Focus Note 3: Rebalancing the policy mix in the euro area

With euro area GDP growth projected to remain weak for an extended period, and downside risks continuing to mount, additional policy measures are required to support near-term demand and strengthen growth prospects in the medium term. In the years following the financial and euro area crises, monetary policy has been used as the main policy instrument to support demand. Rebalancing the policy mix in the euro area would be even more effective for macroeconomic stabilisation and lower the risks to financial stability from a prolonged period of very accommodative monetary policy.

To illustrate these issues, this note summarises the outcomes of simulations that contrast the impact of an extended period of quantitative easing (QE) in the euro area with that from an alternative policy mix that combines a more active use of fiscal policy, greater structural policy ambition and a more modest increase in monetary policy accommodation.

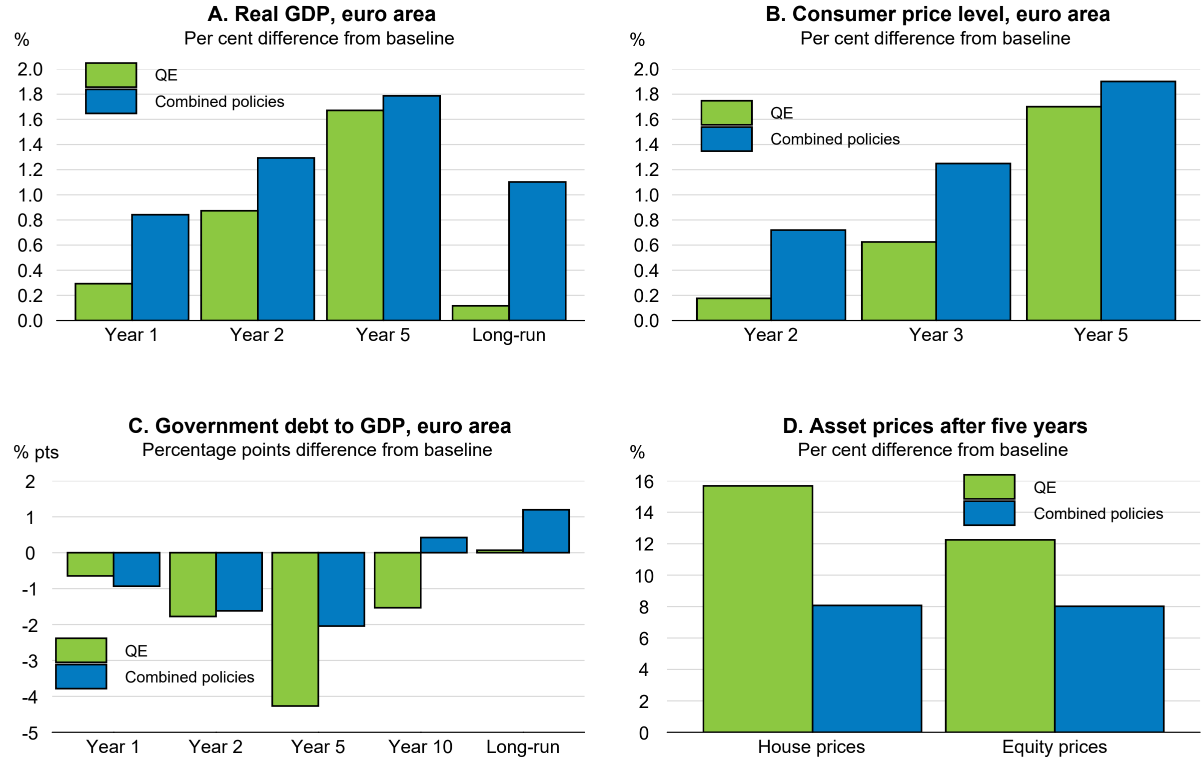
In the QE-only scenario, the term premium on 10-year government debt in the euro area is lowered for an extended period, calibrated on ECB estimates of the impact of the Asset Purchase Programme (APP) following its expansion to include public sector asset purchases in 2015 (Eser et al., 2019). At its peak, in years 3 to 5 of the simulation, the term premium is reduced by 100 basis points relative to baseline, with this effect fading slowly thereafter. Euro area policy interest rates are also held fixed for five years. An (imperfect) allowance is also made for the impact of the targeted longer-term refinancing operations (TLTROs) that have been implemented alongside the APP to support bank lending to the private sector in recent years. Interest rates on borrowing for house purchase are lowered by an additional 100 basis points for five years, over and above the impact of the term premia shock on private borrowing rates.

The different policy measures considered in the alternative combined policy scenario are:

- All euro area countries raise public investment by ¾ per cent of GDP for five years. This offsets the large and persistent reductions in public investment after the financial crisis (Blanchard, 2019). Euro area general government net investment (investment less capital consumption) averaged around 0.7% of GDP per annum over 1999-2008, but has declined to zero since 2013. Countries such as Germany, the Netherlands, the Slovak Republic and the Baltic States have scope to implement this type of policy through additional debt issuance. Their headline budget deficits are well below 3% of GDP, and debt levels are on a declining trajectory. Other countries, including France, Italy, Spain and Belgium, have less space available for fiscal easing, with still sizeable budget deficits and high government debt-to-GDP ratios. In these countries, the additional public investment spending is assumed to be offset fully by higher direct taxes, so that the *ex ante* budget impact is neutral.
- All countries are assumed to undertake productivity-enhancing structural reforms that raise total factor productivity (TFP) growth by 0.2 percentage point per annum over five years, with the 1% higher level of TFP being maintained permanently thereafter. Such reforms offset part of the slowdown in euro area TFP and potential output growth experienced since the crisis, in part due to the fading of reform ambition (OECD, 2018).
- A smaller QE programme is undertaken, reducing the term premium on 10-year government bonds by 50 basis points at its peak, with the profile of the shock over time similar to that in the QE-only scenario. Policy interest rates are again held fixed for five years and the allowance for the TLTROs is scaled down proportionately. Further ahead, monetary policy is assumed to be set in a way that takes into account the longer-term supply-side gains that arise from enhanced structural reforms. In effect, forward guidance is being used to help interest rates stay low for longer.

Figure 2.6. The impact of alternative policy approaches in the euro area

Differences from baseline



Note: See text for details of the shocks applied in the QE and combined policy scenarios.
Source: OECD calculations using the NiGEM global macroeconomic model.

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The simulations are undertaken on the NiGEM global macroeconomic model. Key features of the QE-only and the combined policy scenarios include:

- After five years, the impact on euro area output and the price level in both scenarios is close, and broadly similar to the estimates by Hammermann et al. (2019) of the impact of the non-standard monetary policy measures implemented by the ECB since mid-2014. The level of euro area GDP is raised by around 1¾ per cent relative to baseline (Figure 2.6, Panel A), and the consumer price level is pushed up by between 1.7-1.9% (Figure 2.6, Panel B), with marginally stronger effects from the combined policy mix.
- In the near term, the impact of the combined policy mix is noticeably stronger, reflecting the direct effect of higher public investment on GDP, the normal lags for monetary policy to take full effect (even in a model with forward-looking behaviour), and the extent to which accommodative macroeconomic policies help to bring forward some of the effects from structural reforms.
- Over time, the QE impact on output gradually fades, whereas area-wide GDP is up by just over 1% in the longer term (after 15 years) with the combined policy mix, reflecting the higher TFP level and a small boost to the public capital stock.

- Even with a sustained fiscal expansion over five years in the combined policy simulation, the area-wide government debt stock relative to GDP remains below its baseline level for some years (Figure 2.6, Panel C), helped by higher nominal GDP as well as lower debt-servicing costs. However, the larger decline in government bond yields in the QE-only scenario results in stronger reductions in debt-servicing costs.
- Asset prices are substantially lower with the combined policy mix than with sole reliance on monetary policy (Figure 2.6, Panel D), reducing potential financial stability risks. Both scenarios raise household and corporate incomes, but the asset price responses are stronger in the QE-only scenario due to the larger decline in long-term interest rates.

Overall, these results suggest that a balanced policy mix is more effective for macroeconomic stabilisation than relying solely on monetary policy. These issues are particularly relevant at the current juncture. A well-designed combination of country-specific fiscal and structural policy actions, along with continued low interest rates, is needed in the euro area for growth prospects to be strengthened durably.

The simulations also shed light on the possible policy choices that the euro area could have made in 2014-15, when the burden of macroeconomic stabilisation was left primarily to monetary policy. Many countries, including Germany, already had scope even then to ease fiscal policy, with low government budget deficits and government debt-to-GDP ratios on a declining trajectory. If the euro area had implemented a balanced policy mix at that time, it would have mitigated some of the stimulus provided to asset prices by a very accommodative monetary policy stance over a sustained period without adding substantially to public debt, and also enhanced longer-term living standards, something beyond the scope of monetary policy.

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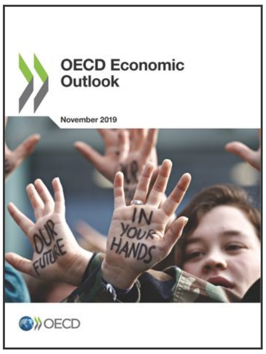

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