



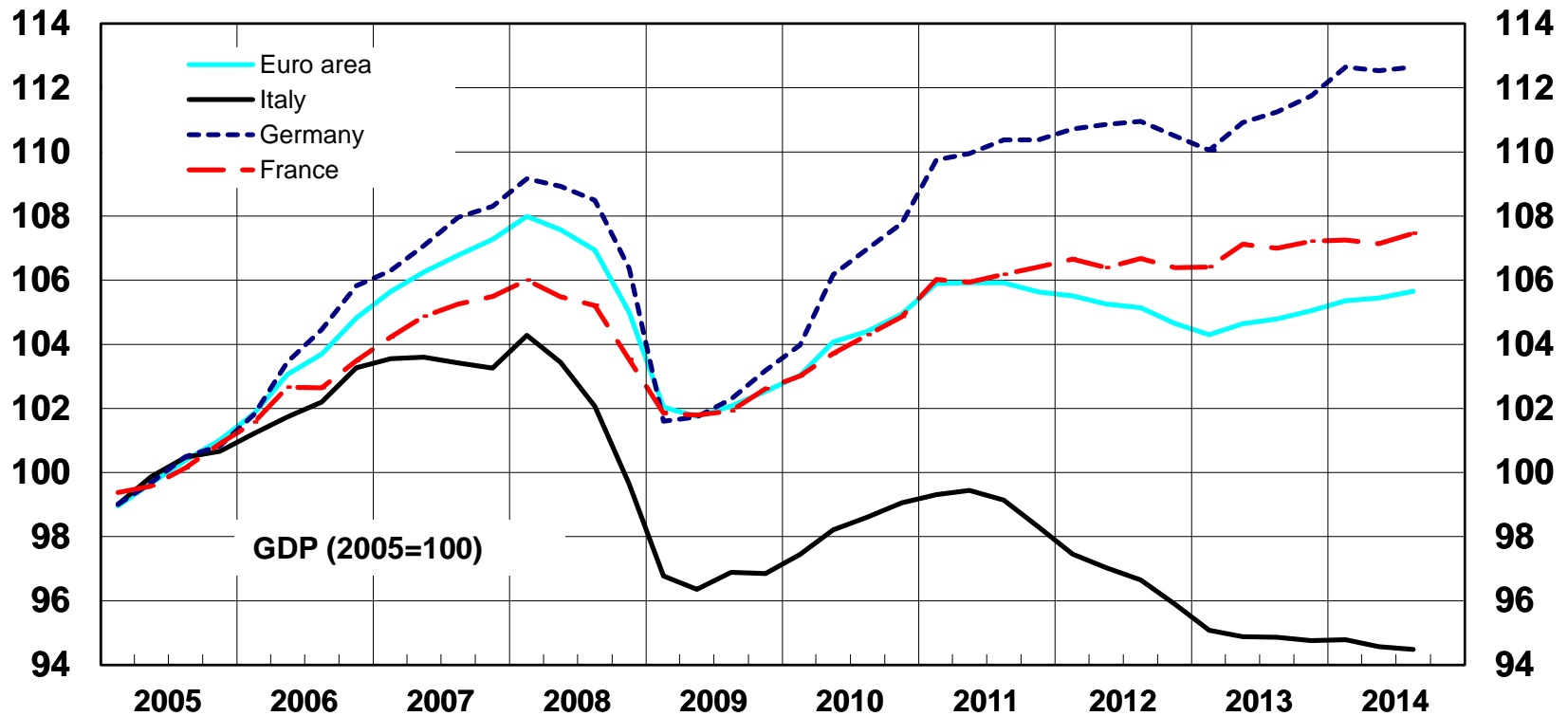
# Calibrating the Macro-Economic Response Europe Needs Now

**Fabrizio Balassone**

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Embassy of Italy - Peterson Institute Conference on  
Restoring Sustainable Growth and Job Creation in Europe  
Washington, Bergsten Conference Center, 18 December 2014

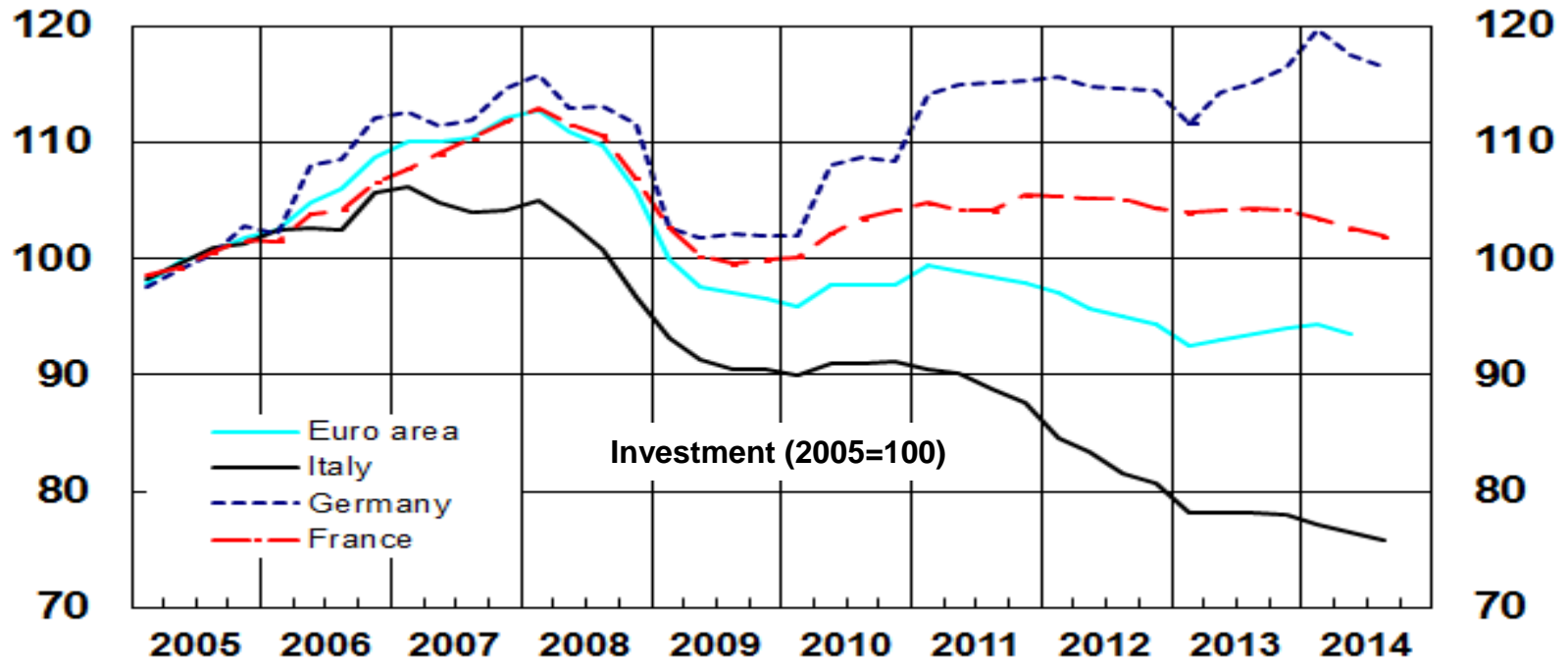
# 1. In the euro area the recovery hesitates



Sources: Eurostat and national statistical institutes.

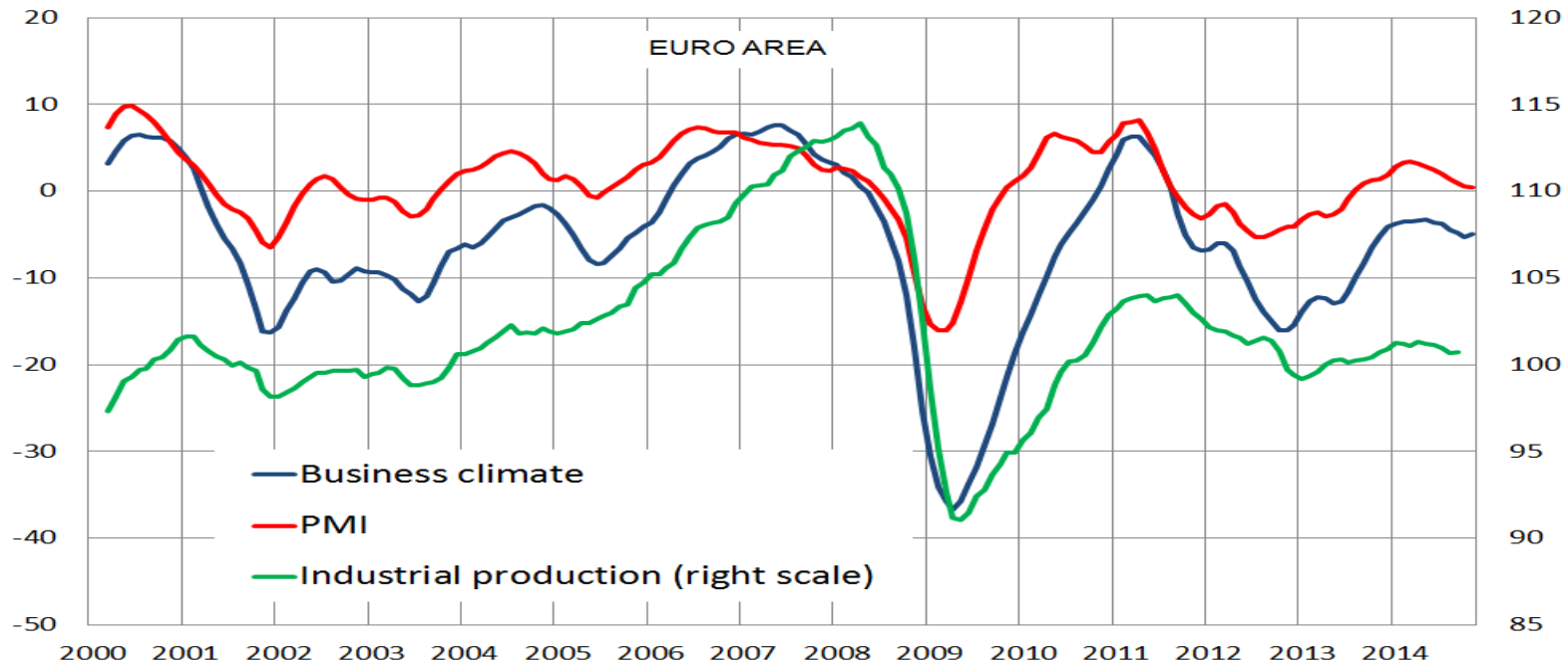
- weakness is not confined to stressed countries

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- exports are losing momentum and domestic demand continues to drag (investment)

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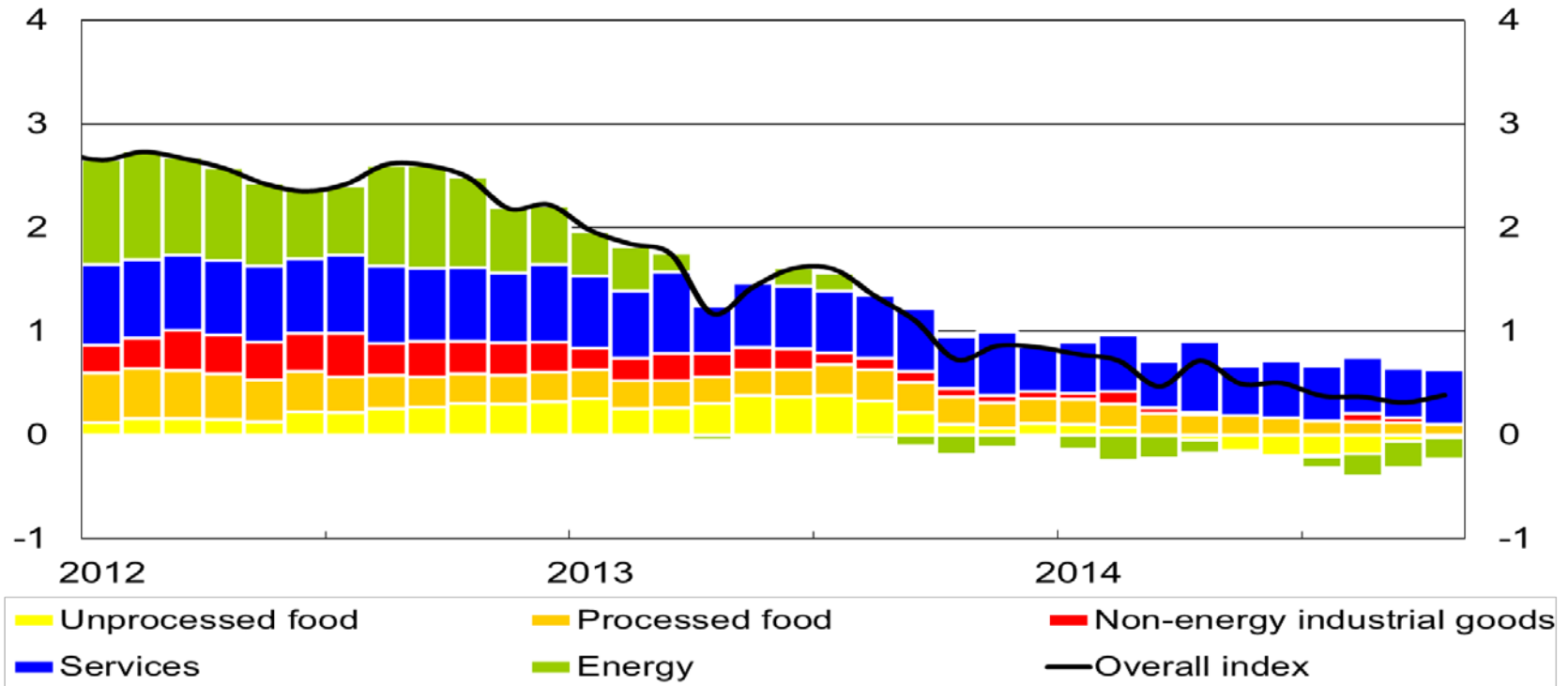
Sources: Bank of Italy, Eurostat, European Commission and Reuters.

- weakness is not confined to stressed countries
- exports are losing momentum and domestic demand continues to drag (investment)
- confidence indicators are worsening

## 2. Inflation has fallen and remains too low

### Inflation in the euro area and contributions of the components (1)

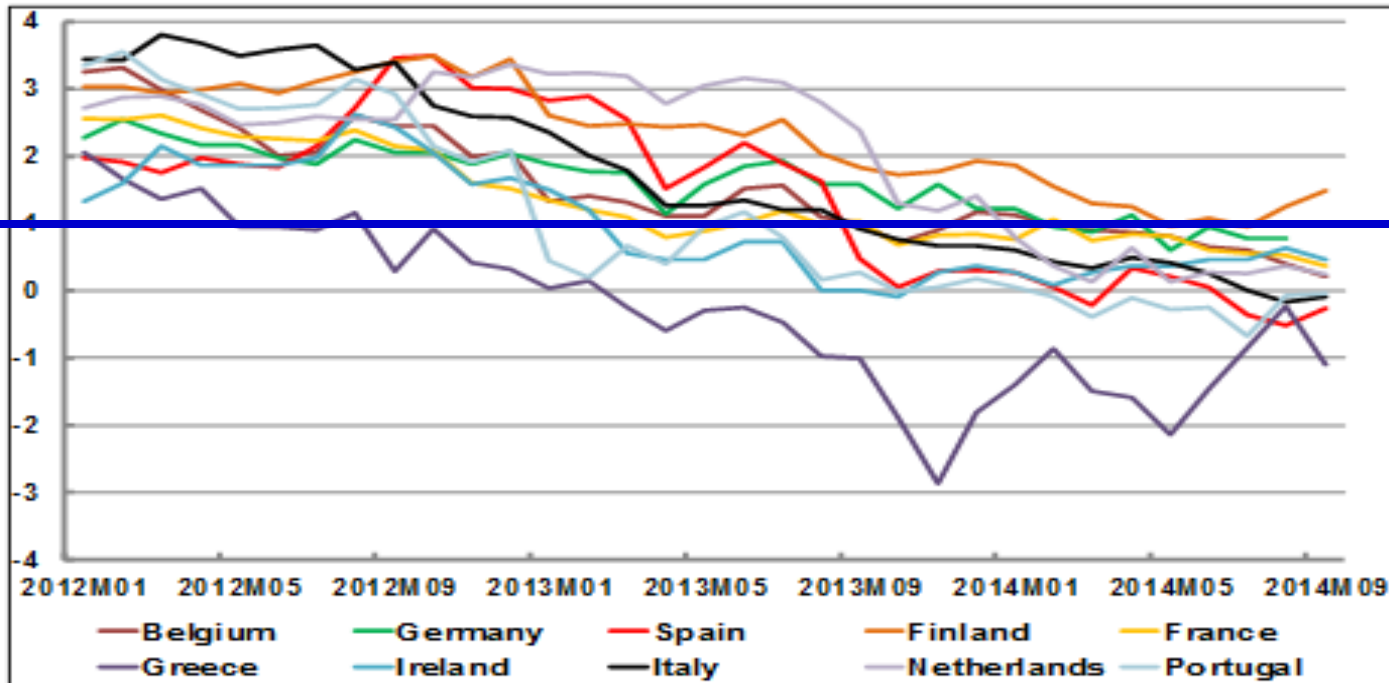
(monthly data; 12-month percentage changes and percentage points)



- both headline and core

## 2. Inflation has fallen and remains too low

**Inflation in the euro area and in selected member countries**  
(monthly data; 12-month percentage changes)

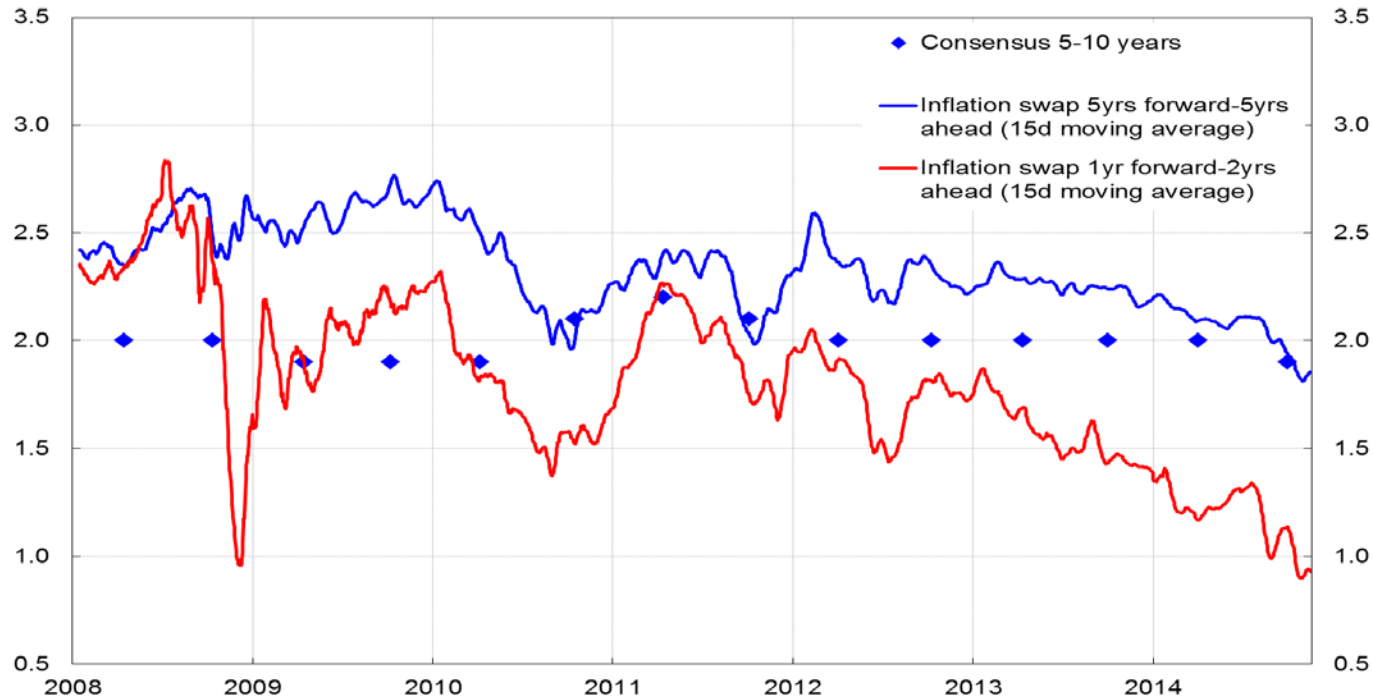


- both headline and core
- in almost every member state

## 2. Inflation has fallen and remains too low

### Long-term inflation expectations

*(percentage points)*

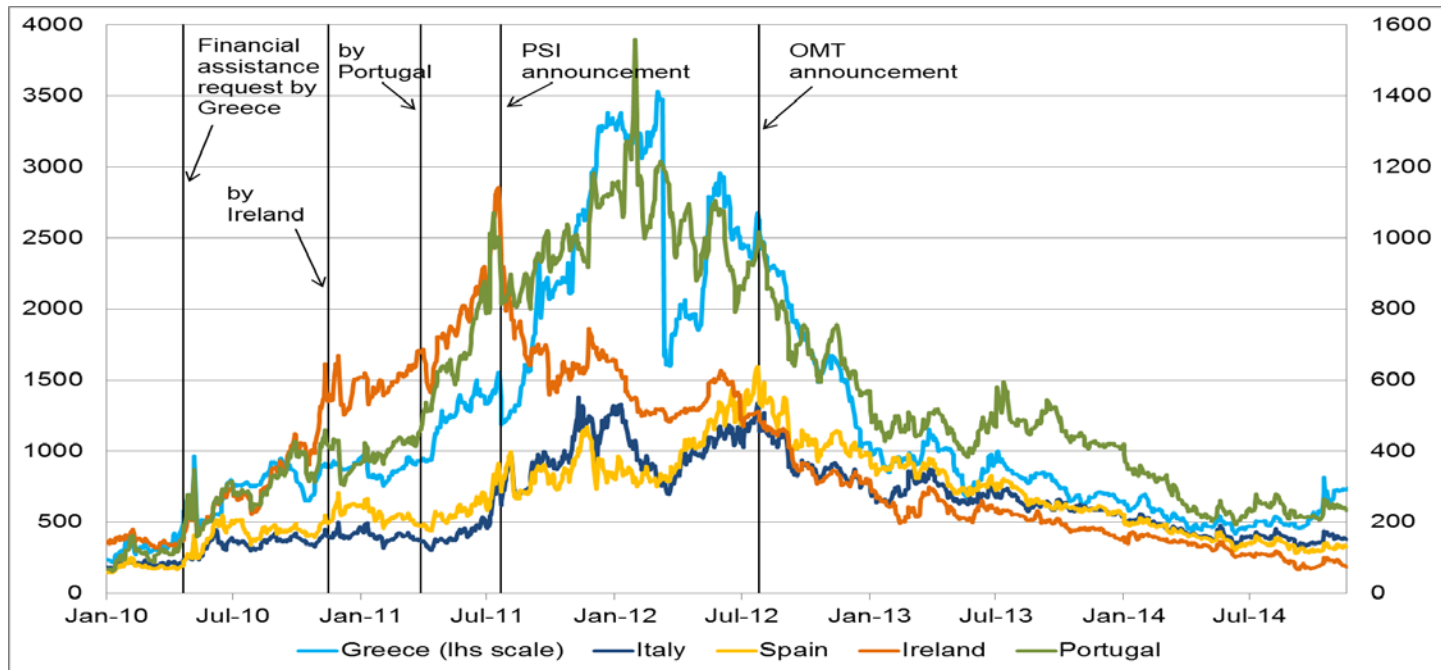


- both headline and core
- in almost every member state
- expectations have fallen markedly

# 3. Fragmentation persists in financial markets

## Euro area government bonds: yield differentials vs Germany, 10yrs horizon

*(daily data; basis points)*

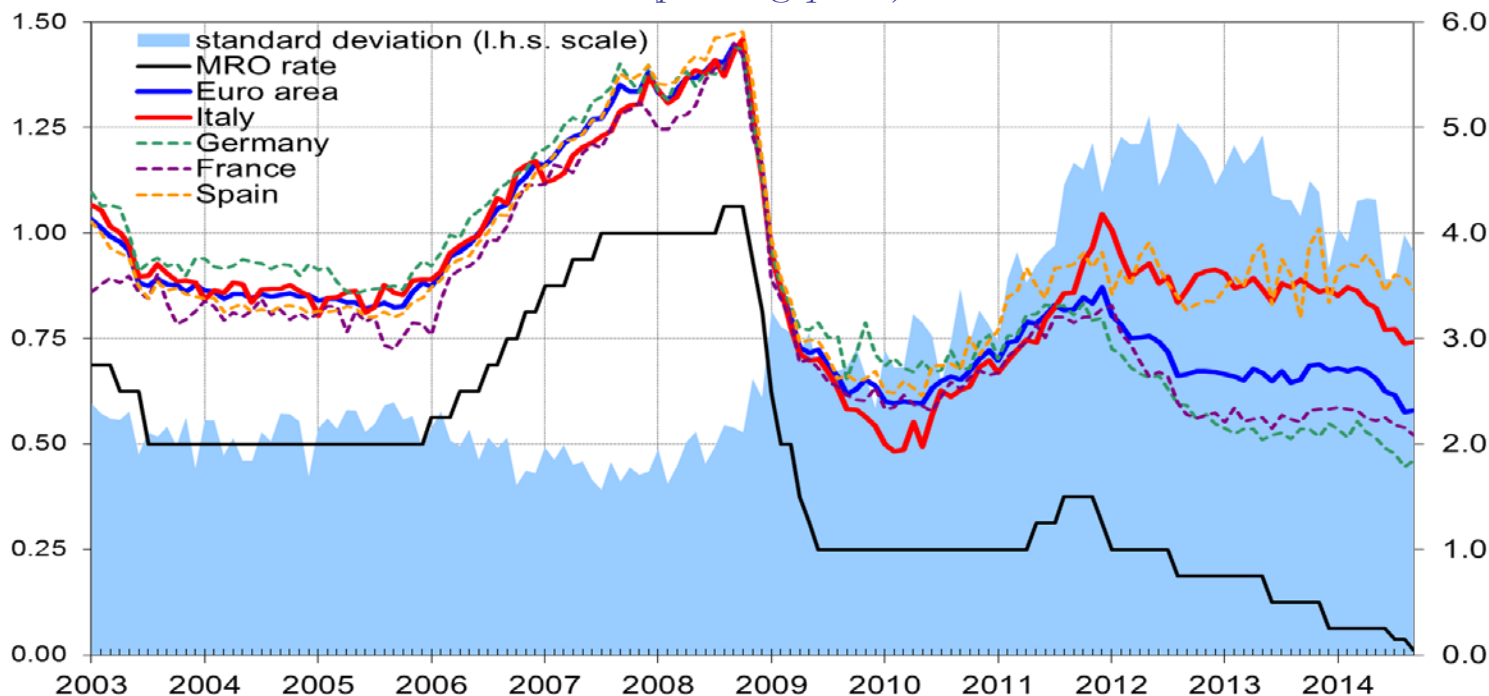


- sovereign spreads narrowed after mid-2012 ...

# 3. Fragmentation persists in financial markets

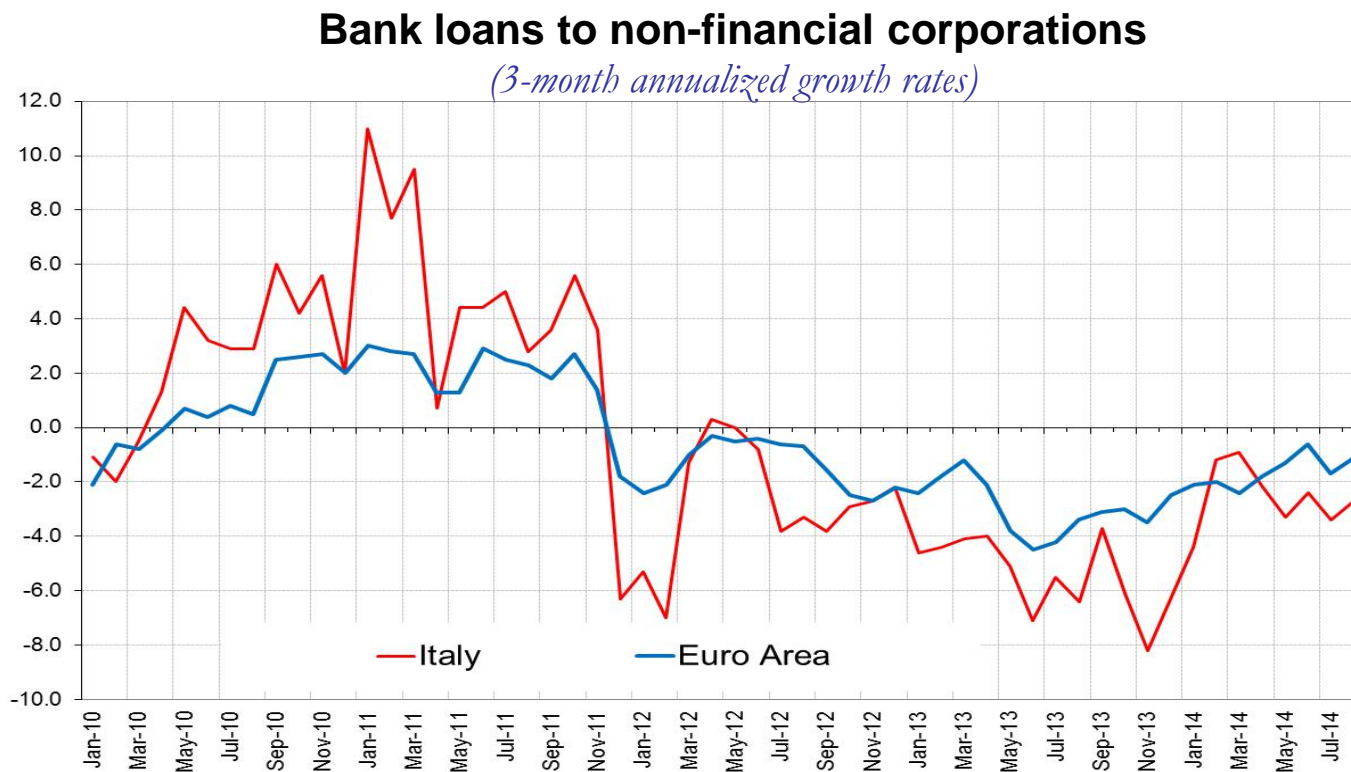
## Interest rates on new loans to NFCs

*(percentage points)*



- sovereign spreads narrowed after mid-2012 ...
- ... but borrowing costs stay higher in stressed countries even though cuts in official rates impacted on market rates ...

# 3. Fragmentation persists in financial markets



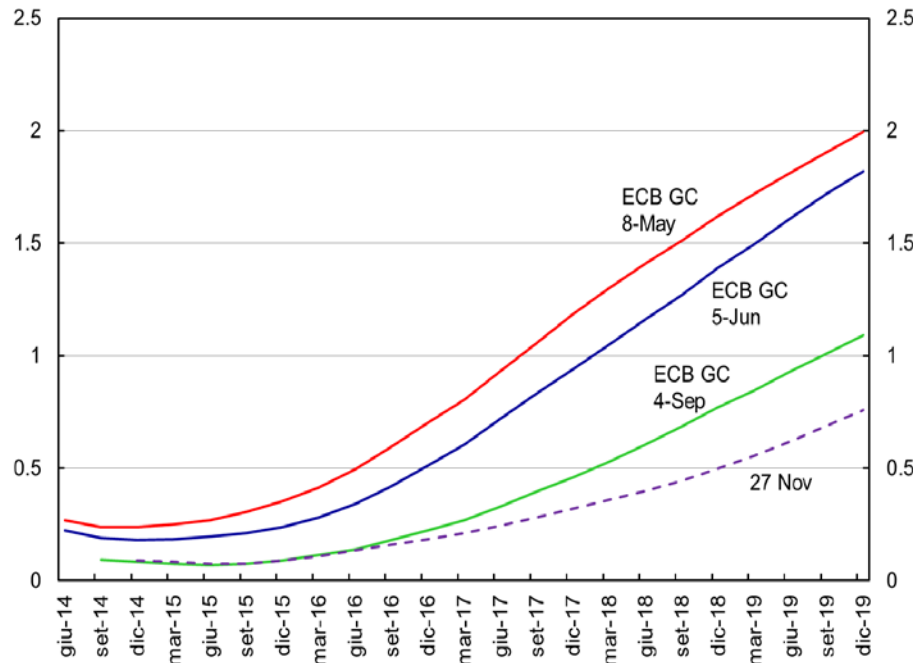
- sovereign spreads narrowed after mid-2012 ...
- ... but borrowing costs stay higher in stressed countries even though cuts in official rates impacted on market rates ...
- ... and the contraction in lending to firms is slowing down

## 4. Wide-ranging response of monetary policy

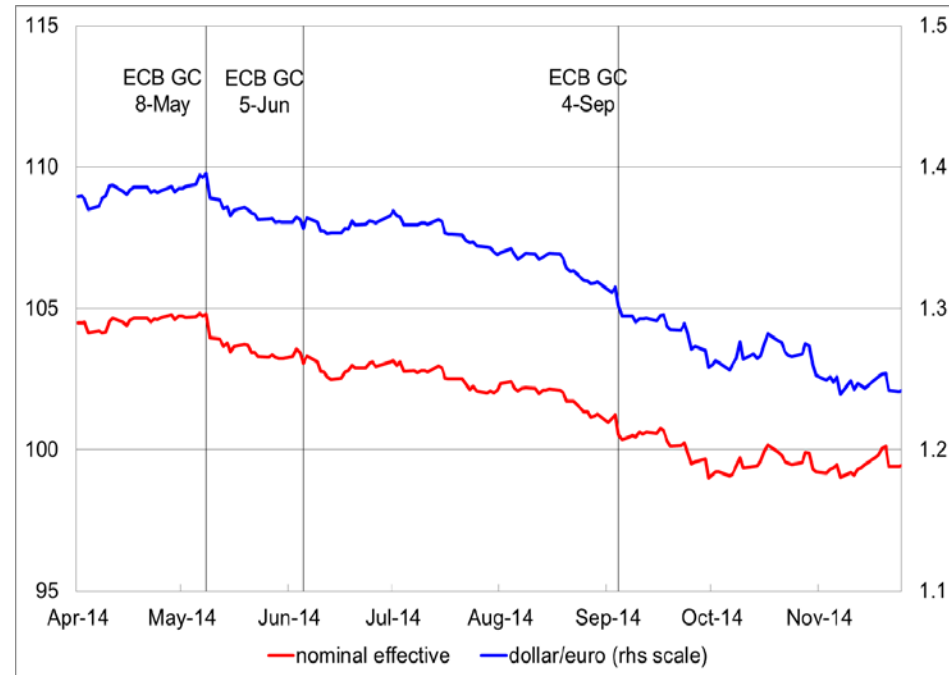
- **the monetary stance has been eased further**
  - rate cuts in June and September (to the ZLB);  
negative rate on the deposit facility
- **support to credit has been strengthened**
  - outright purchases of ABSs and covered bonds
  - TLTRO (lower funding costs conditional on new lending)

# 4. Wide-ranging response of monetary policy

**Implied yields on  
3-month Euribor futures**  
*(percentage points)*



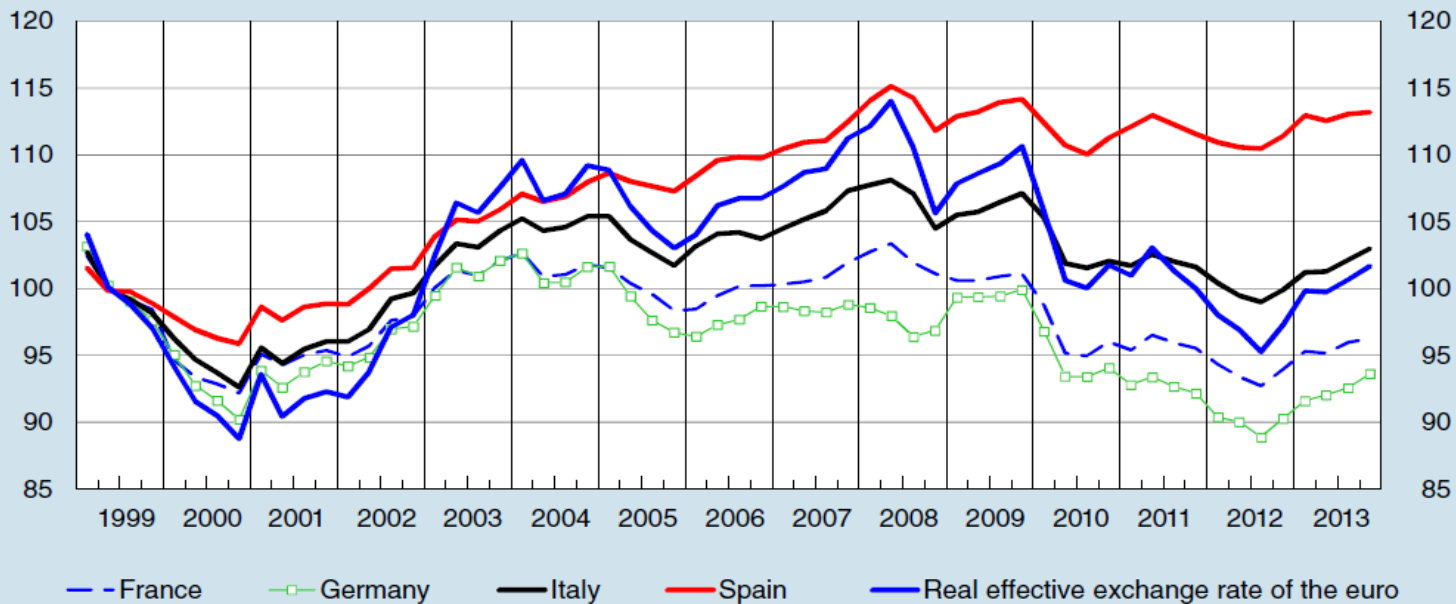
**Euro exchange rate**  
*(daily data)*



- too early to assess effectiveness, but there are already some positive results

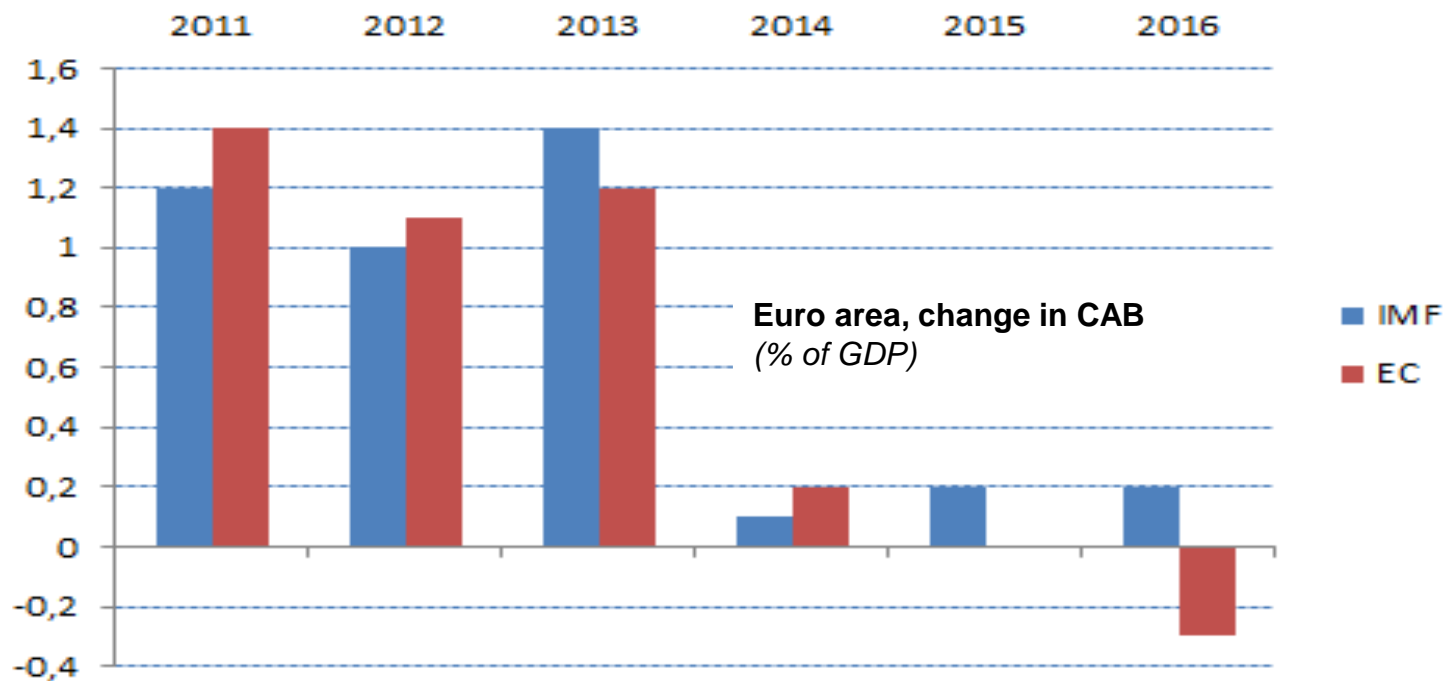
# 5. But monetary policy alone is not sufficient

Indicators of competitiveness of the major euro-area countries  
and the real effective exchange rate of the euro based on the producer prices of manufactures (1)  
(indices, 1999=100)



- need to tackle underlying problems: competitiveness and productivity ...

## 5. But monetary policy alone is not sufficient



- need to tackle underlying problems: competitiveness and productivity
- ... but also weak demand: fiscal adjustment was necessary at the peak of the crisis, now the fiscal stance should be more in line with cyclical conditions

# 6. Structural reforms are key for medium- and long-term growth prospects

Italy: model-based estimates of the effect of structural reforms on GDP growth

SOURCE	REFORMS OF:	IMPACT ON GDP LEVEL (%)
Italian Gov. (2013)	Product and labour markets	3.9
IMF (2013)	Product and labour markets	5.7
OECD (2013)	Product markets	5.5
ECB (2012)	Product and labour markets	7.0

- structural reforms can affect growth significantly

# 6. Structural reforms are key for medium- and long-term growth prospects

Italy: model-based estimates of the effect of structural reforms on GDP growth

SOURCE	REFORMS OF:	IMPACT ON GDP LEVEL (%)	TIME HORIZON (years)
Italian Gov. (2013)	Product and labour markets	3.9	8
IMF (2013)	Product and labour markets	5.7	5
OECD (2013)	Product markets	5.5	10
ECB (2012)	Product and labour markets	7.0	9

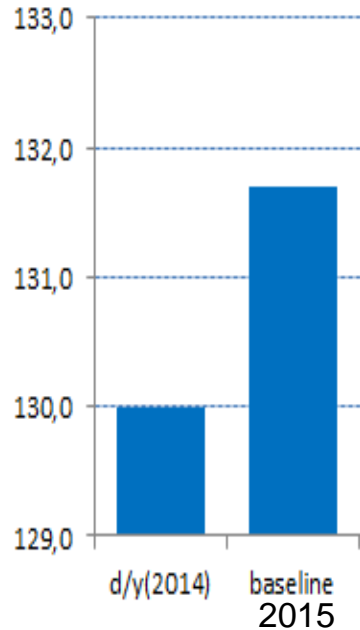
- structural reforms can affect growth significantly
- but they take a long time to implement and bear fruit, in the short term they can be costly, must be accompanied by measures supporting demand

## 7. Need to “make best use” of flexibility in SGP

- the need to have a common fiscal shock absorber is now recognised
- but establishing a fiscal capacity for the euro area is a long-term project
- in the meanwhile we need to “make best use” of the flexibility embedded in the SGP
- “blind” implementation of fiscal rules can be counterproductive

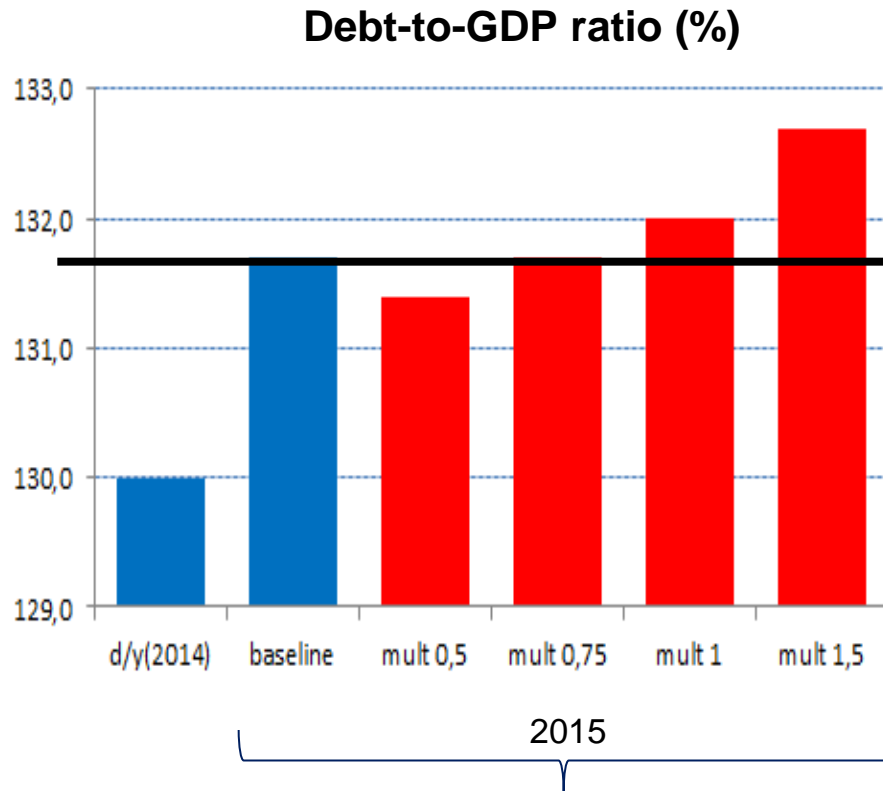
# 8. Fiscal rules and flexibility: an example on Italy

**Debt-to-GDP ratio (%)**



*2015 baseline: deficit=3%; real GDP growth: 0.5%; GDP deflator: 0.5*

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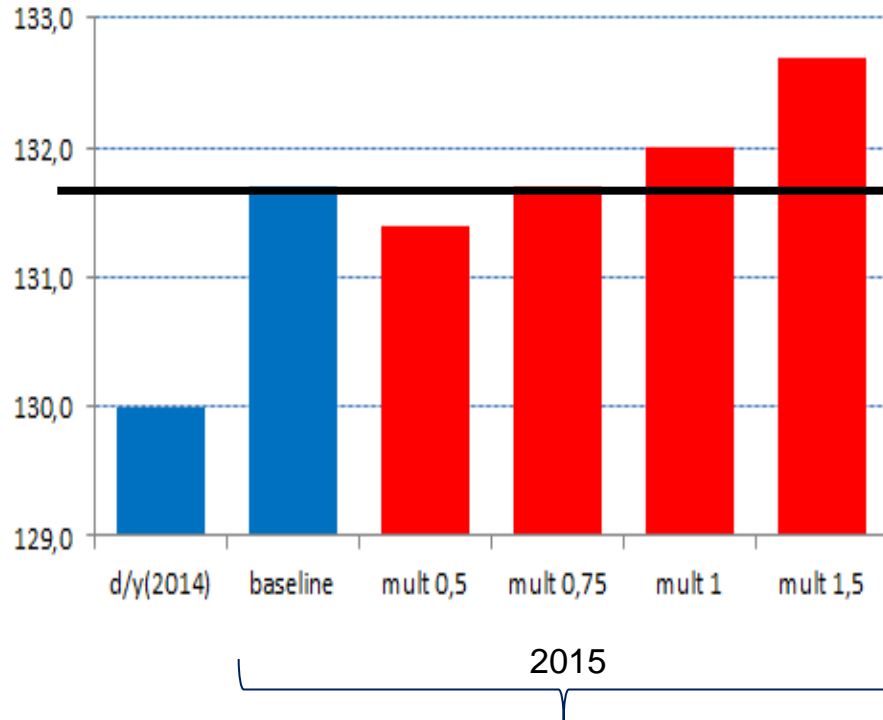


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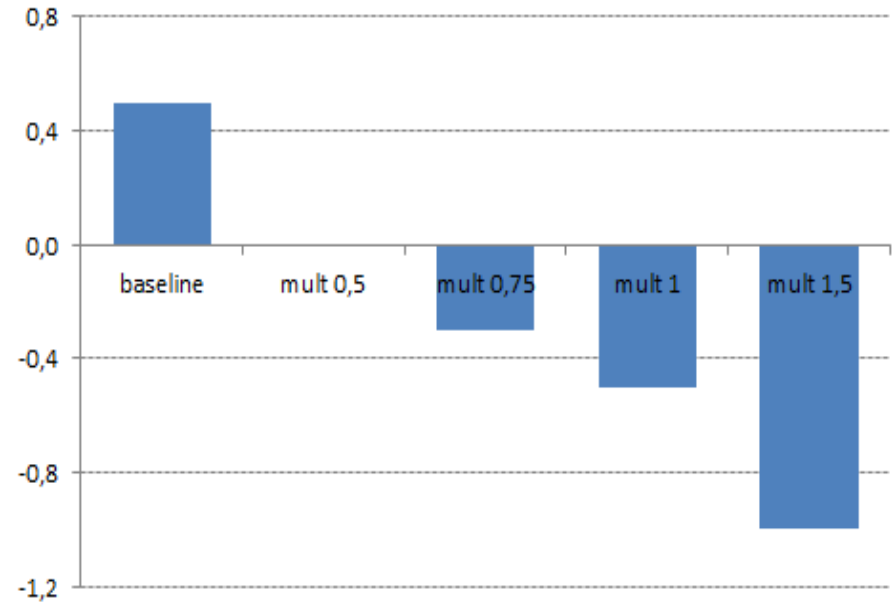
*2015 alternative scenario: fiscal adjustment of 1% of GDP*

# 8. Fiscal rules and flexibility: an example on Italy

Debt-to-GDP ratio (%)



Real GDP growth rate in 2015



*2015 baseline: deficit=3%; real GDP growth: 0.5%; GDP deflator: 0.5*

*2015 alternative scenario: fiscal adjustment of 1% of GDP*

## 8. A coordinated European fiscal response is possible without pooling resources

- proper implementation of rules should be enough ...
- ... accompanied by reinforced commitment to reforms
- coordination reduces potential for adverse reactions
- **two recent positive developments**
  - the decision on France and Italy draft budgets
  - the announcement of the “Juncker’s plan”
- **but**
  - a short-lived slowdown in consolidation may be insufficient
  - size and timeliness are key for the success of the investment plan



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