Ministero dell'Economia e delle Finanze

"Promoting Growth, Employment and Solidarity in Europe
after the British Referendum"

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Francoforte, 21 ottobre 2016

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- Professor Haar, President Weidmann, Professor Issing, Professor Krammen, ladies and gentlemen I would like to warmly thank you for the today invitation. I am delighted to speak in the **prestigious Goethe University in Frankfurt**, in front of **such a distinguished audience**.

- The title of my speech is "*Promoting Growth, Employment and Solidarity in Europe after the British Referendum*". Let me summarize my points; first of all we have to take into account that we now live in a world of increased policy uncertainty. Against the backdrop of a heightened uncertainty, we need a **coordinated strategy to preserve the sustainability of the European Project**.

- The outcome of the British referendum has further certified how much the European Union is struggling: to underpin the EU project it is crucial to **rebuild trust and confidence**, regaining growth and creating good quality employment.

- To this effect we have to use both our **common and national toolboxes** to boost public and private **investment**, implement a more balanced **fiscal stance**, achieve an effective interaction between structural reforms and **an EU reinforced action**.

- We have to reinforce **common tools and institutions**, to manage European public goods and face new challenges, such as migration.

1. The heightened uncertainty and the prolonged weak growth

- Despite the collective effort at EU and global level towards strong, sustainable and balanced growth, **economic prospects remain weak and unequally distributed**, with significant downside risks. The latest updates to the outlook delivered by international organizations have once more reviewed growth projections downward.

- After the deep recession in 2008 and 2009, **we would have expected a fast acceleration of growth putting the world economy quickly back to peak levels of GDP and inflation rates**. This did not happen, certainly not in Europe, leaving the recovery significantly below expectations based on past patterns in comparable circumstances.

- So we are in a new scenario. In a nutshell such a scenario can be described as the result of a rising **preference for saving accompanied by a decreasing propensity to invest; this combination hampers growth, reduces real interest rates and compresses inflation**. In such a context, markets expect that interest, inflation rates as well as growth, will stay low for long. And markets have embedded in their expectations what we could call **a "new normal".**

  Where monetary policy cannot do much to resume inflation and growth, despite the very accommodative stance. While high savings can be justified by higher risk aversion low in-

vestment can be explained by weak demand and high policy uncertainty.

- **Weak demand is the primary determinant of low investment** and is associated to **inflation** being consistently **below central banks' target**. At the same time, the effectiveness of the monetary stimulus is itself hampered by **low inflation as real rates end up above desired levels**, as well as incomplete structural adjustment.

The impact of policy uncertainty

- Nowadays, heightened policy uncertainty should not be related specifically to election results – elections are not a new feature, they have always been there, but rather to the possibility that election or referendum outcomes **are seen as able to trigger systemic impacts** (as it was the case for British referendum).

- This implies that as elections or referendum approach a **"wait and see" attitude by businesses and households prvails**: this holds back investment and consumption decisions, while it increases (precautionary) savings.

- In addition, in an environment of uncertainty, frequent and significant shocks to aggregate demand, if not properly addressed, can produce **persistent damages to the economy through the so-called hysteresis effects**. After a negative shock (or recurring bad news) firms can choose to postpone their investment plans, e.g. in research and innovation, cut turnover and – eventually – shut down factories and productive sites.

- If prolonged, a recession implies an **increase of long term unemployed who tend to lose their skills and/or separate from the labor market**, deteriorating the match between demand and supply and increasing segmentation. At the aggregate level, these effects can have long lasting impacts on the future productive capacity of the economy. Potential output will go down and stay down. In addition, being out of work depresses confidence and exacerbates inequality.

We need to share a coordinated, certain growth strategy

- In such a context, **policy action is crucial to dissipate uncertainty**. Long term policy action must support demand and supply factors in a coherent framework in order to amplify the benefits of structural reforms and investment.

- All available policy tools must be activated in a coordinated fashion: monetary policy must be accommodative; **fiscal policy** should be supportive, where fiscal space is available – **while structural reforms should clear the path to higher growth rates from administrative and regulatory hurdles by liberalizing labor and product markets**, making the system more flexible and reactive to policy stimuli.

- Along these lines, **an effective growth strategy should include reforms aimed at making the institutional framework more predictable and sta-**

ble, so that policy decisions can be introduced quickly and reinforce long term expectations and propensity to invest.

- Evidence shows how significant the negative impact of institutional instability can be on growth. This stems from the uncertainty it generates for consumers and investors, from a more conflictual relationship between different layers of government, from **the lack of policy direction which makes an economy more vulnerable to shocks**.

2. A struggling European Union

- Policy uncertainty and low growth prospects: **are prominent in the European landscape today**.

- The **EU is particularly exposed to the risks of prolonged weak growth** compared to the other regions as in Europe population is ageing more quickly, innovation is less dynamic and the financial system is more fragmented, weakening further the transmission mechanisms of the monetary stimulus.

- In such a perspective it is not surprising if, after 8 years of recession, financial crisis and stagnation, **the European project is suffering "a credibility crisis"**: this crisis is compounded by the diffuse perception that the policy reaction to the economic downturn and the sizable unemployment is insufficient. European citizens fail to perceive the value added of being part of the Union and look for different alternatives.

- **A consequence of such a credibility crisis is that national interests are prevailing over the collective ones**. Growing signs of disaffection, fed by the exceptional duration and intensity of the crisis, are boosting consensus for populist proposals; Euroscepticism is on the rise in many Member States, thus enhancing the impact of policy uncertainty.

- I believe instead that **the EU is a historic opportunity**. We must seize such an opportunity and deliver to our citizens what they expect, less inequality, more jobs, more security.

- We have gone a long way in our integration process, including since the out-break of the financial crisis, but **now Europe is at a crossroads**: if we were to keep "muddling through" an uncertain recovery, progress in growth and job creation would fail to emerge and both the EU and the Euro area would remain exposed to shocks, undermining their sustainability. Importantly, as support for the EU project falters mutual trust also weakens, making it more difficult to reinforce common institutions.

- If Europe is to be part of the solution – and not of the problem – **we must re-build trust among our citizens, member states and European and national institutions**, and develop an EU-wide strategy to restore sustained growth, boost jobs and fight inequality.

3. The engine to catch up with higher growth rate

- A **virtuous interaction between national policies and EU coordinated action** is the master strategy for the EU to catch up with higher growth and jobs.

- The integration process must leverage **the centrality of the European Monetary Union**, an anchor of stability and confidence, a precondition for the health of our welfare state; to increase ur prosperity and security, to fight against growing inequality it **is of paramount importance to strengthen the Eurozone governance and institutions**.

- Let me offer a few examples of how the strategy could unfold.

The central role of public and private investment

- As I have already mentioned, against a backdrop of slow and fragile recovery, **boosting investment – both public and private – is the top priority to put the EU back on a path of sustainable growth**.

- Investment supports demand in the short-term and strengthens supply and potential output in the medium-term. Over the recent past, **the fall in investment in the European countries has been widespread**; we have to use all the policy measures available at the national and the EU level to accelerate a reversal.

- The **Junker Plan and the European Fund for Strategic Investment** (EFSI) were launched by the new Commission with the goal of deploying public leverage to reach out to potentially profitable investment plans whose risk the private sector would not bear on its own. This strategy must be extend and implemented more forcefully also by targeting the creation of knowledge-based capital, innovation and infrastructure.

- We should boost a **Financing and Investment Union**, where the completion of the Banking Union, the Capital Market Union and the Juncker Investment Plan contribute to the more effective transfer of savings towards investment, including infrastructure investment.

- The EU governance framework should provide for **more incentives for investments in European public goods** including migration, and possibly defense, also at national level. Further common European initiatives should be explored: projects to enhance EU growth potential could be financed by joint debt issuances.

A more coordinated and balanced fiscal stance

- Moreover, at the national level **to expand investment and support growth member countries should use the composition of their budget by targeting public resources to support investment and competitiveness**.

  In presence of protracted modest growth rate and exceptionally low inflation even the extraordinary measures put in place by the European Central Bank are proving insufficient.

- At the same time, restoring a sustainable pace of growth and job creation is also the most effective way to keep debt on a sustainable path. **Flexibility represents an incentive for more investment and reforms**; it is misleading to depict it as a way to escape from fiscal discipline.

- In this respect, **the newly established European Fiscal Board should take a pan-European view in its analyses and formulate fiscal policy recommendations for the euro area as a whole**. This is key to develop an aggregate policy stance and an EU-wide growth strategy which goes beyond the mere sum of national performance.

- Fiscal rules should also prove their **adequacy to cope with a challenging economic environment**. A framework designed for "normal" conditions of growth and inflation has proved incapable to tackle effectively **the impact of very low nominal growth on potential growth and on debt dynamics**.

  These shortcomings have implications for the measurement of fiscal indicators on which policy recommendations are based and should be addressed. Price developments should therefore be more effectively embedded in fiscal rules.

- **Symmetry is needed in macroeconomic adjustment**: there is room for significant improvement in economic surveillance of macroeconomic policy and structural reforms. Instilling more balance in the way macro-surveillance refer to deficit and surplus countries is a key starting point to improve efficiency of the EU surveillance mechanism.

- **The macroeconomic imbalance procedure should be implemented more effectively to this end**. A more cooperative approach to support demand would lead to a win-win equilibrium complementing structural reforms.

The worthy interaction between structural reforms…

- Structural reforms in all Member States are as relevant as fiscal discipline **to build up EU's economic resilience to external and endogenous shocks and to boost economic convergence**. Structural reforms unveil new profit and investment opportunities. The key point is their full implementation. In this respect the following issues come to mind.

- First, consensus matters. When designing a plan for **structural reforms** it is of upmost importance that potential winners and losers are identified beforehand so that measures can be included in the strategy to preserve inclusiveness.

  They could be implemented straight-away or being triggered by some well-defined indicators after a phase of monitoring.

- Second, **structural reforms take time** to deploy their effects. In Europe we know this very well. Germany, for example, has proved to be more resilient than other countries during the financial crisis also thanks to labor market reforms implemented 10 years back.

- Third, **focusing the reform effort only in one area, even a high priority**

one, might not be sufficient. Some reforms are more ground breaking than others; however experience shows that reforms benefits cumulate if a package of reforms is introduced.

… and the EU reinforced action

- To the same extent, benefits of structural reform in anyone country would be magnified if other countries also introduce reforms. This calls for coordinated action of national and EU wide reforms.

- Having a EU dimension for reforms is one of the reasons why deepening the **Single market** remains one of the main drivers of growth. And the Single Market uncompleted agenda is rich. I have mentioned the finalization of the **Capital Markets Union**, I would add the creation of a proper **Energy Union** and the establishment of an **Innovation Union** – a strategy to pool research and knowledge capital, improve spillovers and diffusion, and deliver a more inclusive economic system.

- Evidence shows that a **more inclusive economic system is one with better growth and employment perspectives**. Over the last decades, inequality has been increasing in most advanced economies notwithstanding that it was commonly believed that higher growth would have been beneficial for all. In fact, the access to economic opportunities is now significantly different at the two extreme of the social ladder and this produces a loss in terms of productivity, growth prospects and wellbeing. On the contrary evidence shows that higher inclusion would reinforce growth. So there is a case for measures to support inclusion, including the better job protection and risk mutualisation. One example is the creation of a **European scheme against cyclical unemployment**.

- Such a mechanism **would enhance citizens' trust in the EU, serving as a positive signal of the effectiveness of Monetary Union**, by building an important link between monetary and financial convergence and the labor market.

- Dealing with structural unemployment requires structural measures; but especially in a monetary union, in the absence of the exchange rate, it is of paramount importance to **address the impact of adjustments on employment and wage dynamics**, while diminishing the impact of severe shocks on budget balance.

- In addition, such a scheme **reduces the probability that a cyclical downturn would produce a long lasting impact on growth potential**, smoothing the fluctuations of the economic cycle and generating positive spillovers across the area.

- The introduction of this system **would not imply any treaty change**. The instrument would be triggered by severe employment shocks (independent from structural factors), providing a stabilization function. It would build on an **appropriate incentive structure in order to limit moral hazard and avoid permanent transfers from some countries to others** – ie no net losers and net winners in the long run.

Every country is from time to time exposed to cyclical shocks – for example recent research has shown that, the tool having been in place from 2002 to 2008, Finland and Germany would have been among the biggest beneficiaries.

4. Facing new challenges

- Finally, one key element of the heightened policy uncertainty environment is the emergence of new challenges. As the five presidents report has acknowledged, the EU countries face **common challenges, interests and responsibilities**. This common destiny requires commonly agreed rules and their effective implementation.

Migration: an urgent and structural issue…

- **Migration represents the most urgent issue that Europe has to face today**. To help address it, a few months ago Italy offered the suggestion to implement **a European approach through a "Migration Compact".** Europe needs to act by deploying an integrated and sustainable initiative addressing both the consequences and the causes of mass migration.

- The June European Council has taken on board key elements of the Migration

Compact, by launching **the new Partnership Framework with countries of origin and transit of migration flows**. We need now to make the Framework operational and effective.

In this respect, the draft proposal of the Commission for an External Investment Plan is a good starting point, but it can be enhanced in view of its formal launch in September. I see three areas for improvement and I hope we can join forces on these.

First, the key point is that we need Europe to approach the priority countries with an integrated offer, made of compacts to be launched in the very short-term, and private sector and infrastructure investment to address the root causes of migration. We don't see this integration in the draft proposal of the Commission, which refers to the investment chapter only and does not include a word on ways and means to exploit synergies with the short-term action. The European initiative risks being ineffective and self-defeating without such joint action, possibly calling on us to replenish at regular intervals the grant component.

Second, the initiative has to be truly European, including in relation to the nationality of investors, for political and visibility purposes. Eligibility to financing and guarantees must be limited to European actors, such as our National Promotional Institutions and the EIB, or controlled by Europe, such as the EBRD and the CEB. Others, including the IFIs, could play a co-financing role, but with their resources and instruments.

Third, the Plan has to be professionally managed, particularly in relation to the Fund and the Guarantee. The Commission is not well equipped in this respect. This job requires banking expertise and the provision of banking services. The EIB has offered to be the manager and it is in our interest to support it in this role, with no impact on eligibility.

… which has to be dealt with through addressing integration and borders

- Let me just mention a few points that are necessary for the response to the migration issue to be effective.

- First, **integration**. **The medium-long term benefits of integrating migrants in national labor markets far outweigh the short-term costs**, particularly as in an ageing society. **Properly designed and effective integration policies** are of the utmost importance to reap such benefits while coping with the costs.

- Second, investment in the origin countries to generate decent conditions and perspectives, in addition to security, for jobs and growth. The external deployment of the Juncker plan should provide the back bone of such a pillar.

- Third, **borders**. An effective migration strategy requires a common management of borders, a truly European public good. Such a policy would send a strong signal of integration. A common management of borders would strengthen confidence and avoid even the suspect of opportunistic behaviors.

- **In the absence of an effective management of the European borders, Schengen would be at risk; the Euro itself could be next**.

Conclusion

- **The Brexit vote has increased policy uncertainty,** especially over the medium term; strategic decisions are being considered by market participants in the expectation that **the redefinition of UK-EU relationship will impact on**

costs and benefits of long term investment and relocations.

- In continental Europe **a sequence of election and referendum events could**, in some cases, **lead to outcomes that would question basic choices** about EU and Euro area membership.

- The alternative – **to remain in Europe** – **is not, by itself, sufficient** to reduce policy uncertainty by a significant amount. The real alternative requires **accelerating the process of integration** so as to deliver to EU citizens a credible promise that Europe is the solution – in terms of jobs, welfare, security and inclusion, rather than being part of the problem.

- More integration is needed both in the Euro area and in the European union. It is a complex task which requires many components. I am convinced that on several of such components Germany and Italy share a common view.