iAGS 2017 - The elusive recovery

Summary of main findings by the Progressive Economy Team

1. Macroeconomic trends and need for more adequate policy responses

a. General trends, recovery in struggle

The recovery which started in 2015 hasn´t produced the desired outcome. **Unemployment** is falling, but at a slow rate.[1] In addition, inflation is failing to meet the target of 2% and the **risk of deflation** still persists (p. 31).

Three unfavourable factors prevent the economy from growing in 2017 and 2018.[2] First, **oil prices are rising**[3] (p. 35). Second, the **pound´s depreciation** against the euro after Brexit, leading to external imbalances (p. 35).Third, **global trade is slowing,** especially due to the slowdown of the Chinese economy.

b. EU policy mix to be improved

This elusive recovery is also a result of the **inconsistency of the EU policy mix**.

- The **ECB's unconventional monetary policies** have succeeded in watering down the sovereign debt crisis and in providing stimulus to private investments. However, banks have reduced **credit supply** to the real economy. (p. 94)
- The **Juncker plan**, while broadly positive, failed to produce a fiscal stimulus in the short term and potential growth in the long term. (p. 21)
- **Fiscal consolidation** measures, within the framework of the current fiscal rules, promoted pro - cyclical policies which led to a **cut in public investments**. (p. 105)

[1] Unemployment level is still above the 2007 rate.
[2] From 1.9% in 2015 to 1.3% in 2018.
[3] From USD 34 in 2016 to stabilize between USD 50 and 60 in 2017 and 2018.

Group of the Progressive Alliance of Socialists & Democrats in the European Parliament

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c. Increasing inequality, poverty and lowering living standards

Austerity policies have had a negative impact on inequalities. To go into more detail, the increase in **taxation,** the **deregulation of the labour market** and **the reduction of public services and social protection** resulted in **rising inequalities**[4] and an **increasing poverty rate** (p. 66).

The impact is not equal and homogeneous. Geographically, **Southern Europe** suffered the most, while Eastern Europe has made progress. In terms of social status, the crisis mainly hit **the poorest**, the **young** (15 - 24) and **women**.

As a result, both the **poverty rate** and the number of **people at risk-of-poverty**[5] have risen. This is especially true for countries with a low level of social protection (p. 74). This also had an impact on **lowering living standards** by an increase in **material deprivation**[6]**,** especially concerning families with children (p. 76).

2. What policy responses to address the elusive recovery, reducing inequality as a priority

The complexity of the scenario and the interdependence of the problematics require a systemic response. In order to **reduce social inequalities** and to **promote convergence** in the Euro area some policy actions are needed in the following domains:

a. Changing fiscal rules for more active demand management

Smarter rules are needed to improve Member States´ **budgetary flexibility** so as to improve **counter-cyclicality** without giving up fiscal sustainability (p. 111). A twofold change is suggested:

- Adopting a **golden rule for public investment**[7]. It is proved that investments in infrastructure[8] as well as in human capital (education) are growth enhancing (p. 113). Due to the multiplier effect, public investments may be largely self-financing (p. 123).

[4] For more details, refer to figure 26 and 27.
[5] From 16% in 2008 to almost 21% in 2015 in the Euro area.
[6] Doubled since 2004 in Southern Europe.
[7] If operated from 2016, the multiplier would cumulate 3% of GDP growth until 2020 in the Euro area.
[8] Marginal returns between 10.2% in the short term and 20.8% in the long-term.

* Replacing the rule of **structural deficit** with a **nominal spending rule** to prevent biased forecasts and calculations. A spending rule would prevent fiscal contraction in bad times and, thus, foster investments. (p. 118)

Both proposals require legal changes, which is in line with the 5 Presidents‘ report. However, in the short term, an interpretation leeway might be enough to allow for more flexibility. (p. 21)

b. Changing policy goals and economic governance for a stronger European Social Model

The driving principles of the EMU, i.e. price stability and sound public finance, need to be implemented to include social and environmental sustainability. To do that, the following main policy goals should be adopted. First, **fairly distributed material well-being**. Second, **full employment and good jobs**. Third, **quality of life and ecological sustainability**. (p. 84)

To take this path, a change in economic governance is required. Concretely, the beginning of the **European Semester** should be complemented with a **broad debate** involving the EP, the Council, the EESC and the Macroeconomic Dialogue based on **Eurostat´s sustainable development indicators** (p. 86). This dialogue should also be open to social partners.

c. Reducing social imbalances with a coordinated wage policy

The belief that the deficit in the Southern countries is caused by excessive wage increases led to severe internal devaluation, i.e. decrease in minimum wages, cuts in social security. Instead of improving competitiveness, these policies compressed the internal demand. (p. 142)

A **coordinated wage policy** is required to ensure convergence in the euro area. A twofold response is proposed:

* Introducing a **golden wage rule**. Wage growth in the EA countries should stay close to the sum of the productivity rate and the inflation target of the ECB. (p. 143)
* Changing macroeconomic surveillance instruments with **more symmetric rules**. The generalization of wage floors should be promoted by **minimum wages** or **collective agreements** and cross-country coordination.

All in all, wage increases should be differentiated, e.g. stronger in countries with account surpluses and lighter in countries facing account deficits (p. 78).

d. Strengthening the welfare state with a fair taxation system

Taxation and **public spending** are essential tools to foster growth in bad times and **reduce inequalities** (p. 80). The taxation system should be adapted to face globalization **and digitalization**:

- International cooperation and transparency need to be enhanced. This can be achieved by **abolishing bank secrecy** and creating automatic systems of **exchange of information** between tax authorities.
- Improving **tax compliance**
- Fighting concentration of wealth and reducing imbalances in the taxation between labour and capital through more **progressive tax systems**. A global annual tax on net wealth might be envisaged.
- Promoting intergenerational and social mobility by increasing **tax on inheritances.**

e. Addressing non-performing loans to stabilize the banking sector

A **bank-centred** market economy such as the EU requires a healthy banking sector. In some Member States, increasing **NPLs**[9] are preventing banks from providing **credit to firms** and are threatening **private savings**. However, instead of being a homogeneous phenomenon, NPLs differ in terms of private borrowers involved, with different potential economic consequences (p. 174). Therefore, different and sometimes complementary measures are required to address this issue:

- Transferring NPLs to dedicated asset management companies (or "**bad banks**") (p. 181).
- Developing a **securitization market** for NPLs in the context of the Capital Markets Union.
- Strengthening the **insolvency framework** (p. 192).
- Enhancing **supervision** (p. 193).
- Amending tax rules to incentivize adequate provision policies within banks, i.e. **deductibility**.

Solving this issue is a fundamental step to complete the **banking union**.

f. Can a Capital Markets Union provide financial stability in the future?

The purpose of the CMU is to eliminate **financial fragmentation** between Member States in order to **unlock inactive capital** and to **stimulate the real economy**. In addition, as already happened in the US during the crisis, by **fostering capital mobility**, a CMU would work as a **risk sharing** mechanism by making the system more resilient to asymmetric shocks (p. 195).

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[9] NPLS in the Euro area have a value of EUR 1 132 billion. From 2,8% of total gross loans in 2008 to 5,7% in 2015 in the Euro area. Italy and Ireland score a variation of 11.7% and 13%, respectively, in the same period.

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However, a number of challenges must be overcome, mainly due to **regulatory fragmentation**, especially in bank lending. As a consequence, firms located in different MS face differences in access to and cost of financing. Completing the banking union and harmonizing financial regulations may help to reduce fragmentation.

In addition, one should notice the **potential negative outcome** of the CMU. Indeed, the securitization of markets inevitably creates a degree of **opacity** about where risks are located. (p. 207)

Final remarks

The multidimensional uncertainty upon which the EU is navigating requires a **strong political response**. The current institutional design provides some policy options, but in the long term changing the Treaties might be necessary. The scope and the reinforcement of the Union should be discussed.

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