CEPS COMMENTARY
Thinking ahead for Europe

The Policy Mix and Macroeconomic Adjustment in the Euro Area

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According to the most recent IMF World Economic Outlook (WEO),[1] the recovery has suffered new setbacks and uncertainty weighs heavily on the future. The IMF forecast, unveiled in Tokyo ahead of the IMF-World Bank 2012 Annual Meetings last week, sees only a gradual strengthening of activity from the relatively disappointing pace of early 2012. Projected global growth, at 3.3% and 3.6% in 2012 and 2013, respectively, is weaker than in the July 2012 *WEO Update,* which was in turn lower than in the April 2012 WEO.

The report argues that the contracting effects of austerity measures in a number of countries (as measured by the multipliers), in fact, may be larger than assumed by most of the official forecasts, including that of the IMF. This implies the risk that the next WEO forecasts may prove to be even weaker than the current ones. Against this background, the IMF recommends that, should growth fall significantly short of the current projections, countries with room to manoeuvre should smooth their planned adjustments over 2013 and beyond. Furthermore, the Fund sees arguments for maintaining the very accommodating monetary stance, including unconventional measures, as interest rates are near the zero lower bound.

Structural reform measures are considered necessary practically everywhere, albeit of a different nature in different countries, and a longer-run pre-condition for a sustainable stabilisation and recovery at world level. Similarly, stabilisation and credible reduction of public debt accompanied by an increasing efficiency of public administration are also equally necessary conditions in most countries for ensuring balanced and sustainable growth. Despite fears in some camps that the exceptionally accommodating monetary policy in the US and the eurozone could pose long-term risks of inflation, the current state of the markets still warn against a premature exit strategy and returning too early to a more stringent stance of monetary policy by both the Federal Reserve and the European Central Bank. At some point, however, the stance of monetary policy must be reversed in favour of the traditional objective of inflation control.

[1] "Coping with High Debt and Sluggish Growth", World Economic Outlook (WEO) World Economic and Financial Surveys, International Monetary Fund, Washington, D.C., October 2012 (http://www.imf.org/external/pubs/ft/weo/2012/02/index.htm).

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A perennial issue in macroeconomic policy analysis, namely the *timing* of the effect of policy measures, seems to have received relatively little attention even in authoritative reports such as the IMF WEO. However, a comprehensive analysis of the current policy stance and its potential effects over the short, medium and long run would require that the question of the timing of the implementation and the effects of the three main categories of economic policy (fiscal, monetary and structural) ought to be dealt with more openly than is now the case.

In fact, a macroeconomic model simulation would show that timing and lags in their effects on economic activity, employment, inflation and external balances would be very different for fiscal consolidation, structural reforms and monetary accommodation. Similarly the pace of the policy implementation would play an important role.

As regards the fiscal consolidation that is underway, or planned, in a large number of the advanced economies, there can be little uncertainty that their immediate consequence will be a fall in private consumption and investment. No doubt that restrictive policies, involving pension and wage cuts or a reduction in the number of civil servants, such as those implemented in the Mediterranean countries, will depress private spending. In other advanced economies, tightening policy measures are more prudent but increasing financial constraints on spending of central governments and local authorities are felt practically everywhere. Sluggish global growth, a persistent euro area crisis and gloomy expectations about a full recovery are trimming down the number of countries that have room to manoeuvre and increasing the number of those having to face a tighter budget constraint.

On the other hand, the loose monetary policy stance, while providing an apparent stabilisation in monetary and financial markets, has patently proven to be ineffective on aggregate demand, unable of boosting business investment and confidence. While some banks in some countries are insolvent or in danger of becoming insolvent, non-bank corporations in many advanced economies display record-high levels of cash and may even suffer from the low level of short-term interest rates. Thus, the accommodating monetary policy is clearly not in a position to boost overall demand in the economy, as validated by the old saying; "you can lead a horse to water, but you can't make him drink." This observation points to the conclusion that the accommodating monetary policy in most countries, perhaps with the exception of the United States, has had little or no effect on aggregate demand.

Concerning the strong need for wide-reaching labour- and product-market reform measures, they have for a long time been at the top of the list of the policy recommendations of almost everybody. There is no doubt that the Mediterranean countries, as well as most European countries and other advanced economies over the coming years must face up to exceptional challenges due to ageing, climate change, environmental damage and natural resources scarcity, which will require a transition towards new systems of production and consumption. Policies framed in such perspective are essential for ensuring macroeconomic stability and sustainability and, thus, for avoiding future crisis. However, they have long lead times as far as the planning and implementation are concerned and require severe reorientations of both demand and supply in the economies. And more importantly, in the current situation, their beneficial effects will be felt with a lag and only very gradually over a longer time span through increased efficiency and productivity. If anything, a flourishing literature shows evidence that structural reforms tend to have a negative effect on output over the short-term, amplifying the downturn inflected by fiscal consolidation.

In light of the foregoing, a question to be urgently considered is whether the implementation of tough austerity measures in a number of countries, including also the UK, the US and France, can create the risk of additional declines in activity in the short run but also of delays, abandonment or even reversal of the reform measures in the medium term, increasing inconsistencies between the different policy components. There is also the danger that the consolidation policies result not only in lower public consumption and transfers but also in possible delays in public investments and other expenditures that should work as a complement to the much-needed reform measures. This could have adverse effects in the medium and longer run.

The question is therefore whether a more pronounced 'smoothing' of adjustments should take place not only in the countries with room for manoeuvre, as suggested by the IMF, but in fact, and perhaps more importantly, in the countries that are now confronted with the strict conditionality imposed by the 'troika'.

The main problem in this approach is the financial constraints. Smoothing the fiscal adjustment implies that deficit targets will be overrun and additional resources will be needed in the immediate future. Who is going to fill the financial gap, if the budget targets and the external budget constraint are binding? Can the profile become smoother following the argument that this is the necessary *quid pro quo* to ensure better conditions for successful reform policies, and hence growth, in the medium and long run?

More fundamentally, can we expect growth to resume if the adjustment is not completed? Countries that have experienced bubbles are unlikely to see acceptable growth rates, i.e. large enough to impact unemployment and deficits, until the excesses are absorbed. In an ideal world, fiscal policy would favour the adjustment and make it less painful, yet under the current conditions, there is little hope this can fully work.

The path of future growth is also of extreme importance. Given that growth rates before the crisis were driven by bubbles and excesses in some parts of the economies, realistically, we should not expect such rates to return without further strong reform measures.

A key condition for a credible and successful additional fiscal smoothing in the short term is therefore strict – and credible – adhesion to a much more rigorous and pronounced medium- and longer-run fiscal consolidation and structural reforms in practically all advanced economies. It may well be argued that this would be necessary to enhance confidence in business in general and especially in financial markets.