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Bulgarian Presidency of the Council of the European Union

Macroeconomic Dialogue at political level February 2018: Discussion on Economic Resilience

Presidency steering discussion note

1. Economic situation

Following a prolonged period of stagnation and subsequent sluggish economic growth, the EU economy appears to be on track. Economic recovery is expected to continue in the near future, as revealed by the recently published Winter Forecast of the European Commission. For the first time in almost a decade, the economies of all EU Member States are expected to grow throughout the entire forecasting period. Real GDP in the euro area has grown for 15 consecutive quarters while employment is growing at a robust pace. Deficit and debt ratios continue declining. Private consumption is still the engine of the recovery, supported by sustained improvements in employment and a rise in nominal wage growth. However, with inflation rising and limiting the growth of household purchasing power this year and next, private consumption growth is expected to slow. Investment growth continues but remains subdued.

Labour market conditions are improving but challenges still remain. The unemployment rate is decreasing but remains above pre-crisis levels. The share of long-term unemployed remains high in some Member States and significant percentage of young people still do not participate in any form of employment, education or training, despite some positive dynamics of the youth unemployment indicator. Low wage growth persists, while productivity growth remains low.

The outlook is surrounded by high uncertainty related to – among others – Brexit, potential disruptions to trade, faster monetary tightening in the US, and the potential consequences of high and rising debt in China.

Issues for discussion:

- *How do you see the priority actions required to sustain the current upswing?*
- *What are the major risks?*

2. Economic resilience

In the last decade, Europe went through a long period of difficulties suffering inter alia from the insufficient degree of economic resilience. The recent economic and financial crisis revealed that many EU Member States had vulnerabilities which proved very costly when repeated shocks hit them

and lacked the appropriate economic structures to smoothly absorb these shocks and quickly overcome the deep economic adjustment that followed. The depth of the downturn was linked to the limited absorption capacity of Member States but also to the fact that the crisis coincided with the unwinding of accumulated current account imbalances and the bursting of housing bubbles which resulted in large and persistent drops in output. The unwinding of these imbalances had repercussions for sovereign debt via sovereign-bank feedback loops, and created spillover effects across Member States, thereby endangering the stability of the euro area as a whole.

Economic resilience is traditionally defined as economy's capacity to absorb and quickly recover from adverse shocks, containing their impact on output and employment. Since temporary losses can easily become a structural drag, this aspect of resilience is a precondition for preserving economy's long-run growth potential. Identifying policy tools to enhance overall resilience is complicated by the existence of trade-offs and interactions in both macroeconomic and structural policy settings.

Macroeconomic policies play a key role in mitigating the shock impact and speeding the recovery in the aftermath of a crisis. Expansionary monetary policy helps shorten recessions by boosting demand. Its effectiveness, however, depends on the type of the shock. It is typically less effective during a financial crisis. There are also limits about how long expansionary monetary policy can be kept in place to support recoveries, without fuelling additional risks. On the fiscal side, effective countercyclical policy requires sufficient fiscal space.

Structural policy settings are also important in enhancing the resilience of economies to shocks, affecting the speed of wage and price adjustment as well as the reallocation of resources. For instance, rigid labour market policies can cushion the impact of adverse shocks, but also slow the recovery by hampering labour reallocation. Active labour market policies can cushion the impact of a shock on the economy by upskilling and training of workers. Likewise, flexible housing markets can facilitate labour mobility. However, housing markets that respond very quickly to increased demand through greater building activity can lead to cyclical swings. Less restrictive product market regulations can help lower the impact and reduce the persistence of shocks.

Policies that may be good for resilience may even also face a trade-off with long-term growth objectives. For example, higher ratios of capital to assets within banks can help weather a crisis. However, beyond a certain point, a large storage of capital may hinder growth by limiting the funds available for lending.

Issues for discussion:

- *Which policy mix should be used to build more resilient economy; how to improve the existing framework and alleviate its shortcomings?*

- *How effective common EU policy tools could be at addressing asymmetric shocks or appropriate national instruments should also play a role?*
- *How do you see the possible trade-offs between policies aimed at strengthening resilience and these focused on sustainable long-term growth?*