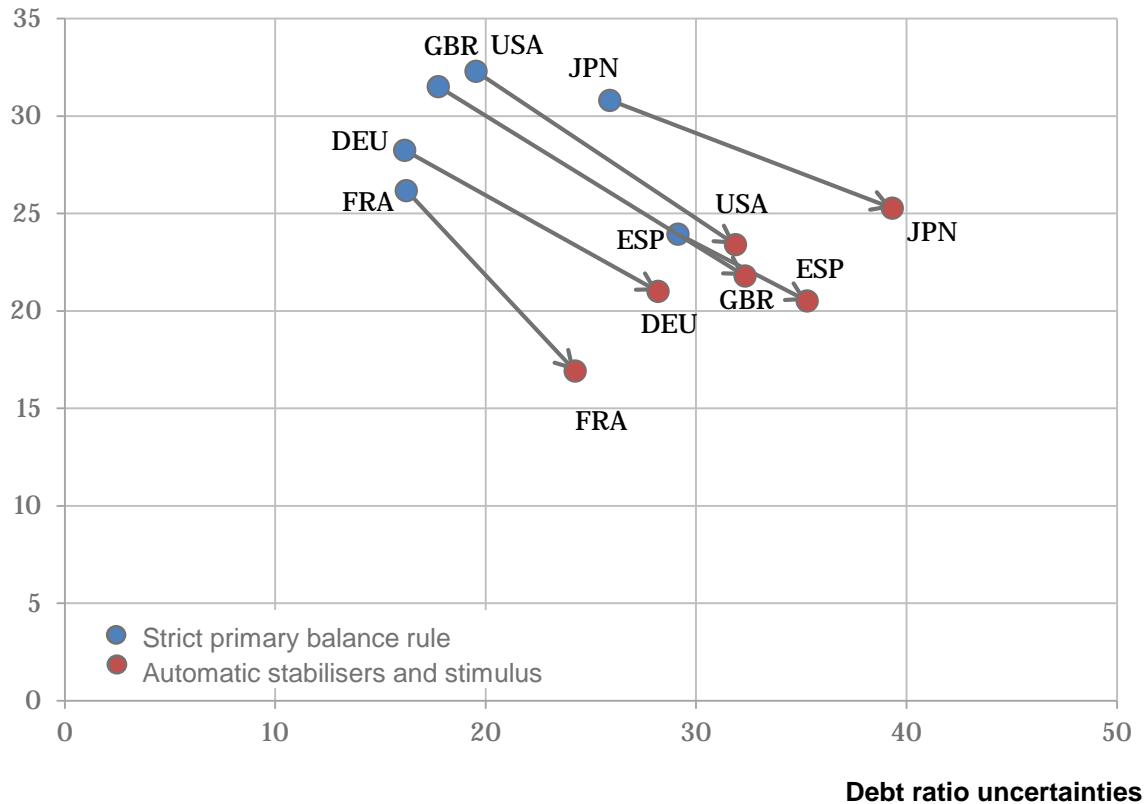
The degree of hysteresis is hard to estimate

Paper	Degree of hysteresis	United States	Euro area
Delong and Summers (2012)	0-0.2	0.1	
Logeay and Tober (2006)			0.3
Kienzler and Schmid (2013)	0.2-0.3	0.3	
Rawdanowicz <i>et al.</i> (2014)	0.1-0.9	0.1	0.2-0.5



The trade-off between fiscal discipline and stabilisation...

Long-term recession risks

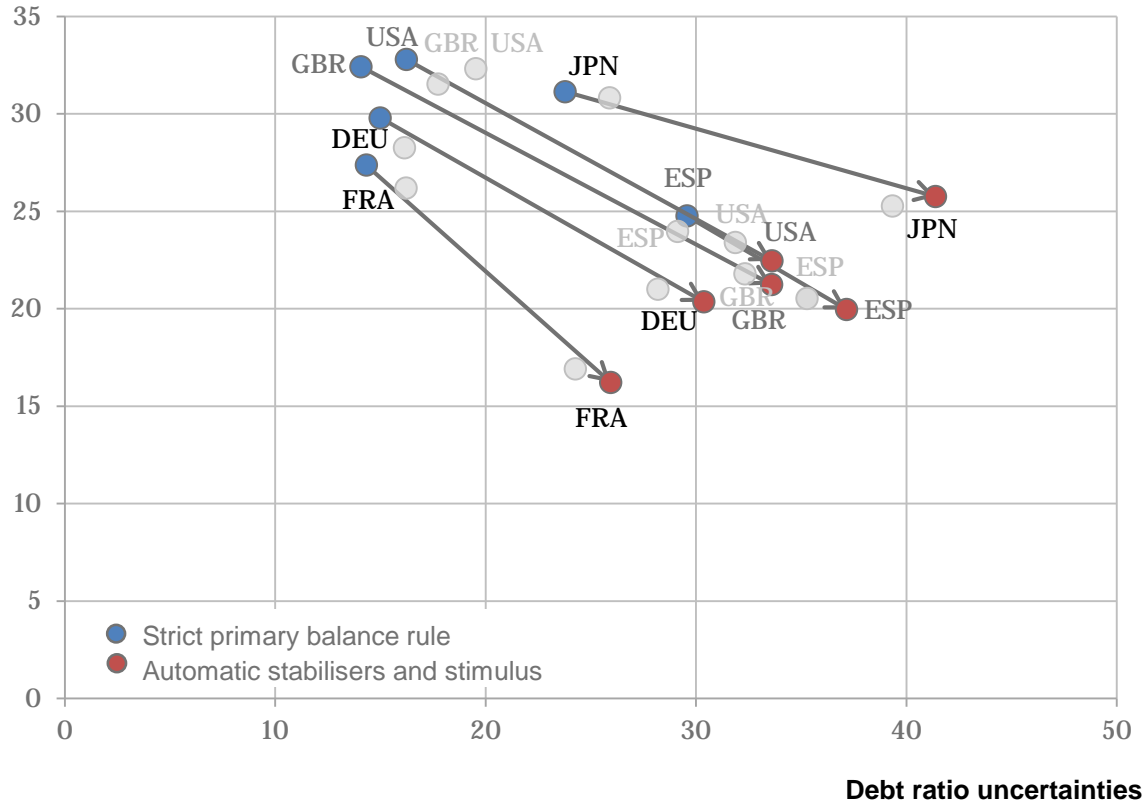


Source: Fall et al. (2015)



...is little affected in a low growth environment

Long-term recession risks



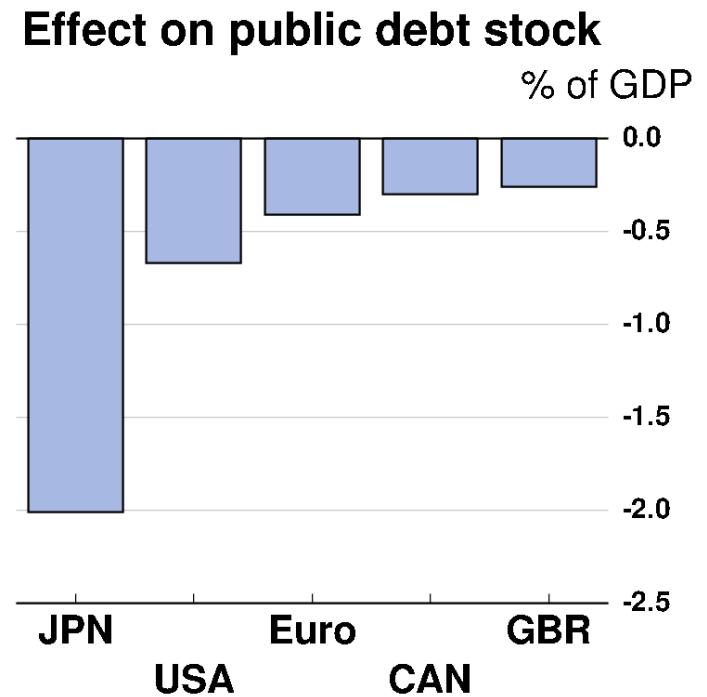
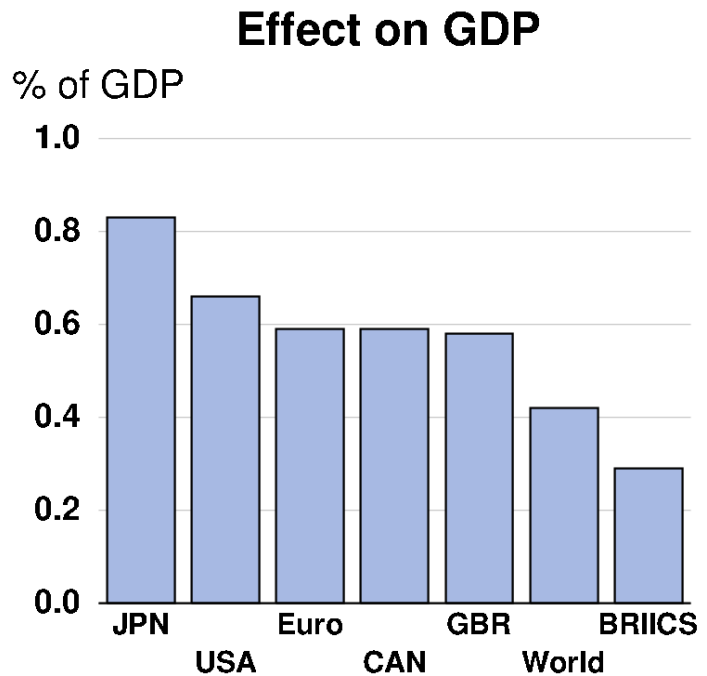
Note: The potential growth rate and the interest rates are assumed to be 1% lower. A large recession risk is the risk that annual GDP per capita growth falls under -1%.

Source: Fall et al. (2015)



Collective action on public investment could support growth without worsening debt ratios

Effects of a ½ per cent of GDP public investment stimulus by all OECD economies
1st year, change from baseline

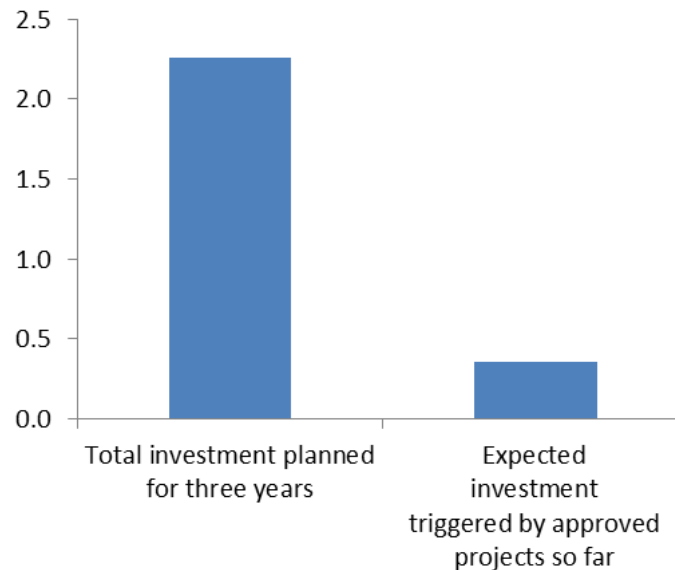


Source: OECD Economic Outlook.



Collective action on public investment needs further harmonisation of regulations

Implementation of Juncker Plan
Per cent of 2014 GDP



Further harmonising regulations is needed to catalyse planned private investment

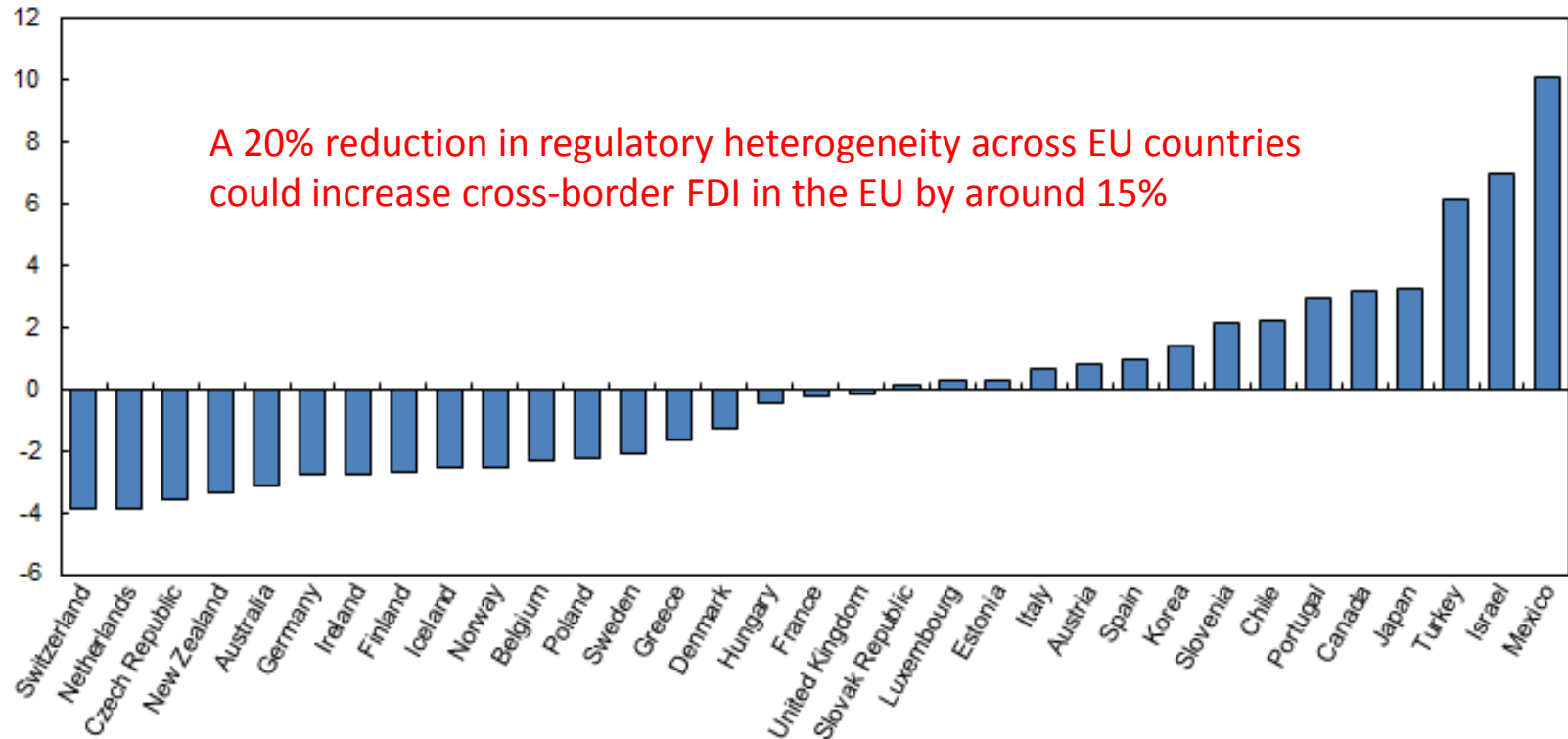
Source: OECD calculations.



Divergent product market regulation harms investment

Fiscal policy

Product market regulation heterogeneity
Deviation from OECD average bilateral heterogeneity, 2013, per cent



“Source: Fournier, J.-M. (2015), “The Negative Effect of Regulatory Divergence on Foreign Direct Investment”, OECD Economics Department Working Paper No. 1268 (forthcoming), OECD Publishing, Paris.



Reforms can raise the effectiveness and efficiency of spending

- Prioritisation of expenditure and spending reviews
- Performance-based budgeting
- Public administration reforms



Reforms can enhance efficiency within instruments

Trade-offs between instruments can be eased by improving their design

- Spending: e.g. efficiency gains in health care and education.
- Revenue : e.g. base broadening, reducing tax expenditures



Fiscal tools have a different impact on growth and inequality

Fiscal policy

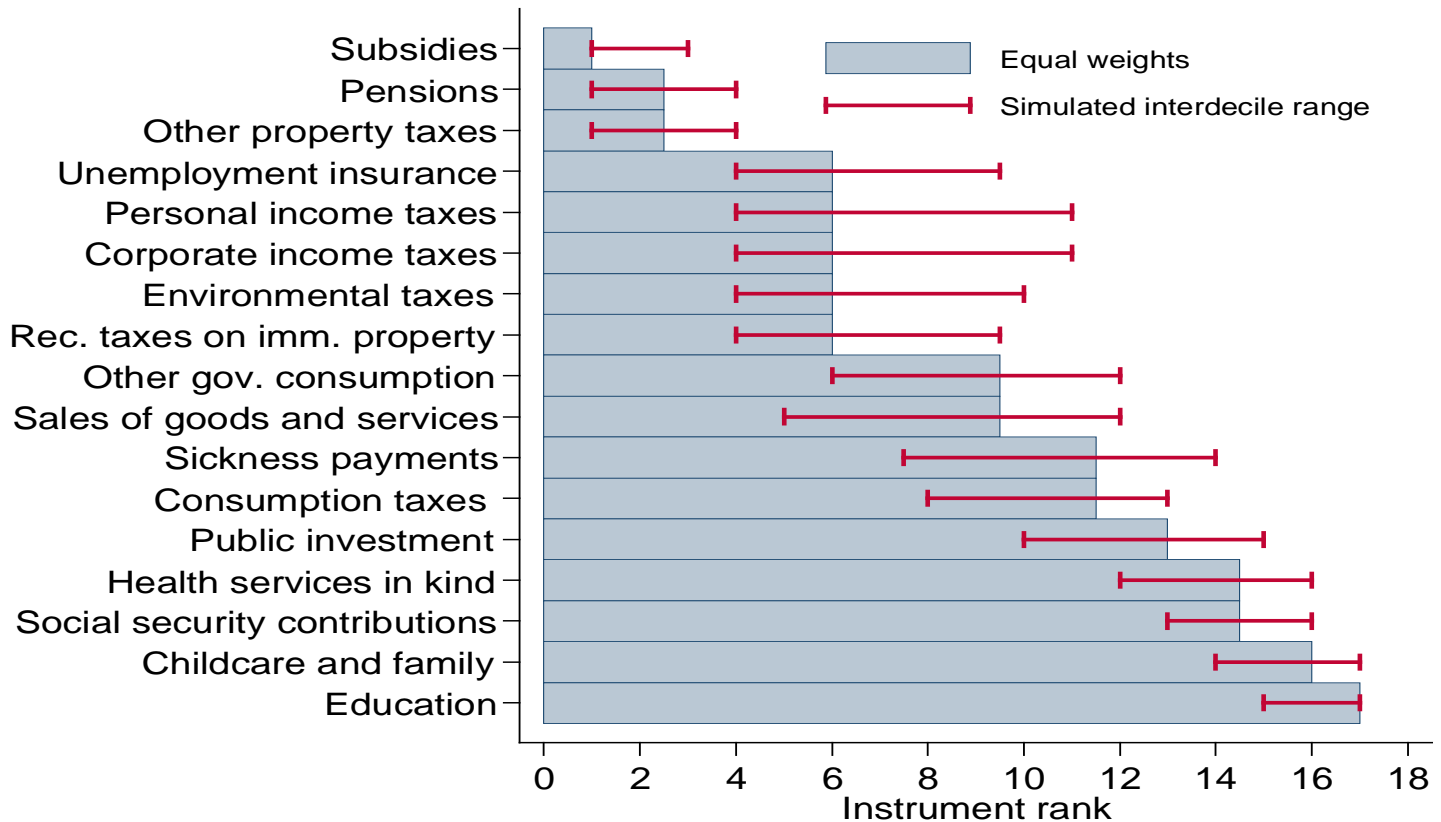
	Growth		Equity	
	Short-term	Long-term	Short-term	Long-term
Spending cuts				
Education	--	--	-	--
Health services provided in kind	--	-	-	-
Other government consumption (excluding family policy)	--	+	-	
Pensions		++		
Sickness and disability payments	-	+	--	-
Unemployment benefits	-	+	-	
Family	-	-	--	--
Subsidies	-	++	+	+
Public investment	--	--		
Revenue increases				
Personal income taxes	-	--	+	+
Social security contributions	-	--	-	-
Corporate income taxes	-	--	+	+
Environmental taxes	-	+	-	
Consumption taxes (other than environmental)	-	-	-	
Recurrent taxes on immovable property	-			
Other property taxes	-		++	+
Sales of goods and services	-	+	-	-

Source: Cournède, Goujard and Pina (2014).



Combining equity and growth in OECD countries

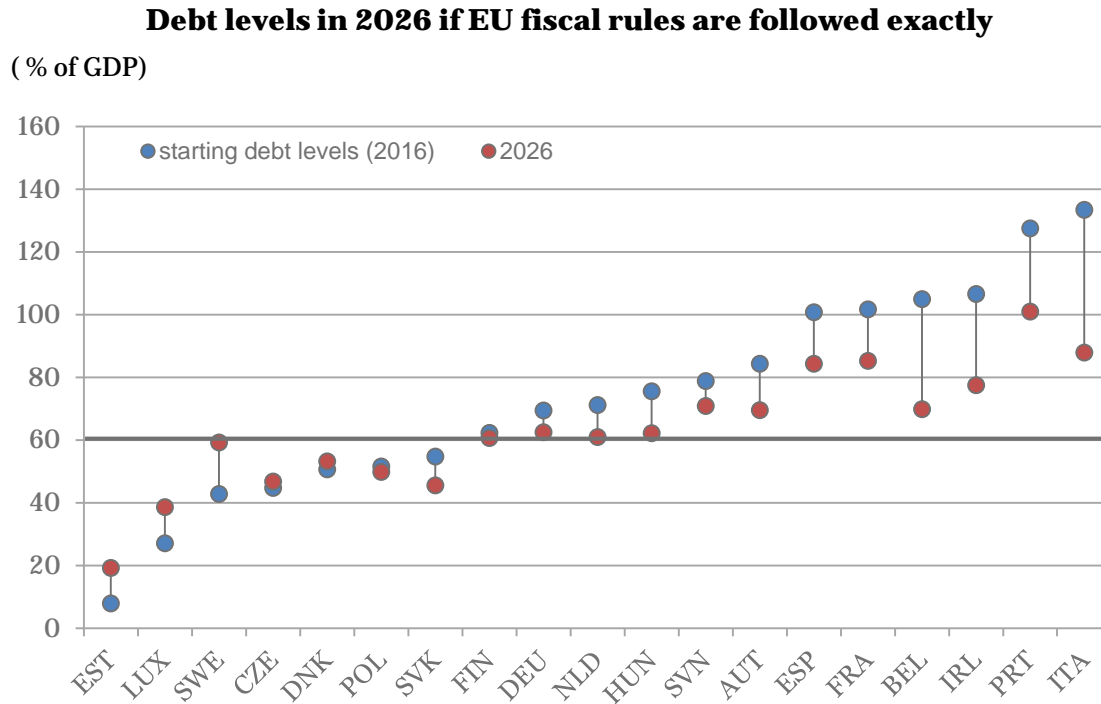
Ranking from most to least desirable instruments of consolidation



Source: Cournède, Goujard and Pina (2014).



EU fiscal rules aim to support debt-sustainability with a set of several rules



- Debt rule (both nominal and cyclically-adjusted; backward- and forward-looking)
- Nominal budget balance rule
- Structural budget balance rule
- Expenditure rule

Source: Barnes, Botev, Rawdanowicz and Strasky (forthcoming).



Uncertainties have implications for fiscal rules

- **Structural balances** are hard to use in real time
 - But they are at the heart of the EU fiscal framework
 - Over the medium term, they will become the most binding rule of all EU fiscal rules
- **An expenditure rule** is more immune to the drawbacks of the structural balance:
 - Long-term potential growth averages vs. annual potential growth rates
 - Allows for revenue shortfalls in bad times, but prevents from spending revenue windfalls in good times
 - BUT, it still is not straightforward how to derive it , e.g.
 - how to quantify bottom-up discretionary measures?
 - how to correctly define no-policy-change scenario?



Uncertainties have implications for fiscal assessments

- 'Prudent' debt targets can account for uncertainties in fiscal frameworks (Fall and Fournier, 2015).
 - Budget balance rules (complemented by an expenditure rule)
- Well-designed escape clauses suspending fiscal rules allow to deal with tail events.



Reforms to be promoted in a context of weak demand

Shift in the composition of public spending towards investment

- Public infrastructure investment with high growth impact (broadband network)
- Regulatory harmonisation

Product market reforms in specific service sectors

- Removing restrictions on the entry of new suppliers in services characterised by low entry costs – and in some cases – latent demand (professions, taxis, etc).

Reforms of benefit entitlements in the areas of pensions and/or health

- Improve sustainability of public finances and create space for fiscal stimulus
- Effective/credible back-loaded consolidation

Reforms easing frictions in the reallocation of resources

- Reducing barriers to geographical or jobs mobility
- Housing market policies and job-search assistance



Reforms least likely to succeed in a context of weak demand

Reforms that initially put downward pressures on wages or mark-ups

- Employment protection legislation, minimum wages or product market regulation (network industries)

Factors mitigating the impacts of such reforms

- **Packaging:** Simultaneous reforms of labour and product markets reduce risks or extent of contractionary effects.
- **Synchronisation:** In euro area, help to reduce transition costs by giving greater scope to monetary policy
- **Boldness:** Once and for all price level adjustment vs lower inflation expectations

Measures to shift the relative strength of channels

- Addressing financial sector dysfunctions to improve credit flow
- Reducing policy uncertainty to boost the positive confidence channel



THANK YOU