Macroeconomic adjustment in the Euro Area:

The role of monetary policy, fiscal policy and structural reforms

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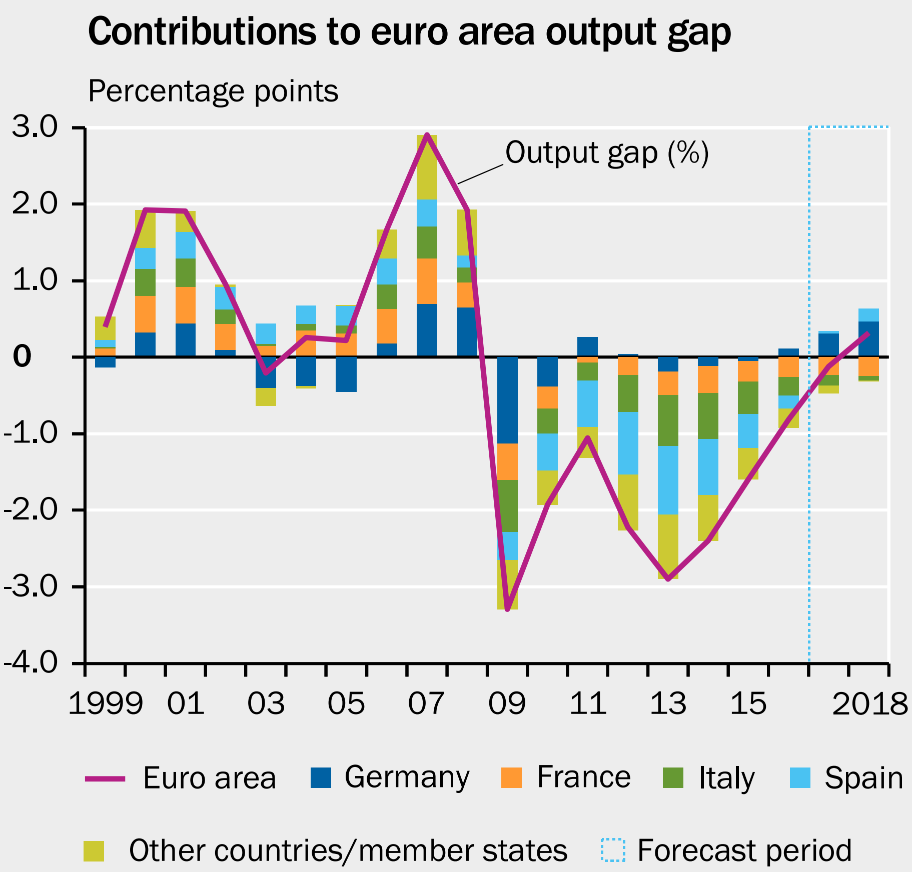
GERMAN COUNCIL
of Economic Experts

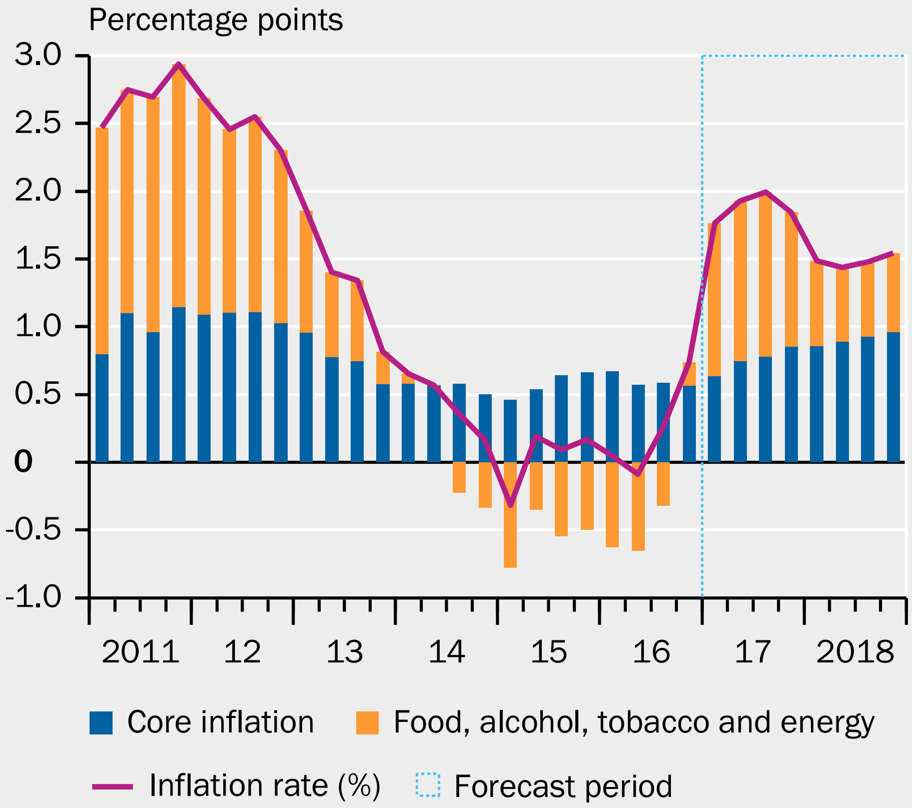
Economic recovery in the Euro Area continues



- The output gap is closing: GDP growth has been exceeding potential growth since 2013.
- Prospects are positive: GCEE expects GDP growth of 1.7% and 1.6% in 2017 and 2018.
- Capacity utilization is rising and the unemployment rate is declining.

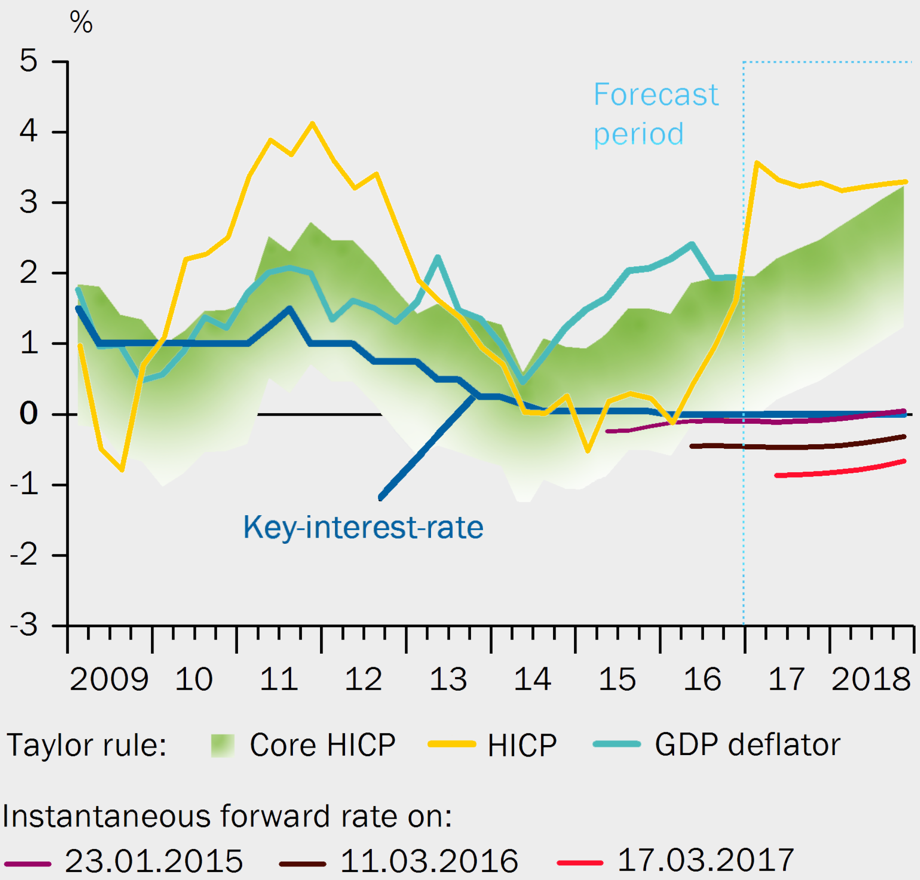
Consumer price inflation is back

Growth contributions of components to the change in HICP



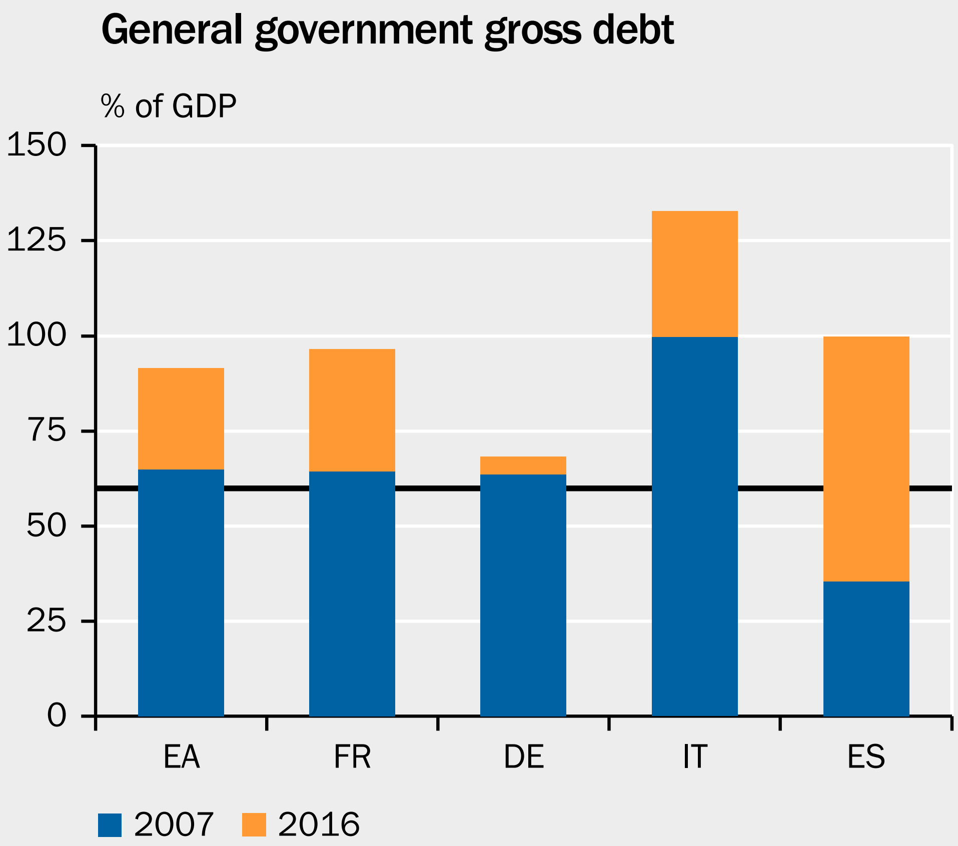
- Positive base effects and accelerating food prices caused the inflation spike at the beginning of 2017.
- Core inflation is expected to rise gradually with increasing capacity utilization and ongoing labor market recovery.
- Headline inflation expected to reach 1.9% in 2017 and 1.5% in 2018.

It's about time for the ECB to taper QE



- Taylor-rule: Benchmark for nominal interest rate.
- Taylor-rules are signaling a too loose monetary policy…
  - …even if a 0% equilibrium interest rate is assumed (lower bound of shaded area).
- The ECB should start exiting from Quantitative Easing (QE).

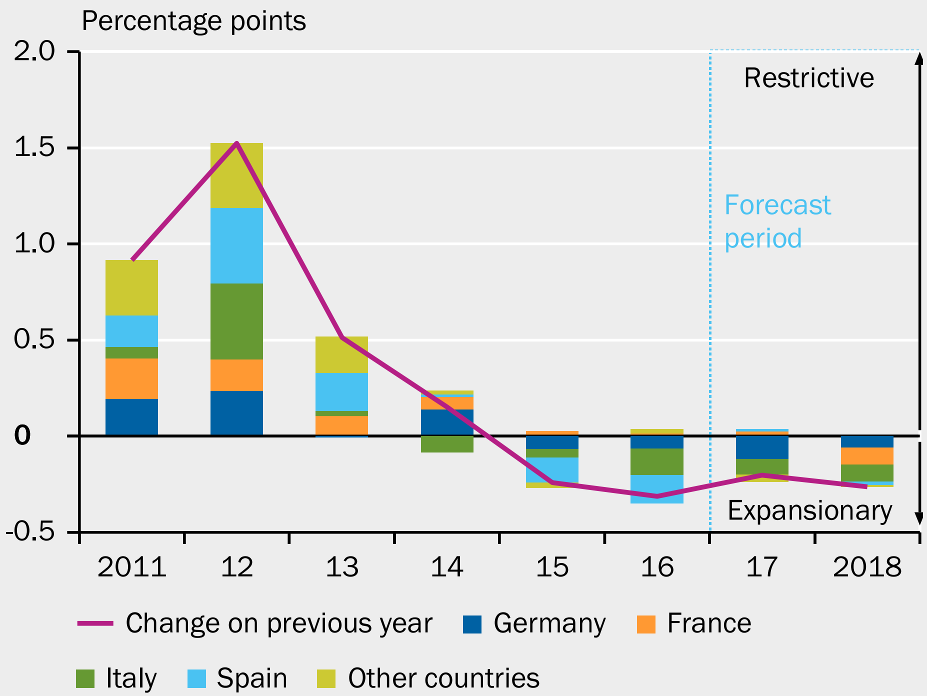
It's about time for the governments to reduce legacy debt and to restart the structural reform process…



- Member states should prepare for normalization of monetary policy.
  - Public debt levels still exceed pre crisis levels by far.
  - Competitiveness in many member states is not sufficient and structural problems persist.
- National governments are called upon to address these issues.

…but fiscal consolidation has ceased despite high public debt, and the appetite for structural reforms has noticeably waned

Change in the structural primary balance in the euro area and contributions of the member states



- Structural primary balances are deteriorating since 2015.
- European Commission predicts further deterioration for the years 2017 and 2018.

A solid framework for the Euro area: Maastricht 2.0

Fiscal and economic policy

No-bailout clause

Strengthening of the market discipline

Reformed Stability and Growth Pact

Preventive and corrective arm

Fiscal compact

National debt brakes

Crisis mechanism

European Stability Mechanism (ESM)

Sovereign insolvency mechanism

Linkages:

- Financial support in case of sovereign insolvency
- Ex-ante conditional liquidity support (compliance with Stability and Growth Pact)
- Financial back-up for bank restructuring

Financial framework

European banking union

- Supervision
- Restructuring and resolution
- Restructuring fund
- But: national deposit guarantee schemes

Accompanying measure:

Phase-out of regulatory privileges for sovereign bonds

National responsibility

European responsibility

Most reforms of the past went into the direction of Maastricht 2.0, but all three pillars need further strengthening

Starting points to further increase stability:

- Introduction of an insolvency mechanism for sovereigns
- Removal of regulatory privileges for sovereign debt
- Banking supervision independent from the ECB
- Enforcement of fiscal rules

In contrast to this:

- Option of temporary exit could have destabilizing effects. It raises the risk of speculations and market volatilities.

➢ Exit from the Euro Area only as a last resort (ultima ratio)

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