# A suboptimal policy mix

## Why Europe needs fiscal measures and growth reforms

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**Very low inflation and the persistent risk of a de-anchoring of inflation expectations continue to dominate the economic outlook for the euro area. The policy mix is suboptimal: there is no common fiscal policy and many countries lack sufficient room for manoeuvre.**

Bank profitability remains weak and several intermediaries may need to strengthen their balance sheets against a background of subdued economic prospects and continuing regulatory reform.

The governing council of the European Central Bank has acted boldly to encourage a return to price stability. Official interest rates have been reduced repeatedly, bringing the deposit facility rate to negative levels. New longer-term refinancing operations have been introduced, with conditions rewarding banks which provide more credit to the economy. The Asset Purchase Programme has been progressively expanded.

### Effective action

Central bank action has been effective. Without these measures, economic conditions would have been much worse, possibly leading to a deflationary spiral. Credit supply conditions, particularly tight in 2011-12, have loosened gradually. The cost of credit to the economy has fallen and financial fragmentation in the euro area has eased. The weak credit dynamics still being observed in the euro area mainly reflect subdued demand.

The measures have fostered a decline in yields and bolstered the prices of a wide range of financial assets. This has had a positive impact on consumption, through wealth effects, and on investment, through a fall in the cost of capital. Business and household confidence have been buoyed.

According to ECB estimates, without the wide range of monetary policy measures introduced between mid-2014 and the first part of this year, annual inflation and GDP growth would be more than half a percentage point lower in the euro area in 2015-17.

This highly expansionary monetary policy stance is the result of well thought-out decisions and a response to the weakness of the economy and the risk of deflation.

Low inflation is undoubtedly in part a global phenomenon. It reflects developments in oil prices; deflationary pressures from the Chinese economy; and possibly also technological change. But it depends too on domestic developments that should not be underestimated.

Domestic factors operate both via expectations and via economic activity. In both respects conditions in the euro area differ from those in other main advanced economies.

Since the end of 2014, the risk of a de-anchoring has increased notably in the euro area, where expectations have fallen further than in other advanced economies. In addition, there is evidence of a stronger link between low inflation and economic slack. In Italy, France and Spain, nominal wages became more reactive to unemployment after the crisis.

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### Low interest rates

The ECB is conscious of the potential for negative collateral effects from a long period of very low interest rates.

In the euro area as a whole there is currently no evidence of risks to financial stability related to an excessive increase in the prices of shares, corporate bonds or houses.

Growth in lending relative to the cyclical position of the economy is moderate. Risks that may arise in specific sectors can be addressed with carefully targeted macroprudential instruments, as has already happened in some countries, without interfering with the monetary policy stance.

Nominal rates that are low or negative for too long may hurt the profitability of some institutions. But a less accommodative monetary policy in the current circumstances would harm everyone.

Strengthening the economy is key to ensuring a return to price stability, as well as mitigating risks to financial stability. In the current cyclical conditions, the main risks to financial stability, the profitability of banks and firms, and even to household income, continue to stem from the uncertain macroeconomic outlook and the persistence of exceptionally low inflation.

The ECB will continue to monitor economic and financial market developments very closely and, if warranted, act again by using all the instruments available within its mandate. The purchase programme is intended to run until the governing council sees a sustained adjustment in the path of inflation consistent with its inflation objective. The relevant committees have been tasked with evaluating the options for ensuring its smooth implementation.

But monetary policy cannot pursue a return to price stability and a more sustained growth rate in isolation. It must be accompanied by fiscal policies consistent with cyclical conditions, and by reforms designed to achieve a permanent return to higher rates of growth potential and job creation.

The fear of continued weak demographics and modest productivity growth is the likely real cause of very low real interest rates.

### Structural reforms

Important structural reforms have been adopted in several euro area countries and these efforts must continue. Their benefits are beginning to be felt, but it will take time to exploit their full potential. Each country has its own problems, and solutions are difficult to standardise.

Reforms imply short-term costs, both economic and political, and we should guard against the risk of unintentionally introducing obstacles. For example, excluding some countries from advances in fiscal and political union until they have achieved sufficient convergence would make their reform efforts more difficult.

Reducing uncertainty is one of the most pressing challenges facing European policy-makers. It not only requires adequate institutions and policy tools, but above all true leadership capable of restoring a common sense of purpose and defining a clear vision for the future of the European project.

This is the only possible response to rising populism and the risks it poses to the future well-being of European citizens.

There are many short-term challenges. But we must continue to emphasise the need for a longer-term perspective. ■

*Ignazio Visco is Governor of the Banca d'Italia. This is an edited extract of a speech given to OMFIF's Seventh Main Meeting in Europe on 22-23 September. A full summary of proceedings and other details of the Rome meeting can be viewed at www.omfif.org/analysis/reports/*