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CURRENT CHALLENGES IN THE EURO AREA ECONOMY AND POLICIES

Pablo Hernández de Cos
Governor

COLLEGE OF EUROPE

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CURRENT CHALLENGES IN THE EURO AREA ECONOMY AND POLICIES

1. The impact on potential growth of the pandemic and energy crises

2. Monetary Policy developments in the Euro Area

3. The role of Fiscal Policy

1. THE IMPACT ON POTENTIAL GROWTH OF THE PANDEMIC AND ENERGY CRISES

THE POTENTIAL LONG-TERM EFFECTS OF THE PANDEMIC

1. The pandemic led to lower labor participation in sectors where it was hard to work from home. In addition, persistent health effects may have had long-term effects on employment. And school closures during lockdowns may also have had negative consequences in terms of human capital accumulation. The more traditional hysteresis effects might also emerge, increasing structural unemployment.

2. The sharp and short-term decline in demand may have deterred investment, particularly since it was accompanied by a significant increase in uncertainty. In addition, the fall in demand could have increased the number of financially vulnerable firms. And all these together may have increased the risk of business bankruptcy and restricted the entry of new competitors, which would also be detrimental to productivity.

3. On the other hand, the shock may have been conducive to an acceleration of digitalisation, and to the adoption of new employment practices, like teleworking, which may also boost productivity. Moreover, if firm destruction is neither excessive nor insufficient, the reallocation of resources between- and within-sectors through a process of creative destruction should eventually be productivity-enhancing.

4. This time the policy reaction was timely, forceful and coordinated policy reaction at both the national and EU level and this might have been crucial to avoid excessive labor market hysteresis and firm destruction.

THE EFFECTS OF NGEU FUNDS

1. Some available estimates point to the structural reforms and investments envisaged by the RRF plans to have the potential to increase euro area potential output by around 1.5 % in 2026.

2. In particular, the program is expected to benefit European economies through four different channels.

- First, the concerted fiscal effort might bring sizable spillovers due to the close trade links of European partners.

- Second, the associated structural reforms, if adequately and timely implemented, could be key for the long-run impact of the plan. And the implementation of these reforms is enhanced by the incentives embedded in the conditional approval of the successive installments.

- Third, the financing with common EU debt would allow for reducing the potential crowding-out effects of public investment.

- And, fourth, the European reaction to the pandemic triggered positive confidence effects that, in particular, helped to reduce risk premia in periphery countries.

THE POTENTIAL LONG-TERM EFFECTS OF THE ENERGY CRISIS

1. Since the European economy is a net importer of gas and oil, the real income of European energy consumers declines as prices rise. Under the assumption of a permanent increase in energy prices of around 30 %, the reduction in the EU's real income would be slightly above 1 percent of GDP.

2. The increase in energy prices could have a negative effect on the capital stock by reducing incentives for firms to invest and by rendering part of the production processes obsolete.

- In the face of a permanent 30 % increase in the costs of energy, potential output could be reduced by around 0.5 % (0.4% if we assume a high elasticity of substitution of energy consumption).

- But, in the very long-run, under high elasticities of substitution, the impact of an increase in energy prices on investment could be even positive if it induces innovation.

- EU-wide policies could mitigate the negative consequences of the energy crisis. More integration and interconnection of EU energy markets will increase competitiveness and allow for lower energy prices.

3. A permanent increase in markups and wages may generate an increase in structural unemployment and a reduction in potential output.

THE FUTURE OF GLOBALISATION

1. In light of the perceived increase in barriers to global input trade, there is some evidence that firms are shortening their value chains, diversifying towards regional or local suppliers, and increasing inventories.

2. Negative effects on potential growth are expected due to higher costs and/or lower incomes resulting from lower trade volumes, and also due to a slower diffusion of technology and innovation, higher markups by local suppliers and less “creative destruction” in the economy.

3. But if the future of globalization implies a higher diversification of suppliers and a regionalization of GVC, it may generate greater macro stability and less volatility.

4. So far, what we observe is a change in the nature of globalisation, towards more regionalisation, more diversification, less trade in goods (especially energy commodities) and more trade in services. Its overall effect on long-term potential growth is far from clear at this stage.

ESTIMATES OF POTENTIAL OUTPUT GROWTH (I)

1. According to the IMF estimates, potential growth for the EA in 2024 was estimated to be around 1.3 % in the October 2019 World Economic Outlook (WEO), and remained essentially unaltered in the October 2022 WEO. And, according to Consensus Economics, the October 2019 consensus forecast pointed to 10-year ahead annual GDP growth of 1.24 %, while the corresponding figure in the October 2022 survey was 1.26 %.

2. When comparing the IMF estimates of the level of potential output for 2024 released in October 2019 with those released in October 2022, it is now estimated to be around 1.5 % - 2 % below its pre-pandemic scenario.

3. To the extent that long-term potential growth remains unaffected with respect to the pre-pandemic scenario, the negative impact in potential output is expected to be permanent. In addition, the negative impact on the level of potential output is expected to be smaller than the one on actual GDP, which suggests the existence of a negative impact on the output gap as a result of the pandemic and the energy crisis.

4. By components, the main sources of the negative (and moderate) impact on the level of potential output are the downward revisions in the contributions of capital and TFP between the December 2019 and December 2022.

ESTIMATES OF POTENTIAL OUTPUT GROWTH (II)

1. There is also evidence of a decoupling between the output gap, which entered negative territory already in March 2020 pointing to a certain degree of slack in the economy, and the unemployment gap, which remains negative, thus suggesting some tightness in the labour market.

2. While several factors might be at the root of this decoupling, two are especially relevant:

(i) the exceptional use of Job retention schemes (JRS) mitigated the impact of the crisis on unemployment more so than on the other components of GDP from the supply side;

(ii) the recently observed wage moderation that not only mitigates the risks of wage-price spirals, but also contains the increase in structural unemployment in the presence of an increase in energy prices.

2. MONETARY POLICY DEVELOPMENTS IN THE EURO AREA

OUR LATEST MONETARY POLICY DECISIONS

1. The December ECB staff projections contained an appreciable upward revision in the average inflation rates for 2023 and 2024 and also projected inflation above our 2% medium-term target. This was an indication that the financial conditions prevailing before that meeting were inconsistent with a timely return to our 2% target. Thus, we raised our rates by 50 bp and, we signaled our intention to continue raising them significantly at a steady pace.

2. After our December communication, there was an upward shift in the risk-free forward curve. In particular, the day before our February meeting, the 10-year OIS rate was 0.27 percentage points higher than before the December meeting, while the 3-month OIS rate was 0.51 pp higher.

3. Our February decision represents a continuation (i.e. "staying the course") of the December tightening path. Our assessment of the inflation outlook led us to assess the risks as being more balanced, especially in the near term. And in the run-up to our February meeting the risk-free forward curve continued to point to expectations of further interest rate increases, including 50 bp hikes in both February and March, with a terminal market rate of around 3.47%.

4. Taking these two elements together, at the time of our February meeting, the risk-free forward curve – together with all the other factors influencing markets' and experts' inflation expectations – could be seen as compatible with a return of inflation to the 2% target in the medium term. And we acted and communicated in accordance with this assessment.

MONETARY POLICY GOING FORWARD

A number of factors will play a crucial role on our policy action beyond March:

1. **The degree of pass-through of the inflationary shock to core inflation and the symmetry of the recent decline in energy prices**

2. **Exchange rate fluctuations. The euro-dollar exchange rate depreciated significantly in the first part of last year. However, in the second half of 2022 and so far in 2023 this depreciation has partially reversed.**

3. **The evolution of wages and mark-ups.**

4. **External developments could be key, in particular, the impact of the end of the zero-COVID policy in China.**

5. **The resilience of euro area growth and its composition.**

6. **Another source of uncertainty is related to the transmission of monetary policy since the current hiking cycle is unprecedented in its speed and today's macro-financial conditions differ from those prevailing in previous cycles.**

3. THE ROLE OF FISCAL POLICY

SHORT TERM CONSIDERATIONS

1. **In the current high inflation setting, the appropriate policy mix requires a fiscal stance that is not at odds with this anti-inflationary stance.**

2. **Government support measures should be temporary, targeted and tailored to preserving incentives to consume less energy. And measures should be gradually rolled back as energy prices fall. Otherwise, we are at risk of driving up inflationary pressures, which would call for a stronger monetary policy response.**

3. **Moreover, the huge need for fiscal support during the pandemic forced the suspension of the fiscal framework and led to a significant increase in the level of public debt, greatly reducing the fiscal space, against a background of pressing long-term public investment needs in the fields of digitalisation and climate change.**

4. **In this context, high inflation and the shift towards a restrictive monetary policy might encourage financial markets to pay more attention to debt sustainability concerns. In a nutshell, a credible fiscal framework is more important than ever.**

THE EUROPEAN COMMISSION PROPOSAL FOR A REVIEW OF THE STABILITY AND GROWTH PACT

1. The main objective of the proposal is to ensure that public debt ratios are put on a downward path, keeping the debt-to-GDP ratio of 60% as the reference value. And retaining the need for public deficits to stay below the 3% reference value over the medium term.
2. Member states should present medium-term fiscal-structural plans that ensure that the debt ratio is kept or brought onto a sustainable path by the end of the adjustment period. The adjustment path will be discussed and agreed upon bilaterally with the Commission, before being adopted by the Council.
3. These medium-term structural plans will incorporate public investment and reform commitments, which could underpin a longer fiscal adjustment period or a more gradual adjustment.
4. The fiscal adjustment path is to be based on a long-term fiscal sustainability anchor, engineered through a so-called debt sustainability analysis framework and implemented through a simple expenditure rule.
5. As for the enforcement mechanism, the effective use of financial sanctions would be de-constrained by lowering their amounts, reputational sanctions would be enhanced, and macroeconomic conditionality would be applied for structural funds and EU financing as an additional lever.

A PRELIMINARY ASSESSMENT OF THE EUROPEAN COMMISSION PROPOSAL (I)

1. The Commission's orientations include country-specific expenditure targets, which could incorporate the differences in potential growth and interest rates into the debt sustainability analysis framework. While this is in principle desirable, the key aspect is how the deadlines for the necessary fiscal adjustment are calibrated. The credibility of the fiscal framework could be endangered if the deadlines are too lengthy or if the adjustment is backloaded.

2. Fiscal rules must be able to avoid the traditional pro-cyclical behaviour of public finances. Thus, a clear incentive scheme to boost efforts to consolidate public finances when the economy is doing well should be included. It should combine positive incentives - such as allowing countries to design the fiscal consolidation path –with negative ones – like an improved regime of sanctions, including restrictions on the access to EU funds.

3. Greater compliance can be achieved with more automatic rules. The Commission's proposal improves automaticity to some degree. But its effective application remains to be seen. In this context, an enhanced role for independent fiscal institutions should be envisaged.

A PRELIMINARY ASSESSMENT OF THE EUROPEAN COMMISSION PROPOSAL (II)

1. **The reform proposal suggests a simple expenditure rule together with a sustainability anchor, based on a debt sustainability analysis framework. Yet the concept of debt sustainability is not easy to operationalise.**

2. **The reform proposal addresses the possibility of redirecting additional public funds towards the climate and digital targets through the use of an extended period of adjustment. This approach is better than the use of the so-called "golden rules" to finance green investment. In any case, the challenges of the green and digital transitions exceed by far the fiscal space of national governments. Thus, a more efficient option would be to set up a common European financing instrument.**

3. **Lastly, the European Commission's orientations miss an essential element: establishing a permanent central fiscal capacity.**