| The 5 Presidents' Report | The Report raises an important question: is it possible to close the unemployment gap, achieve public finance sustainability, reduce macro imbalances, and ensure the liquidity and solvency of financial institutions at the same moment? There are **many trade-offs** that would make achieving these objectives simultaneously very hard. In addition, the Report makes some flawed assumptions: <ul><li>The closure of the **unemployment gap** and the reduction of **macro imbalances** can be fulfilled thanks to an improvement in **competitiveness**, which can be reached via **wages cuts or low wage growth**.</li><li>**Fiscal sustainability** remains intrinsically related to **fiscal austerity** which weighs on price development and on output.</li></ul> The euro area risks being forced into **an equilibrium of low growth and low inflation** that will make it more painful to reduce external and public disequilibria. This equilibrium of low growth and low inflation is called **secular stagnation**. |
| --- | --- |
| Secular Stagnation | **a) Monetary Policy** <br><br> In order to counter secular stagnation, monetary authorities have, first, reduced their policy rates, and then, after policy rates have hit a **zero-lower bound** (ZLB), they have had recourse to **Quantitative Easing** (QE): <ul><li>The ECB helped to reduce sovereign risk by announcing the OMT and then improved financial conditions and boosted the low euro by implementing QE</li><li>Some countries, like Germany, have historically low interest rates; exchange rate – not interest rates - may not be the main QE transmission channel</li><li>When inflation is positive, QE is able to alleviate the costs of fiscal consolidation via lower government yields. When deflation occurs, QE cannot alleviate these costs. Hence, success of QE depends on government interventions.</li><li>Expecting too much from QE would be a mistake: ECB rate to interest rates has been effective while the transmission mechanism of ECB rate to lending volumes / bond issuance has been weak. The more targeted, the more efficient monetary policies are.</li><li>ECB should reinforce its action by making securities issued to finance investments (public or private) eligible for the assets purchase programme (targeted monetary policy)</li></ul> In the current situation, where deflation is never far, the right policy mix consists in supporting **structural progressive policy** with a more expansionary monetary policy by the ECB. |

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| | **b) Structural Reforms**<br><br>According to many commentators, what is needed, now more than ever, is a dose of **supply-side "structural reforms" to be actively coordinated at European, or euro area (EA), level**, including the idea that swingeing sanctions must be imposed on recalcitrant governments in order to force them to do so. This is also the approach sketched out in the Five Presidents' Report. Often the debate seems to be driven by an at least implicit belief that European economies have long been unwilling or unable to implement structural reforms. A failure to reform economies, for each country to "do their homework" is widely seen as being the deeper cause of the current economic crisis.<br>• It is not easy to assess the "volume" of reforms that countries have implemented at different times. As an indicative and intuitive starting point we consider labour market reforms (labour taxation, unemployment benefits, other welfare benefits, employment protection legislation and wage setting regulation) drawing on the European Commission's own database of labour market reforms, LABREF, which indicates the number of individual labour market reforms identified by the European Commission for each year from 2000 to 2013.<br>• **In no year did the EU countries fail to implement more than 130 reforms.** Since the crisis the rhythm has accelerated to around 300, and most recently some 400 reforms a year. Altogether, over the period considered **EU countries implemented more than 3,500 labour market reforms**.<br>• At first sight these data are hardly consistent with a widespread perception of policy paralysis or reform fatigue. Rather it would seem that member states have been engaged in an unrelenting and indeed intensifying reform program.<br>• However, **the data does not clearly show positive labour market impacts**. Countries with a high intensity of "good" reforms were on the whole somewhat more likely to have above-average unemployment at the end of the period.<br>• The benefits of organising such processes with strong elements of coercion and applying across-the-board recipes are likely to be limited - and the economic but also political costs may be high. |
| **Fiscal Rule** | • As set out in chapter 1, the economic outlook of Europe benefits from a new momentum. In the euro area, GDP is expected to reach 2% in 2016 and unemployment rate is expected to decline. Yet, it would still stand at a high level: 9.9% of labour force in 2017 against 7.5% before the outbreak of the subprime crisis.<br>• Considering a fall in the unemployment for 2016-2017 close to 0.6 percentage point per year**, it will take almost seven years to bring the rate back to its pre-crisis level**. The social and long term consequences of this situation have been analysed in chapter 2 and we have also claimed that more investment – and notably public investment – would boost growth and help to erase the scars of the crisis. Yet, EMU countries have also to comply with fiscal rules and the MIP and should then implement policies to bring public debt back to 60% of GDP in the long run and to correct external imbalances.<br>• Given the current situation in terms of public finance and current accounts, **we can identify countries that will need to make additional efforts to comply with the debt rule and countries for which an adjustment in relative prices is needed to reduce the current account deficit** (*see graphs at the end of this table*).<br>• **The German case**: a fiscal impulse in the core would substantially benefit the periphery. The fiscal stimulus would not only help close the unemployment gap in the country implementing the impulse; it would also produce an improvement in the convergence between EU countries, without endangering the sustainability of public finances. A once-and-for-all rise in public investment in Germany by 1 percent in 2016 (roughly equivalent to a rise of 30 billion €) would increase GDP in Germany by 1.4 percent, while GDP in the EU would increase by 0.5 percent. |

| External Imbalances and Incompatibilities | • **External disequilibrium in the Euro Area countries:** Since the start of the crisis, the current account of the EA has strongly increased, starting from a current account deficit of 0.7% of GDP in 2009, to a surplus of +3.4% of GDP in 2014. Almost all countries are in surplus in 2015-Q2, except Belgium, Cyprus, Finland and Greece. This apparent improvement mainly comes from the harsh reduction of current account deficits in southern countries – Spain, Italy, Greece and Portugal – and from the fall in oil price since 2014-Q3. |
|---|---|
| | • **Structural trade balances** (STB) are generally lower than current trade balances, since almost all EA countries face a more negative output gap than that of their partners. The gap between the STB and its target reveals external disequilibria. Some countries need to strongly increase their STB to reach the target. It concerns first and foremost Greece: a strong improvement in Greek competitiveness is needed to improve the trade balance in the long run. Finland, France, Italy, Portugal and Spain are concerned to a lesser extent. Conversely, Germany and the Netherlands should reduce their STB. |
| | • **Price competitiveness**, both on domestic and foreign markets, is the means by which these disequilibria could be reduced. As expected, surplus countries (Germany, Austria, the Netherlands) must achieve a substantial real exchange rate appreciation to reach their external equilibrium; on the other hand, Greece, and to a lesser extent Belgium and Finland, must achieve a significant real depreciation. |
| | • The adjustments needed either to comply with debt objectives or to deal with current account imbalances would imply additional fiscal consolidation and an adjustment of relative prices. It should be noticed that countries which are supposed to implement further consolidation are generally those that will need to adjust relative prices. |
| | • The current account surplus increases the links between EA economies. It is well known that openness of trade in a fixed currency framework is important. |
| | • The magnitude of this channel makes **the responsibility of EA countries with high surpluses (e.g. Germany) substantial**. The existence of these spillover effects urges the use of available fiscal space. Even so, solutions must primarily be sought in the area of coordinated macroeconomic policy. |

**Table 1. Public finance and output performances under the baseline scenario (no risk premium, no fiscal impulse beyond 2017, time-varying fiscal multiplier, hysteresis effects)**

| | Public debt (in % of GDP) | | Structural balance (in % of GDP) | | Cumulative fiscal impulse | GDP growth rate (in %) | | Average output gap | Inflation rate (in %) | |
|---|---|---|---|---|---|---|---|---|---|---|
| | (1) 2020 | (2) 2035 | (3) 2020 | (4) 2035 | (5) 2015-35* | (6) 2016-20 | (7) 2021-35 | (8) 2016-35 | (9) 2016-20 | (10) 2021-35 |
| DEU | 57 | 24 | 0.8 | 1.4 | 0.7 | 1.3 | 1.0 | 0.2 | 1.8 | 2.0 |
| FRA | 95 | 97 | -2.7 | -3.6 | -1.1 | 1.9 | 1.4 | 0.0 | 1.2 | 2.0 |
| ITA | 123 | 80 | 0.3 | 1.1 | -0.2 | 1.2 | 0.2 | -0.3 | 0.7 | 2.0 |
| ESP | 96 | 89 | -2.3 | -2.7 | -0.7 | 2.3 | 1.4 | 0.0 | 1.1 | 2.0 |
| NLD | 67 | 62 | -1.4 | -1.9 | -0.1 | 1.7 | 1.3 | -0.1 | 1.2 | 2.0 |
| BEL | 102 | 87 | -2.0 | -2.1 | -1.0 | 1.8 | 1.5 | 0.0 | 0.9 | 2.0 |
| PRT | 110 | 49 | 0.9 | 2.5 | -1.2 | 1.9 | 1.0 | -0.3 | 0.9 | 2.0 |
| IRL | 76 | 21 | 0.9 | 2.6 | -1.2 | 2.6 | 1.8 | 0.4 | 1.8 | 2.1 |
| GRC | 175 | 108 | 0.4 | 0.8 | -1.4 | 3.1 | 1.0 | -0.8 | -0.7 | 1.9 |
| FIN | 65 | 74 | -2.4 | -3.3 | -0.6 | 2.1 | 1.6 | -0.2 | 1.3 | 2.0 |
| AUT | 83 | 69 | -1.3 | -1.5 | 0.7 | 1.6 | 1.4 | -0.3 | 1.2 | 2.0 |
| EA | 87 | 65 | -0.8 | -0.8 | -0.3 | 1.7 | 1.1 | 0.0 | 1.3 | 2.0 |

\* In the baseline scenario, fiscal impulses are equal to 0 from 2018 to 2035.
*Source*: iAGS model.

**Table 2. Is it possible to reach a 60% debt-to-GDP ratio? (baseline scenario except +/- 0.5 fiscal impulses depending on public debt gap *vis-à-vis* 60% target)**

| | Public debt (% of GDP) | | Structural balance (% of GDP) | | Cumulative fiscal impulse | GDP growth rate (%) | | Average output gap | Inflation rate (%) | |
|---|---|---|---|---|---|---|---|---|---|---|
| | (1) 2020 | (2) 2035 | (3) 2020 | (4) 2035 | (5) 2015-35 | (6) 2016-20 | (7) 2021-35 | (8) 2016-35 | (9) 2016-20 | (10) 2021-35 |
| DEU | 60 | 59 | -1.4 | -2.0 | 3.1 | 1.6 | 1.0 | 0.4 | 2.1 | 2.1 |
| FRA | 97 | 60 | -0.7 | 0.4 | -4.0 | 1.4 | 1.5 | -0.5 | 0.6 | 1.8 |
| ITA | 128 | 60 | 1.9 | 3.3 | -1.9 | 0.6 | 0.3 | -0.7 | 0.1 | 1.9 |
| ESP | 96 | 60 | -0.3 | 0.2 | -2.5 | 1.9 | 1.5 | -0.3 | 0.6 | 1.9 |
| NLD | 63 | 60 | -1.5 | -1.9 | 0.4 | 1.9 | 1.2 | 0.2 | 1.6 | 2.1 |
| BEL | 99 | 60 | -0.4 | 0.2 | -1.7 | 1.7 | 1.5 | 0.0 | 0.7 | 2.0 |
| PRT | 106 | 60 | 0.1 | 1.1 | 0.8 | 2.2 | 1.0 | 0.0 | 1.4 | 2.1 |
| IRL | 76 | 60 | -1.0 | -1.5 | 3.4 | 3.0 | 1.8 | 0.7 | 2.3 | 2.2 |
| GRC | 206 | 152 | 1.3 | 5.2 | -8.7 | 1.8 | 0.7 | -3.6 | -2.3 | 0.2 |
| FIN | 63 | 60 | -1.7 | -2.1 | -0.5 | 2.1 | 1.6 | -0.2 | 1.2 | 2.0 |
| AUT | 79 | 60 | -1.0 | -1.0 | 0.5 | 1.9 | 1.4 | 0.0 | 1.6 | 2.0 |
| EA | 88 | 61 | -0.5 | -0.3 | -0.5 | 1.5 | 1.1 | -0.2 | 1.1 | 1.9 |

*Source*: iAGS model.

**Table 4. Is it possible to reach a 60% debt-to-GDP ratio with financial fragmentation? (baseline scenario except permanent risk premia and +/- 0.5 fiscal impulses depending on public debt gap *vis-a-vis* 60% target)**

| | Public debt (in % of GDP) | | Structural balance (%in of GDP) | | Cumulative fiscal impulse | GDP growth rate (in %) | | Average output gap | Inflation rate (in %) | |
|---|---|---|---|---|---|---|---|---|---|---|
| | (1) 2020 | (2) 2035 | (3) 2020 | (4) 2035 | (5) 2015-35 | (6) 2016-20 | (7) 2021-35 | (8) 2016-35 | (9) 2016-20 | (10) 2021-35 |
| DEU | 59 | 60 | -1.3 | -2.2 | 3.5 | 1.6 | 1.0 | 0.6 | 2.1 | 2.2 |
| FRA | 96 | 60 | -0.8 | 0.3 | -4.0 | 1.5 | 1.5 | -0.4 | 0.7 | 1.9 |
| ITA | 135 | 69 | 0.9 | 7.5 | -9.3 | 0.5 | 0.1 | -1.8 | 0.0 | 1.0 |
| ESP | 99 | 60 | -0.9 | 0.8 | -4.1 | 1.8 | 1.4 | -0.5 | 0.5 | 1.8 |
| NLD | 63 | 60 | -2.0 | -2.1 | 1.1 | 2.1 | 1.2 | 0.5 | 1.8 | 2.2 |
| BEL | 97 | 60 | -0.9 | -0.1 | -1.1 | 1.9 | 1.5 | 0.3 | 1.0 | 2.2 |
| PRT | 120 | 60 | 0.5 | 2.2 | -2.4 | 1.4 | 1.1 | -0.5 | 0.2 | 2.0 |
| IRL | 76 | 60 | -1.3 | -1.6 | 3.3 | 3.0 | 1.8 | 0.9 | 2.4 | 2.3 |
| GRC | 204 | 142 | 1.4 | 5.8 | -8.7 | 1.8 | 0.7 | -3.5 | -2.2 | 0.3 |
| FIN | 61 | 60 | -2.0 | -2.3 | 0.2 | 2.3 | 1.6 | 0.1 | 1.6 | 2.1 |
| AUT | 78 | 60 | -1.3 | -1.2 | 1.0 | 2.0 | 1.4 | 0.2 | 1.8 | 2.2 |
| EA | 88 | 62 | -0.8 | 0.1 | -1.4 | 1.5 | 1.1 | -0.3 | 1.1 | 1.9 |

*Source*: iAGS model.

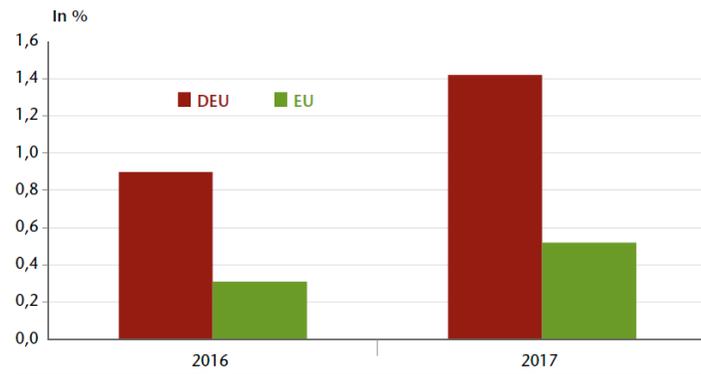Figure 3. Impact of the German fiscal stimulus on GDP

In %

DEU    EU

2016    2017



Figure 4. Job creations after the German fiscal impulse

Job creation (1000)

DEU    The rest of EU

2016    2017

*Note:* Accumulated effects.
*Source*: Calculations with HEIMDAL.