François Villeroy de Galhau: Central bank role to support a strong and sustainable growth in the medium and long term

Speech by Mr François Villeroy de Galhau, Governor of the Bank of France, at the global economic symposium "Reigniting Global Growth: Headwinds and Tailwinds", co-hosted by The National Association for Business Economics (NABE) and the Organisation for Economic Cooperation and Development (OECD), Paris, 23 May 2016.

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Introduction

Good evening ladies and gentlemen. It is a pleasure for me to be here this evening. A well-known joke asks "how many central bank economists does it take to screw in a light bulb?" and answers "Just one – he holds the light bulb and the whole earth revolves around him". By addressing the role of central banks in supporting growth, you may think I am taking a step too far my role as a central banker. But as you will see, my views are more modest.

As we all know, growth in the long run is determined by real forces: the accumulation of physical capital, the development of new products and production techniques, the provision of public infrastructure, investment in education and skills and the efficient allocation of resources between alternative uses. Long run growth is not determined by anything nominal and thus it may seem odd to think that central banks play any role in supporting strong and sustainable growth in the medium and long term. Monetary policy is usually seen as the demand and supply side.

However, I would like to argue that there are at least three important ways how central banks may increase the sustainable rate of growth.

The first contribution central banks can make is well-known and is to provide price stability. This helps narrow the range of future paths of the aggregate price level and thereby provides some assurance about the real economic value of nominal contracts. Reducing the inflationary risk premium reduces the uncertainty of longer term contracts which, in turn, facilitates investment in projects with high potential returns but long gestation periods.

Price stability also helps consumers and businesses to identify changes in relative prices more easily. In turn, a clearer view about relative prices allows an economy to move its resources more rapidly to more profitable uses, to improve its competitiveness and thereby aggregate productivity.

However, I would like to elaborate on two other less well-known ways how central bank can help to increase the potential growth rate of an economy:

- monetary policy can contribute to alleviate the medium term negative effects of a deep recession on potential growth in particular in the aftermath of a financial crisis; and
- monetary policy can foster long-term growth by supporting structural reforms and in particular the ones favoring a more resilient and efficient financial system.

1. Monetary policy can contribute to alleviate the medium term negative effects of a deep recession on potential growth

1.1. First, "border line" between appropriate counter-cyclical monetary policy and medium-term sustainable growth is an open one.

A deep recession, such as the Great recession, can have long lasting effects on potential growth, which are different in nature from the usual consequences of a cyclical downturn. Because of its duration and amplitude, it may damage the available human and physical capital stock as well as medium-term productivity growth. Monetary policy may alleviate these effects through an appropriate accommodative stance.

First, a deep recession may lead to a depreciation of the available human capital stock[1]. Long term unemployment reached historical heights during the Great Recession in the United States, Spain, Italy or France, as you can see on this graph. The skills of long-term unemployed' may then be eroded by lack of practice.

Long-term unemployment may also discourage part of the labour force, which may leave definitively the labour market. The structural decline in the labour force participation rate accelerated with the crisis in the United States. This evolution is however not shared by all countries, such as Spain. Indeed, the reverse behaviour may be observed as the unemployment of one member of a household may lead other members of the household to enter the labour market. The two effects can offset or dominate one another, leading to different country paths, as shown on the graph.

Finally, a deep recession may lead to sectoral reallocation, with part of the labour force lacking appropriate skills. As can be seen in this graph, the Spanish construction workers had to face a sharp contraction of the share of employment in that sector, from 13% of total employment to 5% and find a job in other sectors. The decline is less significant but still relevant in countries which experienced a construction boom. More generally, according to a Banque de France research paper[2], the Beveridge curve has shifted in the euro area and the United States, with more vacancies associated with a similar level of unemployment, pointing at an increase in structural unemployment.

These effects of the crisis on human capital would fade away only slowly, with the arrival of new cohorts on the labour market. However, they could be mitigated by active labour market policies, such as an appropriate training policy, which have a very effective and targeted impact on human capital depreciation.

1.2. Second, in Europe, the ECB has significantly loosened monetary policy in recent years even after the limits of conventional monetary policy have been reached.

But this has been no ordinary recession. It has also been associated with an acute financial crisis and history has shown that recessions associated with financial crises can have an even longer lasting impact on economic performance. During financial crises, credit constraints can tighten drastically for banks and for firms and households which in turn harms physical capital and labour productivity growth.

Financing constraints may lead to increased firm defaults. This may not be detrimental to long-term growth if it has a "cleansing effect", if non performing firms and equipment disappear and free resources for innovative young firms[3]. However, it may also hit young, innovative and risky firms, which are more fragile and financially dependent[4]. According to Foster, Grim and Haltiwanger[5], reallocation in the United States during the Great recession

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1 R. Jackman and R. Layard, 1991. "Does Long-term Unemployment Reduce a Person's Chance of a Job? A Time-Series Test," Economica, London School of Economics and Political Science, vol. 58(229), pages 93–106, February.

2 A. Maravalle, M.-E. de la Serve. and G. Verdugo, 2014. "The euro area Beveridge curve in the post-crisis period: increase in structural unemployment since 2010," Quarterly selection of articles – Bulletin de la Banque de France, Banque de France, issue 36, pages 95–109, winter.

3 R. J. Caballero and M. L. Hammour, 1996. "On the Timing and Efficiency of Creative Destruction," The Quarterly Journal of Economics, Oxford University Press, vol. 111(3), pages 805–852.

4 M. Ouyang, 2009. "The scarring effect of recessions," Journal of Monetary Economics, Elsevier, vol. 56(2), pages 184–199, March.

5 L. Foster, C. Grim and J. Haltiwanger, 2016. "Reallocation in the Great Recession: Cleansing or Not?," Journal of Labor Economics, University of Chicago Press, vol. 34(S1), pages S293–S331.

was less intense and productivity-enhancing than in normal times, contrary to previous recessions. Similar decrease in reallocation was found in the United Kingdom by the Bank of England[6].

Financing constraints also hit more particularly R&D financing: according to a Banque de France study[7], R&D investment share becomes procyclical when credit constraints bites and does not increase proportionally in upturns. As the Great Recession was global, years of R&D efforts lost cannot be recovered by the purchase of technology from abroad, as all countries have been hit. In the medium term, this will weigh on productivity growth, which is partly fed by technical innovation.

Financing constraints may contribute to a depressed investment, especially in industries with heavier reliance on external finance or lower asset tangibility[8], which can slowdown capital stock and hence potential growth, but also lead to its aging and weigh on its productivity through the use of older equipment vintages. As we can see on this graph from a Banque de France study[9], both the great Depression and the great Recession led to a significant ageing of the equipment stock.

The Governing Council of the ECB has been particularly conscious of the acute strains in the financial system over recent years and the impairment of the credit channel. In particular, it has been concerned that bank deleveraging could reduce the supply of credit and undermine the supportive effects of lower interest rates on firms' balance sheets. This could have been a significant "headwind" for monetary policy and has reinforced the case for decisive action.

To counteract this impairment of the credit channel, the Governing Council has, alongside other non-conventional measures which don't need repeating, also launched two targeted lending programmes. These so-called TLTROs I and II allow banks to borrow up to a fixed fraction of their loan portfolio at an interest rate linked to the ECB official rates. Banks that make new loans in excess of their benchmarks receive a lower average cost of funding. This provides a powerful incentive to expand lending and goes some way towards alleviating funding risks when nominal interest rates are negative.

In a further step to alleviate the credit channel, the Governing Council decided to include corporate bonds in its asset purchase programme in March 2016. This should directly reduce the cost of corporate borrowing in capital markets.

Overall, these measures have been quite effective in easing credit conditions in the Euro-area. The volume of bank lending to non-financial corporations has begun to grow again and bank lending rates have fallen across the Euro-area but most noticeably in those countries where that had tightened the most.

2. Monetary policy can foster long-term growth by supporting structural reforms

The financial crisis in some ways revealed some structural weaknesses in many economies. In some cases there were excessive levels of public debt.[10] In others it were structural

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6 R. Riley, C. Rosazza-Bondibene and G. Young, 2015. "The UK productivity puzzle 2008–13: evidence from British businesses," Bank of England working papers 531, Bank of England.

7 P. Aghion, P. Askenazy, N. Berman, G. Cette and L. Eymard, 2012. "Credit Constraints And The Cyclicality Of R&D Investment: Evidence From France," Journal of the European Economic Association, European Economic Association, vol. 10(5), pages 1001–1024, October.

8 P. Aghion, D. Hémous and E. Kharroubi, 2014. "Cyclical fiscal policy, credit constraints, and industry growth," Journal of Monetary Economics, Elsevier, vol. 62(C), pages 41–58.

9 A. Bergeaud and G. Cette and R. Lecat, 2016. "The role of production factor quality and technology diffusion in 20th century productivity growth," Working papers 588, Banque de France.

10 C. Reinhart and K.S. Rogoff. 2010. "Growth in a Time of Debt." American Economic Review, 100(2): 573–78; Lane, Philip R. 2012. "The European Sovereign Debt Crisis." Journal of Economic Perspectives, 26(3): 49–68.

impediments to the flow of resources, in particular in the labour market and in the way credit was allocated between sectors, hence revealing that a malfunctioning of the financial sector can reinforce structural weaknesses.[11] In some cases both were present at the same time.

Of the uttermost importance were the structural changes targeting an improvement in the monitoring and the resilience of our financial system. Arguably the financial crisis partly resulted from excess risk taking and overinvestment in low productivity sectors.[12] The Basel 3 framework worldwide and the Single Supervisory Mechanism in the euro-zone provide new supervisory and prudential tools to mitigate these risks in the future.

That said, many countries within the zone also have had to make sharp fiscal adjustments and implement significant structural reforms.

Unfortunately, many of these structural reforms may have a transitory deflationary impact. This is the case of product market reforms, which directly target lower prices, but also of reforms fostering supply if demand is depressed. Enhanced competition in telecom led to an impressive decrease in prices: in France, the entrance of a fourth mobile phone operator led to a decrease in mobile costs by a quarter and a negative impact on the average CPI of 0.3 point in 2012. There have been similar disinflationary effects in many of the so-called stressed jurisdictions of the euro-zone.

However, at the current juncture, structural reforms are badly needed due to the productivity slowdown and larger product and labour market reforms should be envisaged in highly regulated countries.[13] In that case, it is crucial for the central bank to anchor inflation expectations, through a clear commitment to its inflation objective. The Governing Council has been clear that it is willing to do everything within its mandate to deliver on this objective which is headline inflation close to, but below, 2% over the medium term.

Structural reforms can also have a short-term negative impact on employment and growth, especially in a depressed environment[14]. In that respect, monetary policy can provide an offsetting support to growth, along with fiscal policy.

The various packages of monetary accommodation implemented by the Governing Council since mid-2014 have already had considerable success in supporting nominal growth. Even though headline inflation is currently negative, it would have been significantly weaker (around 80 basis points in 2016 according to the Euro-system's estimates) without these interventions. Real economic growth is slightly stronger and unemployment lower.

However, it is important to stress that monetary policy is a companion to structural reforms rather than a substitute. Stimulatory monetary policy cannot be an excuse to postpone structural reforms.

Indeed it sometimes feels as if central banks had sole responsibility for supporting growth in the short-run. This is not a comfortable position for us and should not be an acceptable position for any of you. Our monetary policy accommodation has made the cost of investment considerably cheaper but its effectiveness is blunted somewhat if entrepreneurs feel constrained by structural impediments and a lack of economic reform. The OECD has

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[11] S.Gilchrist and B.Mojon, Forthcomning "Credit Risk in the Euro Area." The Economic Journal.

[12] V. V. Acharya and S.Sascha, 2015. "The 'Greatest' Carry Trade Ever? Understanding Eurozone Bank Risks." Journal of Financial Economics, 115 (2): 215–236.

[13] C. Teulings and R.Baldwin, 2014. "Secular Stagnation: Facts, Causes, and Cures" VoxEU.org eBook, CEPR Press.

[14] M. Cacciatore, R. Duval, G. Fiori and F. Ghironi, 2016. "Market Reforms in the Time of Imbalance," NBER Working Papers 22128, National Bureau of Economic Research, Inc.; in 't Veld, Jan. 2013. "Fiscal consolidations and spillovers in the Euro area periphery and core." Economic Papers 506, European Commission.

been urging a faster pace of structural reforms for many years now and I wish more governments would listen.

But monetary policy and domestic structural reforms should not be the only game in town. We need a better overall policy mix. Against a background of accommodative monetary policy and faster economic reform, we need looser and better targeted fiscal policy at a European level. For example, more could be done to increase investment in public infrastructure, education and apprenticeship in Southern Europe. Fiscal expenditure could be shifted towards retraining programmes or other measures to help shift resources between sectors.

One way of thinking about our current predicament is that the natural short-term real rate of interest is too low, due to insufficient *ex ante* investment relative to savings. The ECB has been providing substantial monetary accommodation using unconventional tools to try to push down the effective nominal rate. A better way in the long-term would be to raise the natural real rate of interest through stronger economic growth and investment.

Conclusion

As for many other economic policies and concepts, the Great Recession led us to reconsider the role of central banks with regard to medium and long-term growth. Beyond their normal-time contribution to long-term growth as price stability guardians, central banks in deep depression have to act against the hysteresis effects of the crisis and the damages from financial sector disruptions. All indicators, from the matching process on the labour market to the reallocation of resources among firms, have shown how serious the shocks from the great recession have been, vindicating a large-scale and determined reaction of economic policy across the world.

In this global economic policy reaction, it would be hard to argue that central banks have not done their share of the job.

At the current juncture, however, all need to do their share. Focusing on the euro area, I am convinced that we would do much better with more growth-enhancing fiscal policies, especially in the member states that have fiscal space, and, at the same time, more ambitious structural reforms, especially in the member states that don't have fiscal space.

Indeed, this is probably the most subtle criticism of the active monetary policy currently undertaken by central banks: has it been an excuse for inaction by other public authorities, in particular structural reforms? Our answer cannot be to stop doing our own job but, drawing on the legitimacy given by our own actions, to strongly invite governments to do more. In particular in my own country, here in Paris, reforms are necessary, as I stressed in my recent Letter to the French President some days ago. But reforms are also possible. Yes, France too, like many of its successful European neighbours, is "reformable".

I thank you for your attention and wish you an excellent dinner.