Peter Praet: EMU – disappointed expectations and how to move forward

Remarks by Mr Peter Praet, Member of the Executive Board of the European Central Bank, at the 5th SEEK Conference on "Overcoming the Crisis: How to Foster Innovation and Entrepreneurship in a Diverging European Economy?", Mannheim, 8 October 2015.

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Thank you very much for inviting me to address this conference this morning. We are meeting today against a mixed economic backdrop in the euro area. While the cyclical recovery is progressively taking hold, many countries are confronting a situation of disappointed growth expectations. For the euro area as a whole, 5 years ahead growth expectations among forecasters have been falling continuously since 2001, from around 2.7% then to 1.4% today. As a result, the economic environment is characterised by seeping pessimism about the prospects for long-term growth.

This matters for two reasons. First, it holds back a stronger recovery, as uncertainty about the future can feed back into weaker investment today through expectations and confidence channels. It is surprising, for example, that businesses currently perceive themselves to have limited excess capacity, despite a large estimated output gap.

Second – and perhaps even more fundamentally – pessimism about future growth challenges one of the founding rationales for the single currency, which is that it would lead to sustainably higher wealth for all its members. This is relevant for the whole monetary union as the cohesion of the euro area depends on the fact that each country perceives itself to be permanently better off as a member.[1]

In short, it is not an issue we can take lightly. In my remarks I would like to discuss how we arrived in this situation of disappointed expectations, and what we need to do to remedy it.

The high expectations for EMU

Why weak growth today is perhaps so disappointing is that the launch of the EMU in 1999 was associated with high expectations. Following the decade of so-called "Eurosclerosis" in the 1980s, the single market and single currency were seen as creating the pre-conditions for a structural break in trend growth, reversing the weak performance in GDP and employment growth that had been visible in many European economies.

As laid out in the Commission's report on "One Market, One Money" in 1990, EMU was expected to create both "microeconomic efficiency gains, which arise from the elimination of exchange rate uncertainty and transaction costs, and lead to a permanent increase in output", and "macroeconomic stability effects, which arise from the elimination of intra-Community exchange rates and from policy discipline in the monetary and fiscal fields." Macroeconomic stability was also expected to be supported by increased financial integration, as in a monetary union "private markets will finance all viable borrowers, and savings and investment balances will no longer be constraints at the national level."[2]

Expectations for the positive effects of EMU always depended crucially, however, on the notion that euro membership would have an endogenous effect on the quality and efficiency of national economic institutions – by which I mean, among other things, institutions governing competition, wage bargaining, civil justice, banking supervision and fiscal policies.

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1 See M. Draghi, "Structural reforms, inflation and monetary policy", Introductory speech at the ECB Forum on Central Banking, Sintra, 22 May 2015.

2 European Commission (1990), "One Market, One Money".

This was because, as governments in a monetary union would have less scope for demand management, they would necessarily focus more on structural reforms. For instance, without the possibility to devalue to regain competitiveness, governments would have to compensate by making changes in product and labour markets to improve the flexibility of relative prices. Moreover, the principles of no bailout and no exit in the EMU framework would, it was expected, encourage countries to improve fiscal sustainability, not least because markets would subject them to stronger discipline. All in all, the conditions for sustained real growth in euro area countries would be significantly improved.

At the same time, it was anticipated that structural and fiscal reforms would support the functioning of adjustment mechanisms that would help keep growth on track. The euro area does not have some features that were seen as important in the literature on "optimal currency areas", such as cross-country fiscal stabilisation or labour mobility. But if countries could adjust through relative price changes, adjustment through quantities (ie labour mobility) would be less important. And if national fiscal policies were sufficiently sound to allow the national stabilisers to play out in a downturn, there was less need for union-wide stabilisation mechanisms. Deeper financial integration would also allow risks to be shared privately across regions, thereby reducing the need for fiscal risk-sharing.

So why were these high expectations not realised?

Why expectations were disappointed

It is beyond the scope of this speech to give a comprehensive answer. But part of the explanation is the fact that governments did not internalise the new constraints created by monetary union. As a result, few took advantage of the favourable financing conditions in the first decade of EMU to make progress on institutional reforms.

On the *fiscal side*, the weakening of market discipline was not matched by a commensurate strengthening of fiscal governance at the European level, which allowed countries to relax underlying consolidation efforts as interest expenditures fell. Some therefore entered the crisis with fragile public finances, which then had to be shored up in the downturn. Fiscal policies in the euro area were consequently largely pro-cyclical and unavailable to stabilise national economies in the slump.

At the same time, improving financing conditions triggered strong cross-border capital inflows into a number of countries and a surge in domestic demand and inflation. That in turn produced a steep fall in real interest rates and a self-reinforcing easing in credit conditions. This not only created the conditions for a pronounced boom-bust cycle and a severe balance sheet recession in the worst affected economies. It is also, crucially, masked the postponement of necessary reforms in the *structural area*.

According to the World Bank's governance indicators, the gap between the best and worst performers in terms of perceptions of institutional quality actually diverged in this period.[3] Relative price flexibility also hardly improved. Though monetary union resulted in inflation differentials in the euro area falling to a level comparable to the US, their persistence remained much greater: the euro area experienced a divergence in relative prices twice as large as the one observed in the US.

In addition, the boom phase contributed to a rapid but unstable form of *financial integration* in the euro area. There was price convergence in many asset classes coupled with a high volume of short-term flows, creating an illusion of deepening integration. But it in fact remained relatively shallow, especially in the banking sector. While euro area interbank markets became

3 World Bank, World Governance Index.

almost completely integrated, the retail banking sector stayed largely fragmented.[4] Contrary to pre-crisis expectations, the banking sector therefore never developed the institutional features to effectively share risk across borders.

In combination, this weakening institutional environment, while not *per se* a cause of the crisis, meant that EMU did not provide the framework for higher sustainable growth that was expected. Countries with inflexible relative prices saw pronounced losses in export market shares and price competitiveness, and capital flowed disproportionately into non-productive sectors, which ECB research suggests led to substantial capital misallocation[5]. In that context, despite relatively strong headline growth rates in the first decade of EMU, the euro area's potential growth rate in fact fell continuously throughout the 2000s.

And when the credit cycle eventually turned, the euro area financial sector was prone to fragment along national lines: indeed, whole national banking systems faced conditions equivalent to a "sudden stop". With banks in some of the most vulnerable countries heavily exposed to their own governments, sovereign and bank stresses interacted in the now infamous "diabolical loop". In this way, the banking sector acted more as a shock amplifier rather than a shock absorber. All this exacerbated the negative impact of the balance sheet recession on the economy.

Elements of a crisis response

Against that background, dealing with the crisis required two types of policy response. The first was a determined stabilisation policy to offset the effects of the boom-and-bust cycle on demand. The second was a policy of structural reform, to bring about the necessary institutional changes that the early years of EMU had failed to elicit.

Stabilisation can in principle be provided either by monetary policy or fiscal policy. With fiscal policies at best unavailable, however, the burden had to be borne principally by the central bank. That task was further complicated by the fragmentation of the banking sector, which severely disrupted the transmission of our monetary policy across the euro area. In this situation, we necessarily had to produce a resolute monetary policy response – both to compensate for the retrenchment of fiscal support for aggregate demand, and to compensate for the diminished traction of our policy over the economy.

This required us to develop several so-called "non-standard measures". These included targeted measures to overcome transmission blockages, such as altering our collateral policy or launching our Targeted Long-Term Refinancing Operations. And they included, as policy interest rates approached lower bound, deploying large-scale asset purchases to expand the monetary policy stance through our Asset Purchase Programme. Those measures were no doubt unprecedented for the ECB. But they should be understood as a necessary reaction to fragmented and depressed environment, where the central bank found itself, in the words of many observers, as "the only game in town".

Our policy has clearly contributed to stabilising the macroeconomic environment. We have always decisively addressed signs of a de-anchoring of inflation expectations. But stabilisation policy can ultimately only buy time for the second type of policy response to be implemented – addressing institutional weaknesses. So has the time bought by our actions been used well? In my view the answer is a qualified yes.

In terms of structural reforms, a great deal of activity has taken place since 2010. To give just a few examples, Greece, Portugal and Spain have all taken measures to improve

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4 Financial Integration in Europe, European Central Bank, April 2008.

5 See Gamberoni, Giordano and Lopez-García, "Capital and labour (mis)allocation across firms: a study of selected euro-area countries", work in progress.

competitiveness (such as increasing wage decentralisation), to strengthen competition (such as reducing barriers to entry in professional services), to enhance economic efficiency (such as improving the functioning of the judicial system), and to raise employment (such as increasing flexibility over working arrangements). Similar reforms have also been implemented in Italy, Slovenia and Cyprus.

Overall this had led to several countries improving their positions in global rankings of structural policies, which should now put them in a stronger position to reap the microeconomic benefits of monetary union. We should nonetheless not forget the lesson of the pre-crisis period that reform momentum can wane as economic conditions improve. The recommendations in the recent "Five President's" report therefore aim to keep up that momentum by setting out a process of convergence towards "similarly resilient economic structures".[6]

We have also seen, in recent years, a strengthening of institutions in other areas where vulnerabilities were revealed by the crisis. We now have a reinforced European framework that should, if implemented effectively, produce stronger governance over fiscal policies, while also allowing some flexibility for the possible short-term costs of implementing structural reforms. It is important, however, that the assumptions underlying decisions to use such flexibility are spelled out in a clear and transparent way ensuring a consistent application over time and across countries.

Perhaps most importantly, policymakers have acknowledged that sustainable financial integration does not follow automatically from sharing a currency. In short, a monetary union comprised of sovereign states requires a Banking Union. That has now largely been brought into being with the creation of the Single Supervisory Mechanism and the Single Resolution Mechanism, backed by a Single Resolution Fund.

Banking Union should, in principle, support the functioning of the EMU framework in two crucial ways. First, European banking supervision should improve the capacity for micro- and macro-prudential policies to be used counter-cyclically, thereby helping contain boom-bust dynamics. Second, European banking resolution should provide a framework for harmonised and predictable burden-sharing through the private sector, which is key to create the conditions for deeper retail banking integration, and hence for the financial risk-sharing benefits of monetary union to materialise. What is needed now is for Banking Union being completed in all the areas that have been identified.

The challenge of lifting productivity

Still, despite the present cyclical recovery and reforms already made, we cannot ignore the fact that the underlying pessimism I alluded to at the start remains. This may be partially lifted as the benefits of those reforms start to appear in headline growth rates. But in my view further reforms will be needed to decisively shift expectations, in particular in the priority area of raising total factor productivity (TFP) which is ultimately what drives long-term growth. The difference between the euro area and the US in this regard shows the possibilities we have for improvement.

The determinants of TFP growth are complex, but broadly speaking it is a function of within-firm and across-firm efficiency. The former is linked to investments in human capital, innovation, management quality and technology. The latter relates to the efficiency of labour and capital reallocation. There are many factors that can influence these processes, but given the focus of today's conference I would like to single out one in particular. That is the nexus between firm growth, technology adoption and resource allocation in the euro area and how it affects productivity growth.

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6 Completing Europe's Economic and Monetary Union", Report by Jean-Claude Juncker in close cooperation with Donald Tusk, Jeroen Dijsselbloem, Mario Draghi and Martin Schulz, June 2015.

Many euro area economies are characterised by a high proportion of micro and small firms, especially in comparison with the US. While small firms can add important value to the economy – indeed, young firms create most net new jobs[7] – that value diminishes if they do not grow over time. For example, the average size of a manufacturing sector start-up in the US and Italy is roughly the same within its first two years – 5-10 employees. After ten years, however, the average US firm has grown to around 75 employees, while the average Italian still has below 15 employees.[8] This static pattern of firm growth hinders both the within-firm and across-firm channels of TFP growth.

Within firms, firms that stay small tend to be less likely to invest in new technologies, in particular ICT investments that are crucial to succeed in the digital economy. This is because, among other things, small firms face relatively higher fixed costs when adopting ICT[9], while they exhibit higher risk aversion and encounter greater difficulties in collecting resources to finance more innovative projects.[10] And if firms do not grow, it also weakens the potential for productivity growth through the across-firm channel: the more resources are concentrated in the most productive firms in each sector, the faster aggregate TFP grows.

For these and other reasons, analysis by the IMF finds that firm size is strongly positively correlated with TFP in certain countries, with micro firms being about a third less productive than large firms.[11] This demonstrates that creating the conditions for a more dynamic distribution of firm growth could make a decisive difference to TFP developments in the euro area – and this is where the need for further structural reforms comes in. Let me lay out just a few of the channels through which structural reforms could support this process.

Structural reforms and firm dynamics

First, by removing regulations that encourage firms to stay below certain size thresholds. In Italy, for example, some studies argue that labour regulations that kick-in at the 15 employees threshold may have encouraged firms to stay small in the past, although these are *de facto* now no longer in force.[12] A similar phenomenon has been observed in France, where size-contingent regulations appear to cause firms to cluster below 50 employees.[13] In Spain, too, there is evidence for substantial bunching of firms just below the “large taxpayer” threshold.[14]

Second, by making it easier for new firms to enter markets and non-productive ones to exit. OECD research suggests that dynamic firm turnover depends strongly on product market reforms that raise competitive pressures, labour market reforms that allow firms to adjust more easily to changing market conditions, and the efficiency of the legal framework in areas such

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7 De Kok, J. et al (2011), "Do SMEs create more and better jobs", EIM Business & Policy Research report, November 2011.

8 Criscuolo, Gal and Menon (2014), “The Dynamics of Employment Growth: New Evidence from 18 Countries”, OECD Science, Technology and Industry Policy Papers no. 14, OECD Publishing.

9 Hitt, Wu, and Zhou (2002) find, when examining IT adoption by firms, ICT investments have high returns to scale because of their low marginal costs but higher fixed costs. See Lorin M. Hitt, D. J. Wu, and Xiaoge Zhou, “Investment in Enterprise Resource Planning: Business Impact and Productivity Measures,” J. of Management Information Systems 19, no. 1 (2002): 71–98.

10 Amatori, F., Bugamelli M. and A. Colli (2011), “Italian Firms in History: Size, Technology and Entrepreneurship”, Banca d’Italia Economic History Working Papers, No. 13, October 2011.

11 IMF (2015), “Spain: Selected Issues”, IMF Country Report No. 15/233.

12 Schivardi, F., and Torrini, R. (2004). “Firm size distribution and employment protection legislation in Italy.” Banca d’Italia Economic Working Paper, No. 504, June 2004.

13 Garicano L., LeLarge C. and J. Van Reenen (2012) “Firm size distortions and the productivity distribution: Evidence from France.” NBER Working Papers, No.18841, March 2012.

14 IMF (2015), “Spain: Selected Issues”, IMF Country Report No. 15/233.

as insolvency law.[15] In keeping with this, other recent evidence suggests that legal reforms such as enhancing the efficiency of civil justice can lead to higher rates of firms' market entry and attract greater foreign direct investment.[16]

Third, by improving the efficiency of financial markets so that resources can be reallocated between growing and shrinking firms. In this context the key structural reform is advancing with the Capital Markets Union project, which should help deepen markets in Europe for early stage venture capital, as well creating new opportunities for market financing – such as private placements – for more mature firms. Framework conditions matter here as well: a new ECB study finds, for example, that the probability to obtain credit is up to 40% higher in countries with a better legal system.[17]

Fourth, by improving human capital, especially in the area of digital skills. After all, if workers lack the skills to operate ICT then firms will be less likely to invest in it, and those that do will find it harder to attract qualified workers and grow. In this sense, reducing barriers across-firm reallocation, such as enhancing skill level, can increase incentives for within-firm innovation and technology adoption. This is primarily comes down to education, but labour market reforms, such as lifelong learning schemes, can also play a role.

Finally, efforts to complete the Single Market – which can be considered a structural reform – would strengthen incentives for firms to innovate and grow in order to benefit from the greater demand of a larger market and to exploit economies of scale. In this context, the Commission finds that reforms facilitating market entry and raising the level of competition on goods and services markets could, over the long-term, result in productivity gains of between 2-4%.[18]

This is no doubt a long and challenging agenda. But it also an achievable one: given the distance to frontier of several euro area countries on structural reforms, fast improvements are well within their reach. And we should not forget, citizens' trust in the euro remains high, and they want it to deliver the gains that were promised. It is therefore incumbent on all policymakers to create an environment for stronger growth, where the many benefits of sharing a single currency and a single market can show through.

On the central bank side, that means supporting demand for as long as necessary to work through weak cyclical conditions. On the side of governments, it means enacting the institutional reforms necessary for sustainable growth within monetary union. Only with such a comprehensive policy response can we ensure that the high expectations of monetary union are finally fulfilled.

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15 OECD (2015), "Young SMEs, growth and job creation", OECD Policy Brief.

16 Lorenzani, D. and Lucidi, F. (2014), "The Economic Impact of Civil Justice Reforms" EC Economic Papers No. 530.

17 Maresch, S., A. Ferrando and A. Moro (2015), "Creditor protection, judicial enforcement and credit access", ECB Working Paper no. 1829, July 2015.

18 European Commission (2004), "The link between product market reforms and productivity: direct and indirect impacts", The EU Economy 2004 Review.