Mario Draghi: On the importance of policy alignment to fulfil our economic potential

Text of the 5th Annual Tommaso Padoa-Schioppa Lecture by Mr Mario Draghi, President of the European Central Bank, at the Brussels Economic Forum 2016, Brussels, 9 June 2016.

* * *

The Footnotes can be found at the end of the text.

In a speech in Vienna last week, I explained why monetary policy could deliver the appropriate level of stimulus to the economy, even in a setting where interest rates are close to their effective lower bound.[1] As inflation is ultimately a monetary phenomenon, a committed central bank can always fulfil its mandate. And that is true independently of the stance of other macroeconomic policies.

But monetary policy does not exist in a vacuum. The situation of central banks is better described as *independence in interdependence*, since other policies matter a great deal. They can buttress or dilute the effects of our policy. They can slow down or speed up the return to stability. And they can determine whether stability is accompanied by prosperity, which is directly relevant to the social cohesion of the euro area.

It is these interactions, and why they matter, that I would like to talk about today.

Policy interactions in stabilising the economy

The objective of the ECB is defined as delivering a rate of inflation below but close to 2% over the medium term. But the medium term is not a fixed period of time. When faced with adverse shocks, the pace at which monetary policy can bring inflation back to the objective depends on two factors: the nature of the shock itself, and the conditions in which monetary policy operates.

Some types of disturbance will inevitably depress inflation for longer than others and make the return to the objective slower. The recent succession of global oil supply shocks is a prime example. In that context, the job of monetary policy is not to fight short-term shocks to prices, but to prevent them from feeding into longer-term inflation dynamics – or put another way, it is to make sure that the effect of shocks on inflation is no more persistent than it needs to be. So when we talk about returning inflation to our objective *without undue delay,* this is what we mean. The return to price stability should take no longer than implied by the nature of the shocks we are facing.

But this is not entirely dependent on our actions, due to the second factor – the conditions in which we operate. Monetary policy can act decisively to support demand, to stabilise inflation expectations and to avert second round effects on wages and prices, which is exactly what the ECB has done over the past two years.[2] But the orientation of other policies also influences the speed with which output returns to potential. So if other policies are not aligned with monetary policy, inflation risks returning to our objective at a slower pace.

There are a number of policy areas that matter in this regard.

First, for monetary policy to stoke demand and inflation, it matters crucially whether the financial system is able to relay our policy impulses efficiently to the economy. In the euro area that transmission mechanism has been impeded repeatedly in the past, initially by rising risk premia linked to unwarranted fears about the survival of the euro area, and later by widespread bank deleveraging.[3] That has diluted the effectiveness of our stimulus and lengthened the "long and variable" lags over which monetary policy works.

We have compensated for this by designing our measures to remove transmission blockages, as well as including an asset quality review in the comprehensive assessment of bank balance

sheets that we launched in 2013. Both measures have helped ease financing conditions, as we can see in our bank lending surveys. But bank balance sheets have not yet been fully repaired, as illustrated by the high stock of non-performing loans in some parts of the euro area. So more work-out of these non-performing assets will have to take place, and the conditions for that will have to be put in place by the right policies and authorities.

Second, it matters for monetary policy whether fiscal policy is steering aggregate demand in the same direction, and how strongly. Fiscal policy was contractionary for several years in the euro area following the loss of confidence in sovereign credit in 2010, and the negative effect on growth was exacerbated by the fact that consolidation in some countries was implemented mainly through tax rises rather than current spending cuts.[4]

This placed the full burden of macroeconomic stabilisation on monetary policy. And in a context of disrupted transmission, that has led to a slower return of output to potential than if fiscal policy had been more supportive.

This is why the ECB has said many times that fiscal policy should work with not against monetary policy, and the aggregate fiscal stance in the euro area is now slightly expansionary. But supporting demand is not just a question of the budget *balance*, but also of its *composition*, especially the tax burden and the share of public investment. So we should not see fiscal policy as solely a macroeconomic tool, which is only available to countries with strong public finances. We should also see it as a microeconomic policy tool that can enhance growth even when public finances need to be consolidated.

Third, it matters for monetary policy whether the right structural policies are in place. Structural reforms can help limit the depth and duration of shocks, which in turn supports the anchoring of inflation expectations and keeps real interest rates low.[5] Such reforms can also reduce the transmission lag of our measures, since a more flexible, more responsive economy is likely to transmit monetary policy impulses faster.[6] And they produce higher potential growth, which leads to higher investment and hence a higher equilibrium real rate. That creates the conditions for the central bank to return to conventional interest rate policy as the means to deliver price stability.

In the euro area, many structural reforms have been implemented in recent years, and especially in those countries worst-hit by the crisis. The benefits can now be seen. But there are many more benefits still to aim for, and so much more needs to be done.

Finally, uncertainty over the institutional stability of the euro area also matters for monetary policy, since it too can slow down the transmission of monetary policy. Firms that lack sufficient visibility over their operating environment over the years to come may understandably choose to deter or even abandon investment plans. That is especially so when the return on those investments depends strongly on the size and openness of the market provided by the euro area and the European Union. This has been clear in the past when the future of the euro area has been called into question.

And that sort of uncertainty not only impacts on firms that borrow to finance real investment. It can also affect the saving rate of firms and households, as the perception of higher risk can call for higher precautionary savings. This would obviously run against the efforts of monetary policy to stimulate higher investment and consumption.

So I will only note once more the critical need to restore clarity and confidence on the institutional setup of the euro area. We know that the current setup is incomplete. There is a large degree of agreement on what its shortcomings are, and many proposals have been put forward on how to overcome them. Progress in this field is necessary for the long-term, but it is also relevant for the short-term because of its effect on investment. Indeed, perhaps the best way to raise output today is to remove the drag on confidence that results from such uncertainties.

Summing up, there is a large degree of interaction between monetary policy and other policies that may in principle be geared towards different objectives. Such interactions do not prevent

a determined central bank from achieving its objective. But they do affect the *time frame* over which we can do so. What this implies is that, for stabilisation to occur no more slowly than is strictly necessary, all policy areas have a role to play.

And in fact, all policymakers should have a strong motivation to do so, because time matters. A too-slow return of output to potential is far from innocuous. On the contrary, it has lasting economic consequences, since it can ultimately lead to potential being eroded as well.

It is well-documented for instance that workers who remain unemployed for too long may suffer the effects throughout their life, in the form of reduced employability, reduced productivity and reduced income – so-called hysteresis.[7] That is particularly true for younger workers who are unemployed during the all-important formative years of their careers and may suffer from labour market "scarring".[8] In the euro area structural unemployment is estimated to have risen during the crisis, while youth employment remains high.[9]

There is also emerging evidence that growing below potential for too long can erode that potential through its effect on productivity growth. When uncertainty is high, a "wait-and-see" attitude can cause the most productive firms not to expand as much as they would otherwise, and the least productive firms not to contract as much as they should.[10] In other words – and contrary to what is often claimed – too-weak demand can slow down "creative destruction", whereas stronger demand can accelerate it. And there are signs of such effects in the euro area, too.[11]

The cost of delay, then, is that labour and productivity suffer, and the output gap closes in the "wrong way" – instead of output rising towards potential, it is potential that falls towards current output.

So it is in fact in everybody's interest to act without undue delay. For the ECB, this means that we do not let inflation undershoot our objective for longer than is avoidable given the nature of the shocks we face. For others, it means devoting every effort to ensuring that output is returned to potential before subpar growth causes lasting damage. And given the harm that has already occurred to potential growth during the crisis, it also means acting decisively to *raise* potential.

While keeping output close to potential is about the right policy mix, raising potential is above all about structural reforms. This ultimately comes down to two factors – employment and productivity. And in both areas there is considerable scope for the euro area to raise output with determined reform efforts.

Raising potential growth

In terms of employment, we know that the euro area faces a long-term drag from its unfavourable demographics. But even accounting for that, I see substantial leeway to lift output in the euro area by exploiting the other margins which determine employment: first, by reducing the trend unemployment rate, which remains too high in many countries; and second, by raising participation rates, which are still short of international norms in several jurisdictions.

Reducing trend unemployment is in part about reversing the hysteresis effects I described above. But it is important to remember that the crisis only added to an already troubling picture: structural unemployment in the euro area was estimated at around 9% even going into the crisis, compared with just 5% in the US. This is a consequence of structural features of euro area labour markets which have been "ratcheting up" unemployment over successive cycles.[12] And it implies that there is a large, latent potential in the euro area labour force which can be unleashed with appropriate labour market and activation policies – and more so than in other advanced economies.

Experience during the crisis has demonstrated how such reforms can work. Reforms implemented by Portugal under its adjustment programme are estimated to have reduced the unemployment rate by around 3 percentage points over the 2011–2014 period.[13] Likewise, the

Spanish labour market reform in 2012 has been a factor supporting employment growth since then.[14] This should give encouragement to reforming countries to continue their efforts – and in particular those where high unemployment has persisted for so long that it has been allowed to become a social norm.

But the challenge is not just moving people from unemployment into employment, it is also raising the size of the workforce – which is where participation comes in. Though the euro area fares quite well in international comparisons, participation rates in some Member States remain relatively low, with a roughly 15 percentage point difference between the best and worst performers. This implies that there is also a latent potential to raise employment on this margin with the right structural policies. For example, we have seen participation rates of older workers grow strongly during the crisis, due in part to pension reforms adopted in many euro area countries.[15]

Still, despite this untapped reserve for accelerating employment growth, we cannot avoid the fact that, over time, the inherent speed limits resulting from the euro area's unfavourable demographics will start to bite. The euro area's working age population is projected to start gradually decreasing in the next decade. In that context, employment growth is likely to start decelerating in the not-too-distant future, even with determined structural reforms, as a higher share of people in work will no longer be able to offset the fall in working age population. Even higher expected migration is unlikely to be able to fully offset this natural population decline.[16]

Public policy can certainly help temper these effects through its role in receiving and integrating migrants. But since policy cannot do much to alter long run demographic trends, the implication is that raising long-term growth will require a complement – namely, raising productivity.

Raising productivity is difficult. It requires a broader set of reforms, and those reforms typically encounter greater resistance from vested interests. That is why many countries have found it easier to reform the labour market than other areas during the crisis, and indeed repeated attempts since the turn of century to make the Europe "the most competitive and dynamic knowledge-based economy in the world" have produced only meagre results.[17] Given the weak outlook for euro area growth, however, tackling the productivity challenge can no longer be delayed.

Broadly speaking, productivity growth comes through two channels. The first is *within-firm* growth, which depends on the generation and diffusion of new innovations and management techniques. The second is *across-firm* growth, which depends on the movement of resources from the least to the most productive firms. The euro area's comparatively weak performance derives from both.

Indicators on research and development suggest that the euro area is lagging behind in terms of innovative capacity, and particularly in the services sector. Indeed, the diffusion of information and communication technology appears to have contributed much less to services productivity growth than in the US, and this accounts for much of the weaker productivity performance of the euro area since the mid-1990s.[18]

At the same time, employment in euro area is undergoing a secular shift from manufacturing to services, and this has only been exacerbated by the patterns of job creation since the crisis.[19] Such shifts are of course taking place in all advanced economies. But since productivity growth in the services sector is often lower in the euro area, it constrains our *aggregate* productivity more.

Yet this picture is not necessarily a cause for pessimism.

For a start, it suggests that there is quite some scope for productivity catch-up through adopting digital technologies. So the debate that is currently raging among US economists about whether the great waves of technological innovation are now over is, for the time being, less relevant.[20] For the euro area the key question is how to create the conditions for more firms to move towards the productivity frontier.

What is more, the secular shift from manufacturing to services can be consistent with higher productivity if resources are well allocated. In fact, there are very large differences between the most and least productive firms *within* each sector, even more so than across sectors.[21] This implies that, even in a services-oriented economy, aggregate productivity can still be improved.

So the euro area faces a twin policy challenge: to get more firms in each sector to the productivity frontier, and to get more labour and capital to those productive firms. And crucially, this would not only boost output, but also employment and wage equality, since labour would be concentrating in firms that are both growing and demanding higher value skills.

To achieve this there are, in my view, three policy priorities.

First is addressing the structural barriers to knowledge diffusion within Europe. This has many facets, but critical are policies that increase trade openness and facilitate firms' participation in value chains, as well as a competitive business environment that favours the adoption of superior managerial practices and organisational structures.[22] The most powerful "quick win" we could make here would be to complete the single market, especially in services, since that would automatically accelerate diffusion from the European frontier where we already have many world leading industries.[23]

For firms to integrate effectively into the single market, however, they need to be able to scale, which is why the second priority is to create the conditions for the most productive firms to expand quickly and attract resources. This depends on well-functioning product and labour markets, a financial system that channels capital to dynamic firms, and policies that prevent resources from becoming trapped in unproductive firms, such as efficient judicial systems and bankruptcy laws. Change of that nature creates opportunities, but it can also be perceived as threatening for individual workers. So adequate social safety nets have to be in place, too.

That is also why the third priority is improving human capital. This would benefit workers who would gain higher pay due to better-matched skills. And it would benefit productive firms by reducing the skill mismatch that constrains their growth.[24] Making progress in this area comes down primarily to education, but labour market reforms, such as lifelong learning schemes and removing labour market dualities, could also make an important contribution – for instance, by providing greater opportunities for both younger and mature workers to gain experience and access training, both of which help raise their individual productivity.

Ultimately, investing in human capital is the key ingredient in making growth both stronger and more inclusive. And over time such investment would help the euro area not just to converge to the productivity frontier, but also to shift it out.

Each country of course has its own challenges. But few euro area countries are displaying high productivity growth, so there is little doubt that progress could be made almost everywhere. That is one reason why the recent Five Presidents' Report called for a new convergence process among euro area countries, which would move all countries towards best practices on structural reforms.[25] What is now crucial is that we move towards a common consensus on *what* the necessary reforms are, *how* countries should implement them, and then, that the process starts.

Conclusion

There are many understandable political reasons to delay structural reform, but there are few good economic ones. The cost of delay is simply too high.

Given the interactions between policies that I have described, it is in everyone's interest that the various strands of policy buttress each other – if only because that would shorten the time it takes for each to produce its effects. And that would mean that we can bring growth back to potential before potential itself becomes damaged.

Of all the ways to accelerate the realisation of our economic potential, perhaps the simplest is to remove the uncertainties that hamper long-term decisions and hold back investment. And speaking here in Brussels, I can only underline in this context the costs of postponing the reform of EU and euro area governance that all agree is necessary, and by the same token, the boost to prosperity and stability that would result from removing those uncertainties, without undue delay.

[1] Draghi, M. (2016), "Delivering a symmetric mandate with asymmetric tools: monetary policy in a context of low interest rates", speech at the ceremony to mark the 200th anniversary of the Oesterreichische Nationalbank, Vienna, 2 June 2016.

[2] For a fuller explanation of this point see Praet, P. (2016), "The ECB's fight against low inflation: reasons and consequences", speech by at LUISS School of European Political Economy, Rome, 4 April 2016.

[3] For evidence on disruptions in monetary transmission see Ciccarelli, M., Maddaloni, A., and Peydró, J.-L. (2013), "Heterogeneous transmission mechanism: monetary policy and financial fragility in the Eurozone", Economic Policy vol. 28, issue 75, July 2013.

[4] For evidence on the impact of the composition of fiscal adjustment on output see Alesina, A., Favero, C., and Giavazzi, F. (2014), "The output effect of fiscal consolidation plans", Journal of International Economics, forthcoming.

[5] For an elaboration of this argument see Cœuré, B. (2014), "Structural reforms: learning the right lessons from the crisis", speech at the Bank of Latvia Economic Conference 2014, Riga, 17 October 2014.

[6] For more on this point see Draghi, M. (2015), "Structural reforms, inflation, and monetary policy", introductory speech at the ECB Forum on Central Banking, 22 May 2015.

[7] For more on this phenomenon see Ball, L. (2009), "Hysteresis in unemployment: old and new evidence", NBER working paper 14818, March 2009.

[8] See for example Arulampalam, W., Gregg, P., and Gregory M. (2001), "Unemployment scarring", The Economic Journal, vol. 111, November 2001.

[9] The European Commission estimates euro area structural unemployment to be 9.7% in 2016.

[10] See for example Riley, R., Rosazza-Bondibene, C. and Young, G. (2015), "The UK productivity puzzle 2008–13: evidence from British businesses", Bank of England Staff Working Paper 531. See also Bloom, N., Floetotto, M., Jaimovich, N., Saporta-Eksten I., and Terry, S.J. (2014) "Really Uncertain Business Cycles", Stanford University mimeo.

[11] Gamberoni E., Giordano, C., and Lopez-Garcia, P. (2016), "Capital and labour (mis)allocation in the euro area: some stylised facts and possible determinants", mimeo, ECB.

[12] See Anderton, B. et al (2015), "Comparisons and contrasts of the impact of the crisis on euro area labour markets", ECB Occasional Paper Series, No. 159, February 2015. This phenomenon had already been noted in Blanchard, Olivier, and Justin Wolfers (1999), "The role of shocks and institutions in the rise of European unemployment: the aggregate evidence", NBER Working Paper 7282.

[13] Vansteenkiste, I. (2016), "Did the Crisis permanently Scar the Portuguese Labour Market?: Evidence from a Markov-Switching Beveridge Curve Analysis", forthcoming.

[14] OECD (2013), "The 2012 Labour Market Reform in Spain: A Preliminary Assessment".

[15] See Anderton, B. et al (2015), ibid.

[16] European Commission (2015), The 2015 Ageing Report.

[17] Lisbon European Council, 23–24 March 2000, Presidency Conclusions.

[18] Bloom, Sadun, and Van Reenen (2012), "Americans do IT better", American Economic Review, 102,1.

[19] ECB (2015), "What is behind the recent rebound in euro area employment?", Economic Bulletin, Issue 8/2015.

[20] See for example Gordon, R.J. (2016), "The Rise and Fall of American Growth: The U.S. Standard of Living since the Civil War", Princeton U.P.

[21] Syverson, C., (2011), "What Determines Productivity?", Journal of Economic Literature, 49(2): 326–65.

[22] OECD (2015), The Future of Productivity.

[23] Cœuré, B. (2014), ibid.

[24] Anderton, B. et al (2015), ibid.

[25] Juncker, J.-C. et al, "Completing Europe's Economic and Monetary Union", June 2015.