

SOME REFLECTIONS ON THE POLICY MIX IN THE EURO AREA

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3 October 2016

GIC – Central Banking Series

Session II: On Europe

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THIS TALK: TWO IDEAS

- **The current European macro-financial landscape (ZLB, low inflation, weak growth, deleveraging, fiscal consolidation...) raises the question about the existence and utilization of policy space (monetary, fiscal and supply-side policies):**
 - *Room for policy synergies and positive country-spillovers*
- **But, some necessary conditions for an effective and “safe” utilization of policy margins are not always guaranteed:**
 - *Credible long-run fiscal strategies.*
 - *Genuine pan-European devices.*

POLICY SYNERGIES (I): CURRENT MONETARY POLICY (MP) ENHANCES THE EFFECTIVENESS OF FISCAL POLICY (FP)

- **In normal times (out of the ZLB), expansionary FP raises inflation**
⇒ Central Bank (CB) raises nominal R ⇒ real R up ⇒ crowding OUT
- **At the ZLB, expansionary FP raises inflation ⇒ but, CB does not raise nominal R ⇒ real R down ⇒ crowding IN**
 - **Hence, FP is more effective in the domestic economy BUT also generates positive (and potentially sizable*) spillovers to the rest of the monetary union***

* *Blanchard, Erceg and Lindé (2016)*

* *Arce, Hurtado and Thomas (2016)*

POLICY SYNERGIES (II): GROWTH STIMULATING FISCAL POLICY MAY IMPROVE THE TRADE-OFFS FACED BY MONETARY POLICY

- **Growth and inflation-stimulating FP may shorten the period of ZLB, allowing for:**
 - **an earlier normalization and higher effectiveness and credibility of MP***
 - **milder financial stability-related risks (negative rates, etc.)****

**Erceg and Lindé (2014)*

*** Brunnermeier and Koby (2016)*

POLICY SYNERGIES (III): A RENEWED TWO-HANDED APPROACH

- **Non-conventional MP and demand-friendly FP reduce the short-term costs of structural reforms by*:**
 - **counteracting the short-term deflationary impact of reforms – this is especially relevant at the ZLB**
 - **increasing the “net present value” of structural reforms**
- **Also, structural reforms may facilitate fiscal consolidation, by rising tax bases**:**

** Andrés, Arce and Thomas (2015);*

** Arce, Hurtado, Thomas (2016)*

** Banco de España (2015)*

*** Gerali, Notarpietro and Pisani (2015)*

IS THERE POLICY SPACE IN THE EURO AREA?

- **Focus on fiscal policy and structural reforms.**
- **Where is fiscal space?**
 - **core countries?**
 - **Other? The issue of *gradual* fiscal consolidations***
- **Where is space for structural reforms?**
 - **Surely in the periphery, but also in the core -> chronic underinvestment is generalized problem**

* *Andrés, Arce & Thomas (2016)*

DO WE HAVE THE NECESSARY DEVICES TO EXPLOIT AVAILABLE POLICY SPACE IN AN EFFECTIVE AND “SAFE” WAY?

- **Focus on the fiscal side, “PROBABLY, NO”.**
- **Previous arguments on positive spillovers and synergies rest on the assumption of full gov’n’t credibility...**
 - “expand today but resume consolidation afterwards”.**

QUID PRO QUO: A PANEUROPEAN APPROACH TO POLICY SPACE REQUIRES PANEUROPEAN DEVICES

- **A pan-European approach to policy space is required, including the swift set up of genuine pan-European instruments**
 - Risk mutualization instruments (deposits guarantee schemes, unemployment insurance, ...)
 - Paneuropean institutions (fiscal councils?)
 - Clear and credible rules, contingency plans, ...
 - Paneuropean financial markets, institutions and assets? (risk diversification, liquidity externalities, asset scarcity...)
 - A road map for a fiscal union?

TO SUM UP....

- **The combination of the previous ingredients –credibility and genuine European devices- could allow for a welfare enhancing mix of demand and supply and demand policies....**
- **....but exploiting additional policy space against the lack of those ingredients may lead to unpleasant outcomes.**