Luis de Guindos: Improving macroeconomic stabilisation in the euro area

SPEECH

Speech by Luis de Guindos, Vice-President of the ECB, at the Global Interdependence Center Central Banking Series conference

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Introduction

A decade after the global financial crisis, the level of economic activity in the euro area remains disappointingly low. It took nine years for real per capita GDP to surpass its 2007 level. Likewise, euro area inflation has stubbornly remained below the ECB’s aim for much of the past decade.

Throughout this period, the ECB has acted decisively to support euro area demand and raise inflation onto a sustainable path towards our aim of below, but close to, 2% over the medium term. This has included lowering the key ECB rates to record low levels and adopting a wide range of non-standard monetary policy measures.

By contrast, the contribution from fiscal policy to macroeconomic stabilisation in the post-crisis period has been muted at best. From 2010 to 2012, economies representing around one-third of euro area GDP carried out procyclical fiscal tightening to restore confidence in their public debt, which significantly contributed to the second recession in that period. Since then, fiscal policy has been broadly neutral.

At our last meeting, the Governing Council responded to the continued shortfall of inflation with respect to our aim. Recent economic data point to a more protracted weakness in the euro area economy. Prominent downside risks remain and inflationary pressures are muted. We introduced a package of measures designed to support the euro area expansion, the ongoing build-up of domestic price pressures and, thus, the sustained convergence of inflation to our medium-term aim.

We also noted the need for countries with fiscal space to act in a timely and effective manner and for all countries to reinforce their efforts to achieve a more growth-friendly composition of public finances.

In my remarks today, I will focus on the roles of monetary and fiscal policy in supporting macroeconomic stabilisation in the euro area. In particular, I will explain why now is a particularly appropriate time for fiscal stimulus. I will also offer some thoughts on how to improve the current fiscal framework.

Macroeconomic stabilisation in a monetary union

The literature on optimal currency areas points to the need to counter two types of shocks: those that are common to all countries, and asymmetric ones that affect a subset of countries.

For common shocks, monetary policy can act to stabilise the economy.

But for idiosyncratic shocks, stabilisation becomes trickier. Monetary policy cannot target individual countries, and those affected can no longer adjust their exchange rate to help cushion the effects of the shock. Hence the literature emphasises the need for economic cycles to converge, so that common shocks generally dominate. For asymmetric shocks, stabilisation comes ex ante from greater cross-border risk-sharing to improve resilience, and ex post from fiscal policy.

But in the light of recent experience, it is worth revisiting this classic separation between using monetary policy for common shocks and fiscal policy for asymmetric shocks. Fiscal policy at a national level in the euro area was unable to fully counter asymmetric shocks during the crisis. And at an aggregate level, stabilisation may benefit from monetary and fiscal policy working in tandem given the current environment of low interest rates.

Nominal interest rates have been declining in advanced economies since the 1980s. In large part, this decline is attributable to the decline in average inflation over that period. Investors require lower compensation for expected future inflation, and the fall in inflation volatility has also reduced the inflation risk premium. The decline is also a result of a secular fall in the natural rate of interest, which is the rate that balances desired saving and investment in the economy. While the natural rate cannot be precisely measured, a range of estimates point to its decline.

There are a number of contributing factors to this decline, principal among which is lower potential growth. Lower potential growth reduces the expected rate of return on capital, so reduces the rate at which firms are prepared to borrow to invest.

Other factors that are believed to have further weighed on the natural rate of interest include the ageing population in Europe, the role of income distribution, increased saving in emerging markets and a general rise in risk aversion.

This fall in the natural rate of interest has important implications for the optimal policy mix in the euro area. The interest rate at which monetary policy becomes accommodative falls directly in line with the natural rate, so the effective lower bound on nominal rates has become a much greater consideration when setting policy. Before the crisis, it was estimated that interest rates in the euro area would be likely to hit zero only once every 50 years.[1] At the current natural rate, rates of zero or below are likely to be a much more frequent occurrence.

As the experience of the past decade has shown, the decline of the natural rate is not an impediment to monetary policy providing accommodation to the economy. But it does mean that monetary policy has to remain accommodative for longer and make greater use of unconventional measures. Those factors carry with them an increased risk of undesired side effects.

In such a situation, economic theory tells us that fiscal policy should play a much more substantive role in business cycle stabilisation than it usually would.[2] The reason for this is straightforward.

In normal times, when output is close to potential and inflation is close to its objective, a fiscal expansion threatens to push inflation above the central bank’s aim. Central banks respond by raising their policy rates, and the increase in interest rates partially crowds out private sector demand. However, when the economy operates below potential the central bank has no reason to fight a fiscal expansion. Policy rates would not increase and private sector demand would be crowded in, leading to a much larger positive effect on aggregate demand and inflation.

In other words, when policy rates are close to the lower bound, fiscal policy becomes more effective in stimulating aggregate demand.[3]

Moreover, while monetary policy must take the natural rate of interest as given, fiscal policy – if enacted appropriately – can help raise it, in turn making monetary policy more powerful. Policies to encourage more people, especially older workers, to participate in the labour force can help raise rates. Increasing spending on education and public investment can support productivity and lift both potential growth and *private* investment.[4]

Every policy implies trade-offs, of course. The side effects of very accommodative monetary policy may become unduly tangible when the economy operates below potential for a long time. In fact, while we believe that, overall, the benefits outweigh the costs, we acknowledge the challenges that a sustained low interest rate environment poses for banks.

Reforming the fiscal framework

So there is a role for fiscal policy to play in helping to counter common shocks at the European level. To the extent that Member States have created fiscal space, it would therefore be desirable for fiscal policy in the euro area to support business cycle stabilisation more actively. Our current assessment is that the fiscal stance is only mildly expansionary at the aggregate level.

But the current institutional framework is insufficient to deliver that required stimulus.

Fiscal policy remains a national responsibility in Economic and Monetary Union (EMU), with some common rules applicable to individual countries. In its first incarnation, the Stability and Growth Pact focused almost exclusively on fiscal sustainability, with little emphasis on fiscal stabilisation.[5] In recent years it has undergone several reforms, some of them with the explicit aim of providing greater prominence to stabilisation considerations, both at the country level and at the euro area level. The result has been rules which are now viewed as complex and opaque, with little evidence that they have delivered a more countercyclical fiscal policy stance in the euro area.[6]

The Stability and Growth Pact has limited flexibility and does not lend itself to incorporating area-wide stabilisation elements. National fiscal rules, with a focus on domestic issues, tend to neglect positive cross-border spillovers. They fail to recognise the benefits of cross-country risk-sharing and the vital role played by the public sector in underpinning it.

In other words, rules based purely at a national level, or even rules that coordinate a fiscal stance across countries, are not enough by themselves. Empirical evidence suggests that spillovers from a fiscal expansion in one euro area country to others are positive, but small. So while it is important for those countries with available fiscal space to use it domestically to support overall stabilisation, a central fiscal capacity with the ability to allocate expenditure across countries would be more powerful.

A dedicated centralised fiscal capacity would not interfere with domestic policy. By focusing on common area-wide stabilisation it need not affect national fiscal space but rather provide an additional layer. This focus would also help ensure that areas of expenditure that are vital for long-run growth are not cut during a downturn, helping to preserve future fiscal space and support real interest rates over the long term.

A central fiscal capacity of this sort would clearly need to be carefully designed to mitigate any risk of moral hazard. But, crucially, it should have sufficient firepower to effectively contribute to macroeconomic stabilisation. It needs to be sizeable and agile enough to react rapidly to emerging threats.

But macroeconomic stabilisation in the euro area can only function properly when other EMU features and institutions are adequately designed and operational.

First, the banking union needs to be completed. Unified banking supervision and the Single Resolution Fund (SRF) have provided greater confidence that banks operating in other euro area countries face the same conditions as in their home market. But the banking union will remain incomplete until a common deposit insurance scheme has been introduced and the fiscal backstop for the SRF has increased in size. While there is political agreement about the SRF backstop and its terms of reference, there is not yet agreement on the European deposit insurance scheme.

Second, it is imperative to accelerate progress on the capital markets union. This is ambitious. It entails streamlining core aspects of national policies, such as taxation and insolvency regimes, which are essential for integrating the legal underpinnings of cross-border markets. Capital markets can smooth country-specific shocks by providing a larger pool of financial assets that can be shared across borders. This helps to decouple wealth and income – and hence consumption – from output.

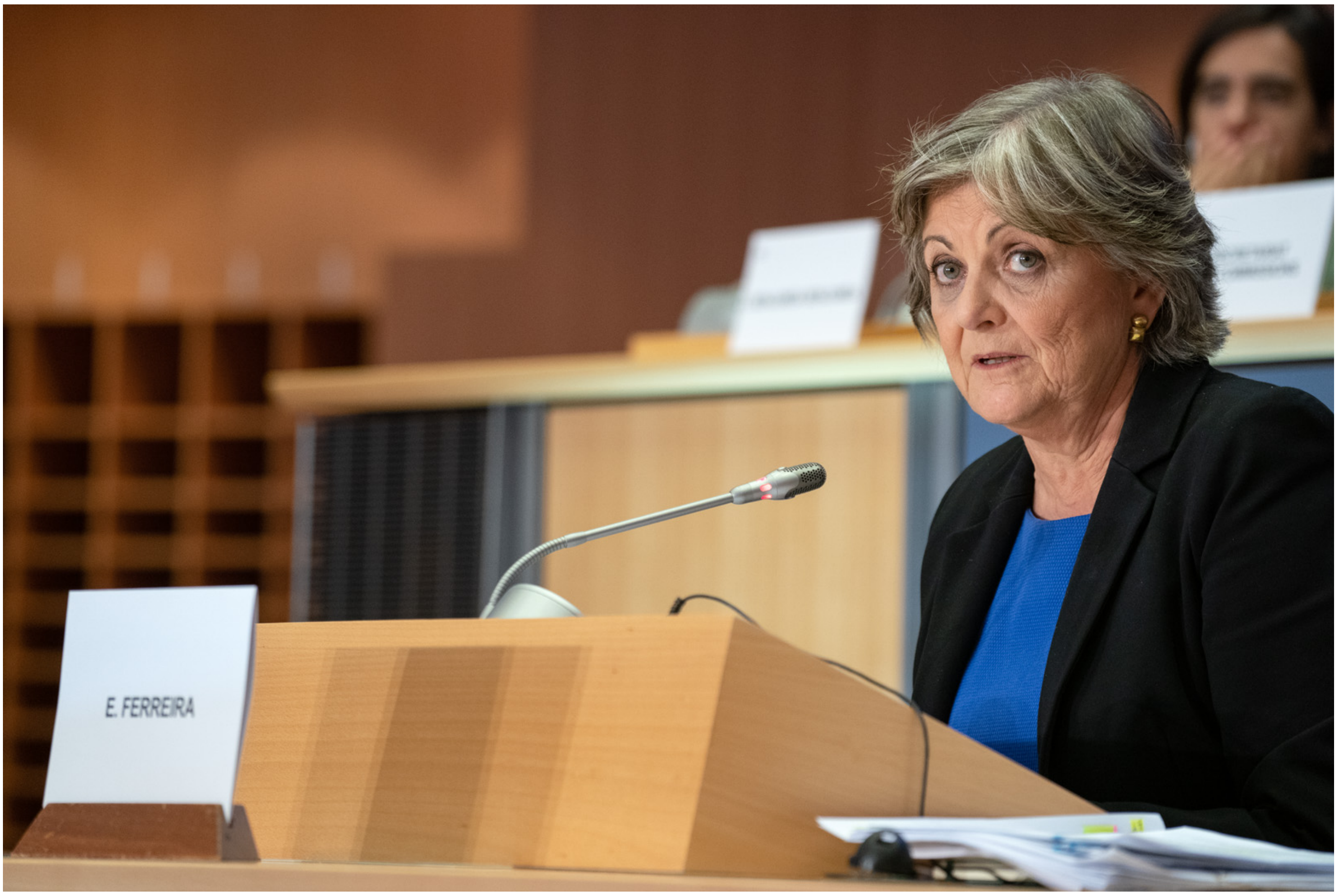
Conclusion

Let me conclude.

The euro area risk outlook is again tilted to the downside. This is a conjunctural concern. The global decline in the natural rate of interest over the past quarter of a century, however, poses structural challenges. Policy rates will likely remain low, by historical standards, and may hit their lower bounds more frequently than in the past.[7] We have learned from the experience in Japan that it is possible to get caught in a vicious cycle of declining inflation expectations, falling inflation and a binding lower bound on nominal interest rates from which it is difficult to escape.

It is thus of utmost importance that we enhance the firepower of euro area stabilisation policy by means of a policy mix that, while continuing to make full use of monetary policy, assigns a more substantive role to fiscal stabilisation policy. Laying the institutional foundations for a European fiscal capacity would be an important step in this direction.

Press release – Hearing of Commissioner-designate Elisa Ferreira



Political groups’ coordinators from the committee will meet within 24 hours to assess the performance of Portuguese Commissioner-designate Ferreira.

No region will be left behind

During her introductory speech, Ms Ferreira mentioned that cohesion policy must be at the top of the EU agenda, and pledged for more coherence between EU policies. She said that structural reforms and cohesion must strengthen each other. She underlined her willingness to build a tailored cohesion policy for all regions, from outermost to mountainous and coal regions. Her motto will be “no region will be left behind”. She added that cohesion policy spending should be strongly linked to the European green deal and digital objectives. She also engaged in building a special and strong partnership with the Regional Development Committee throughout her mandate.

MEPs put forward several questions on how she plans to defend a strong budget for cohesion in the next MFF, reduce territorial disparities and simplify and accelerate the implementation of cohesion policy. Several questions also referred to the role of cohesion policy in tackling climate change in order to achieve a zero carbon economy, and to the proposed “Just Transition Fund” meant to support regions most affected by the transition to a green economy. Members also questioned the Commissioner-designate on the macro-economic and rule of law conditionality.

You can watch the video recording of the full hearing here.

Press point

At the end of the hearing, Committee Chair Younous Omarjee (GUE/NGL, FR), together with Commissioner-designate Elisa Ferreira, held a press point outside the meeting room: [watch it here].

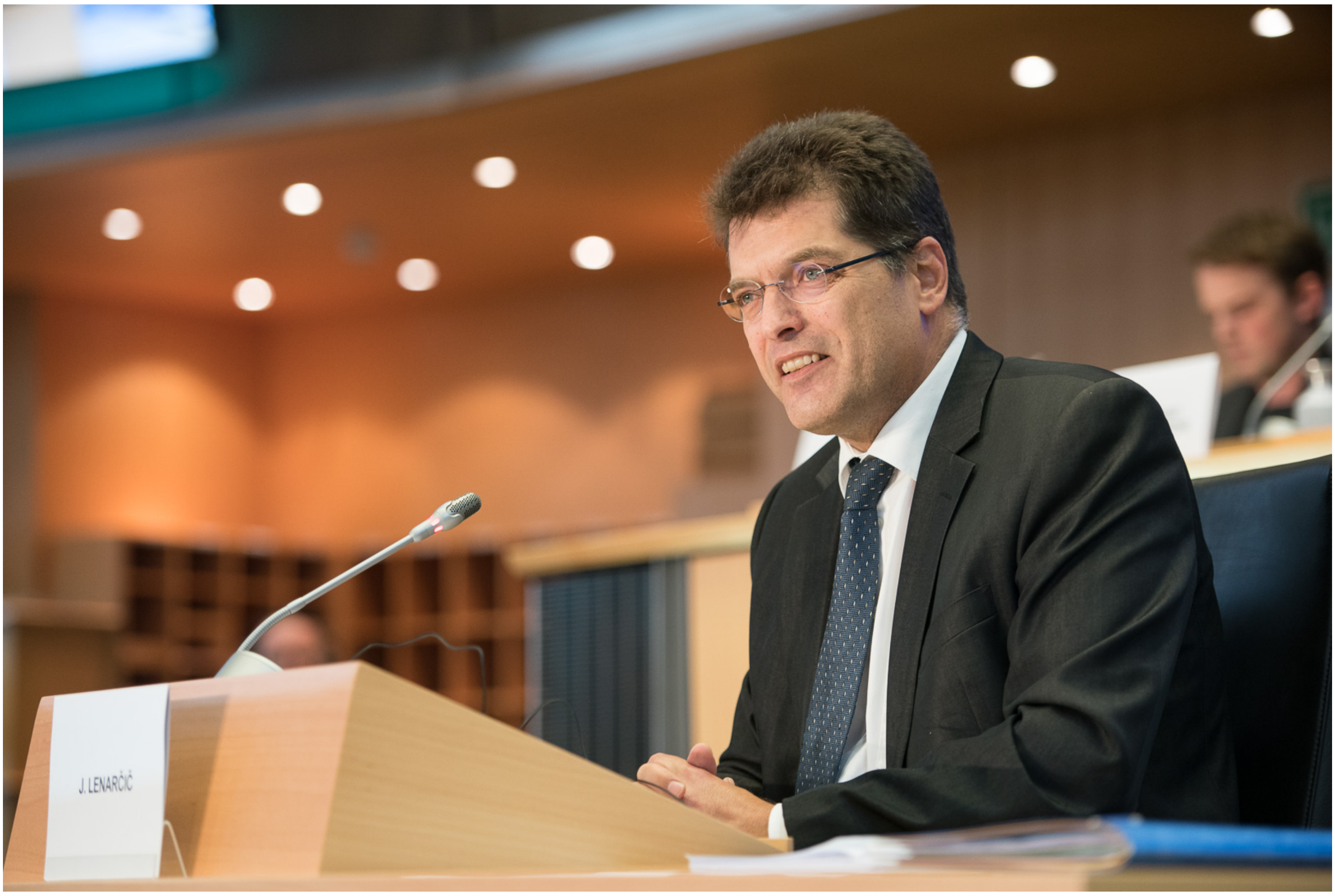
Next steps

Based on the committees' recommendations, the Conference of Presidents will decide on 17 October if Parliament has received sufficient information to declare the hearing process closed. If so, the plenary will vote on whether or not to elect the Commission as a whole on 23 October, in Strasbourg.

Background

The hearing was chaired by Younous Omarjee. Members from the associated Committees (Budget and Economic & Monetary Affairs) also participated in the hearing.

Press release – Hearing with Commissioner-designate Janez Lenarčič



Political groups' coordinators from the committees will meet shortly after the hearing to assess, within 24 hours, the performance of the Slovenian

Commissioner-designate.

Disaster risk reduction, humanitarian aid and EU values

During his introductory speech, Mr. Lenarčič said that humanitarian aid is central to the European Union’s response to crises and disasters, as it stabilises host societies, displays the European Union’s leadership, and builds coalitions based on European values. His priorities include strengthening the EU’s response capacities, stepping up risk reduction, and integrating humanitarian aid, development and environmental policies. He added that this will ensure efficient delivery of aid, particularly to vulnerable groups, including children, girls and women.

MEPs put forward questions on how the commissioner-designate would ensure that humanitarian aid is driven by the EU’s values and the principle of impartiality rather than foreign policy objectives. They also asked about measures to protect civilians and the security of aid workers in complex crises as well as about efficient responses to national and man-made disasters and climate change.

Members also asked how he intends to ensure that the European Commission delivers on the commitments made at the 2016 World Humanitarian Summit.

You can watch the video recording of the full hearing here.

Press point

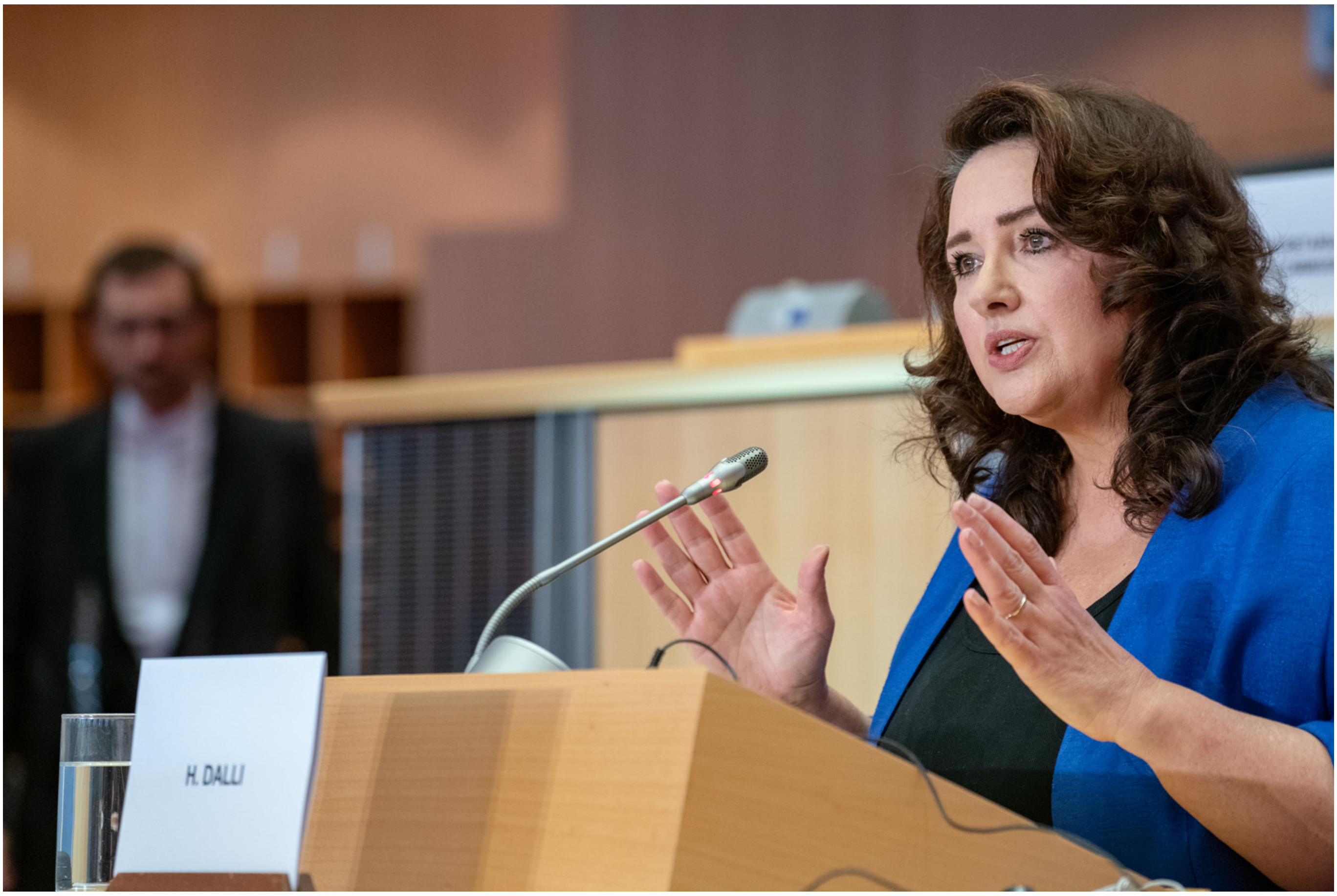
At the end of the hearing, Committee Chair Tomas Tobé (EPP, SE) held a press point outside the meeting room.

Next steps

Based on the committees’ recommendations, the Conference of Presidents will decide on 17 October if Parliament has received sufficient information to declare the hearing process closed. If so, the plenary will vote on whether or not to elect the Commission as a whole on 23 October, in Strasbourg.

The Environment committee was associated to this hearing.

Press release – Hearing of Commissioner-designate Helena Dalli



Political groups’ coordinators from both committees will meet within 24 hours to assess the performance of Maltese Commissioner-designate Helena Dalli.

Fighting discrimination, stereotypes and closing the gender pay gap

During her introductory speech, Ms Dalli said that discrimination is ‘‘harming both individuals and society as a whole’’, and that she would fight for a Europe ‘‘free of discrimination’’. If approved, she committed to establish, within three months, a Task Force on Equality to build an intersectional approach on gender mainstreaming in all EU policies. She also promised an EU Gender Equality Strategy, with new measures on issues such as pay transparency, the gender pay gap, violence against women and gender stereotypes.

MEPs welcomed the President-elect’s decision to appoint an Equality Commissioner for the first time. They put forward questions on several files blocked for years in the Council, such as the Women on Boards Directive, the Anti-discrimination Directive or the ratification of the Istanbul Convention on preventing and combating violence against women. Ms Dalli said that she would do her utmost to unblock these essential files, by meeting with ministers to convince them to move forward.

During the three-hour hearing, MEPs also questioned her on the protection of sexual and reproductive health and rights, the digital gap faced by women, disability, female genital mutilation (FGM), forced marriages, and the rights of LGBTI people, in particular transgender and intersex people.

You can watch the video recording of the full hearing here.

Press point

At the end of the hearing, Women's Rights and Gender Equality Committee Chair Evelyn Regner (S&D, AT) and Employment and Social Affairs Committee Chair Lucia Ďuriš Nicholsonová (ECR, SK) held a press point outside the meeting room: watch it here.

Next steps

Based on committees' recommendations, the Conference of Presidents will decide on 17 October if Parliament has received sufficient information to declare the hearing process closed. If so, the plenary will vote on whether or not to approve the Commission as a whole on 23 October, in Strasbourg.

Background

Members from the associated Civil Liberties, Justice and Home Affairs Committee also participated in the hearing.

Statement by the European Commission following President Jean-Claude Juncker's phone call with Prime Minister Boris Johnson

President Jean-Claude **Juncker** spoke to Prime Minister Johnson on the phone this afternoon. The Prime Minister informed the President about the contents of the UK's latest proposal – which includes a legal text, explanatory note and letter from Prime Minister Johnson.

President **Juncker** welcomed Prime Minister Johnson's determination to advance the talks ahead of the October European Council and make progress towards a deal. He acknowledged the positive advances, notably with regards to the full regulatory alignment for all goods and the control of goods entering Northern Ireland from Great Britain. However, the President also noted that there are still some problematic points that will need further work in the coming days, notably with regards to the governance of the backstop. The delicate balance struck by the Good Friday Agreement must be preserved. Another concern that needs to be addressed are the substantive customs rules. He also stressed that we must have a legally operational solution that meets all the objectives of the backstop: preventing a hard border, preserving North-South cooperation and the all-island economy, and protecting the EU's Single Market and Ireland's place in it.

President **Juncker** confirmed to Prime Minister Johnson that the Commission will now examine the legal text objectively, and in light of our well-known criteria.

The EU wants a deal. We remain united and ready to work 24/7 to make this happen – as we have been for over three years now.

Next steps

Meetings between the EU and UK negotiation teams will take place in Brussels over the coming days.

In keeping with the EU's transparency policy, we will inform the European Parliament and the Council at every step of the way. The European Commission's Chief Negotiator Michel Barnier and his team will update the European Parliament and the Council this evening. President **Juncker** will also speak to Taoiseach Leo Varadkar and will listen carefully to his views.