Yves Mersch: Reviving growth in the euro area

Speech by Mr Yves Mersch, Member of the Executive Board of the European Central Bank, at the Institute of International European Affairs, Dublin, 7 February 2014.

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Ladies and gentlemen,

Thank you very much for inviting me to speak to you today. It is a pleasure to be here in Ireland at this time when the country has newly exited its adjustment programme and restored its economic autonomy. While the challenges are not over, the Irish people have set an example to the rest of the euro area about how to face a period of economic difficulty – that is, to face it head on, to take the necessary measures, and in doing so to bounce back as quickly as possible.

The good news is that recovery also appears to be taking hold in the rest of the euro area. The latest data suggest that economic growth has continued to pick up, with activity being supported not only by net exports, but also by internal consumption. Nevertheless, the recovery remains relatively weak and uneven, and there is a long way to go to bring down the very high levels of unemployment. This raises the question of how we can revive sustainable growth across the euro area.

In my view, there are limits to how much we can expect from demand stimulus. Monetary policy will remain accommodative for as long as necessary, but it cannot solve all problems; it merely buys time. Fiscal policy is necessarily constrained by high debt levels. And while the private sector undergoes a period of deleveraging, we cannot – and should not – expect to see a return to the debt-fuelled aggregate demand growth of the past.

This means that to revive growth we have to look mainly to the supply capacity of the economy – that is, its potential growth. And here the situation is not encouraging. According to the European Commission, potential growth in the euro area has fallen from 2.2% in 2000–07 to 0.9% in 2008–12. We need to do everything in our power to reverse this situation, and what I would like to discuss in my remarks today is how we can achieve this.

Why has potential growth fallen?

Let me start by briefly reviewing why potential growth has contracted during the crisis and the challenges this creates for policy makers. In doing so, I will use a broad definition of potential growth, namely the economic activity that can be sustained by means of the available production factors – capital, labour and technology – without engendering inflationary pressures *and/or* fuelling asset price boom-busts.

Starting with capital, investment has been one of the main casualties of the crisis, with total investment shrinking by more than 15% in the euro area since its peak in 2008. This is of course to some extent cyclical, as well as reflecting a necessary correction of previous over-investment in the construction sector. Yet we have also seen a strong and, thus far, persistent contraction in business investment, which may weigh on future productivity growth as such investment tends to raise the technology content of capital. A prolonged period of below-trend investment could also lead to an excess of savings over investment, and therefore a fall in the natural interest rate.

Developments in labour supply have also been weak. One positive factor has been the increase in the labour participation rate in the euro area by around 1 pp during the crisis, whereas in the U.S. participation has fallen by more than 3 pp. However, this has to be set against an increase in euro area long-term unemployment from 3% to 6%, which creates a risk of workers' skills being eroded and skill mismatches emerging. This is particularly

relevant because unemployment is concentrated among those with lower skills: around 20% of low skilled workers are unemployed, compared with only about 7% of high skilled workers.

Total factor productivity – which principally captures long-term technological progress – has fallen only marginally during the crisis, most likely reflecting the underutilised capacity in the inputs to production. However, this is no cause for comfort as TFP was on a declining trend in the euro area well before the crisis, and has recovered less quickly than in the United States.[1]

These developments create two interrelated challenges for policymakers. The first is how to prevent the fall in observed growth from feeding back into potential growth. Here the key issue is to avoid that rising long-term unemployment and structurally low investment create hysteresis effects.

The second challenge is how to raise potential growth in a durable way. In line with my broad definition of potential growth, recent research has suggested that pre-crisis estimates may have been overstated by effects linked to the financial cycle.[2] In other words, after incorporating information on the unsustainable developments in real interest rates, credit growth and property prices that characterised the 2003–08 period, potential output may have been lower than we thought. A return to the *status quo ante* may not therefore be enough to restore high levels of sustainable employment.

These challenges are interrelated because, to the extent that we can achieve an upward shift in the future growth potential, it will affect growth expectations today. This might induce firms and households to frontload consumption and investment decisions, thus helping lower the risk of hysteresis effects. And vice versa, if there is no prospect of higher growth in the future, we could fall victim to self-fulfilling negative expectations.

For this reason, I see policy action on both fronts as urgent. And there are three policy areas that I see as relevant: monetary policy; financial sector repair; and, most importantly, structural reforms.

How can we raise potential growth?

Monetary policy

We know that monetary policy can help buy time for necessary structural measures to be implemented. Going beyond that, it may seem strange to include monetary policy in a discussion of potential growth. The pre-crisis consensus was clearly that monetary policy could not affect the supply side of the economy – while it could help stabilise output around its trend, it could not affect that trend.

However, there has been some discussion recently among central bankers as to whether monetary policy can have more lasting effects. For example, if an extended period of low demand is creating hysteresis effects, a more accommodative monetary policy that boosts the economy may prevent a permanent downward shift in productivity. That is, it can for a time prevent a cyclical fall in growth from becoming structural too quickly.

The jury is still out on this discussion. It is clear that the supply capacity of the economy is determined by its structural features, and monetary policy cannot substitute for this. Nevertheless, some see that monetary policy can play a “defensive” role in a period of

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1 “Potential output, economic slack and the link to nominal developments since the start of the crisis”, ECB Monthly Bulletin, November 2013.

2 Claudio Borio, Piti Disyatat and Mikael Juselius, “Rethinking potential output: Embedding information about the financial cycle”, BIS Working Papers, February 2013.

economic weakness. In our case, by delivering our price stability mandate, while we cannot raise growth potential, we can perhaps limit or delay the degree to which it falls.

The effectiveness of monetary policy in the euro area has unfortunately been hindered during the crisis by financial fragmentation – and in the countries where low interest rates are most needed. But we are now seeing signs that monetary policy is once more gaining traction across the euro area, in particular via the bank lending channel.

On the funding side, bank funding conditions have eased considerably since mid-2012. Interbank counterparty risk has fallen, as evidenced in the sharp decline in the spread between secured and unsecured money market lending. And benchmark interest rates, notably sovereign yields, have been responding much more homogenously to our rate reductions.

On the lending side, the transmission of our interest rate decisions to bank lending rates is still uneven across euro area countries, but the dispersion has narrowed considerably. Our latest Bank Lending Survey also confirmed a stabilisation in lending conditions, with improvements highly concentrated in stressed countries.

In short, we have reason to be optimistic that our accommodative monetary policy is feeding through to the real economy and, as such, can help prevent damage to potential growth caused by a prolonged period of economic weakness. Yet it is also clear that low interest rates cannot raise growth on a structural basis. What is crucial to actually lift productivity is credit being allocated where it is most productive.

Let me therefore turn to the issue of financial sector repair.

Financial sector repair

There is considerable empirical evidence that a strong driver of aggregate productivity growth is "churn" between firms – less productive firms exiting the market and new innovative firms entering, or existing firms reallocating resources to more productive sectors.[3] The job of the financial sector is to ensure that credit allocation supports this process.

However, what seems to have happened, at least in parts of the euro area, is that banks with weak balance sheets have retarded this process. One recent study found that larger banks have reallocated credit away from riskier firms, preventing new entrants, while smaller banks have engaged in so-called ever-greening of loans, inhibiting firm exits.[4]

Weak banks also appear to have slowed down sectoral reallocation. To give just one example, despite the recent improvements in cost and price competitiveness in Greece, the sectoral allocation of credits has not substantially shifted towards export-oriented firms.[5] This suggests that banks in certain euro area countries are not facilitating sufficiently the shift towards more productive sectors.

Financial sector repair therefore has to be at the core of any policy to raise euro area growth potential. And to ensure that lending is directed towards productive activity, in my view there are two policy priorities.

The first is to strengthen bank balance sheets – that is, for losses to be properly acknowledged and for adequate recapitalisation to follow. This is why our ongoing

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[3] See for example Foster, Lucia, John Haltiwanger, and Chad Syverson (2008), "Reallocation, Firm Turnover, and Efficiency: Selection on Productivity or Profitability?" *American Economic Review*, 98(1): 394–425.

[4] Albertazzi, U. and Marchetti, D. J. (2010), "Credit crunch, flight to quality and evergreening: an analysis of bank-firm relationships after Lehman", Working paper, Banca d'Italia.

[5] *OECD Economic Surveys: Greece 2013* (November 2013).

comprehensive assessment of banks is so important. It will not only restore confidence in the sector, but also create the conditions for potential growth to recover more quickly.

The assessment has a further benefit as well: it ensures the ECB's low interest rates do not encourage banks and firms to delay restructuring. In this way, it allows us to maintain the monetary policy stance that is appropriate for the euro area, while mitigating any possible negative effects linked to misallocation of resources.

The second priority is to encourage alternative funding sources in the euro area and to develop capital market financing, so that long run productivity growth is not so dependent on the health of banks. To some extent this is happening organically: corporates in large countries are already substituting bank lending for security and equity issuance. But this option is largely not available for SMEs, making them very sensitive to banking sector stress.

This is why I have been vocal in supporting the revitalisation of the securitisation market in Europe, which has virtually dried up in recent years. I see this as an important tool to help banks manage the credit risk associated with lending to SMEs. However, for it to recover it is critical that the regulatory treatment of asset-backed securities (ABS) is based on real data and not the legacy of the US sub-prime disaster. We have a very different experience with ABS here in Europe: between mid-2007 and the first quarter of 2013 the default rate on ABS in the EU was only around 1.4%, whereas it was 17.4% in the United States.[6]

Structural reforms

While financial sector repair can help ensure that credit flows to the most productive firms, we also have to ask the question: where will those firms come from? The incentive for firms to exploit economies of scale, invest and innovate – that is, to be productive – depends critically on the business environment. We therefore need to ensure we have the economic framework conditions that encourage this.

This brings me to the key topic of structural reforms. Put simply, there is no way we can achieve higher potential growth in the euro area without them. Structural reforms are essential to raise the trend components of the inputs to production (investment and labour) and the efficiency with which they are used (total factor productivity).

Let me explain why.

First, while investment in the euro area may pick up as the uncertainty caused by the crisis recedes, to raise trend investment there needs to be fresh opportunities for firms to develop new business models and grow. For euro area economies, the main area where that can be achieved is through addressing regulatory barriers – for example, planning laws that limit retail expansion or transport regulations that hinder cross-border projects.

A recent report by a consultancy found that 45% of fixed investment in Europe was concentrated in sectors where governments have significant regulatory influence, implying that structural reforms in these areas could provide a significant boost to investment.[7] And as many investment projects benefit from returns over decades, they could be made viable with regulatory changes even in a relatively weak economy.

Second, given weak demographic trends in Europe, raising trend labour supply is only really possible through further reform measures. We know that these can work. The increase in labour participation during the crisis has been largely driven by previous reforms to increase

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[6] Standard & Poor's, "Transition Study: Less Than 1.5% Of European Structured Finance Has Defaulted Since Mid-2007", 11 June 2013. See also Moody's Investors Service, "Structured Finance Rating Transitions: 1983–2013", 7 June 2013, as well as Fitch Ratings, "The Credit Crisis Four Years On … Structured Finance Research Compendium", June 2012, and "EMEA Structured Finance Losses", August 2011.

[7] *Investing in Growth: Europe's Next Challenge*, McKinsey Global Institute, December 2012.

female participation rates, as well as reforms related to early retirement and pensions that have raised the participation of older workers.

The challenge now is to extend this activism to groups that have suffered during the crisis, in particular younger people and the low skilled. Key measures here include reducing labour market duality and shifting from passive labour market policies, such as unemployment benefits de-linked from incentives to find a job, to active ones, such as job search assistance and training.

Improving the conditions for cross-border labour mobility will also be key, especially in those countries that are ageing more rapidly. For example, the OECD projects German potential growth to decline to below 1% soon after 2020 on account of skill shortages.[8] In addition, higher immigration may imply stronger private demand dynamics, including higher demand for investment spending.

Third, total factor productivity is unlikely to reverse its downward trend without structural reforms to improve resource allocation. By fostering competition and reducing economic rents, such reforms ensure that resources – and rewards – flow to high productivity sectors, which in turn supports innovation and technological progress. A recent study found that increasing competition in tradable and non-tradable sectors in Italy could increase output by 4.0% in 5 years and 7.7% in the long run.[9]

Moreover, one explanation for the low TFP growth before the crisis was that structural barriers were slowing down the adoption and diffusion of information and communication technology (ICT), in particular in the services sector.[10] Reforms to deepen market integration between euro area countries – such as implementing the Service Directive in full – could therefore provide a boost to productivity through this channel.

These may seem like theoretical arguments. Yet Ireland is a very concrete working example. Thanks to prior structural reforms, relative prices in this country adjusted almost immediately after the 2008–09 recession, allowing the economy to quickly begin regaining its competitiveness. The unemployment rate started declining in 2012, falling from 14% in December that year to 12% a year later. By contrast, in other programme countries with less flexible economies the recovery started much later.

While we need to be cautious attributing causation, the significant decline in investment in Ireland over the last five years now appears to have ended. Capital formation in the first three quarters of 2013 declined in annual terms, but stripping out the impact from a fall in aircraft purchases there appears to be stronger underlying recovery in investment.

All this suggests that Ireland is implementing the right kind of policies to raise its growth potential in the future – and in a sustainable way that is not linked to the financial cycle. The current level of Irish government bonds spreads implies that this is a view widely shared by financial markets.

However, I trust that this good news will not give rise to complacency, as Ireland continues to face considerable challenges on several fronts. These include further repair of both public and private sector balance sheets. They include reducing the still high rates of unemployment for the long-term unemployed and the young. And they include restoring the functionality of the banking sector, so that it supports rather than hinders the domestic economy as it emerges from the crisis.

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[8] *OECD Economic Surveys: Germany 2012* (February 2012).

[9] Lusine Lusinyan and Dirk Muir, "Assessing the Macroeconomic Impact of Structural Reforms: The Case of Italy", IMF Working Paper, January 2013.

[10] Ramon Gomez-Salvador, Alberto Musso, Marc Stocker and Jarkko Turunen, "Labour Productivity Developments in the Euro Area", ECB Occasional Paper, No. 53, October 2006.

Conclusion

Let me conclude.

The challenges the euro area is facing today to raise its growth potential are not new. Since the 1990s we have known that supply conditions in the euro area needed to be reformed. This was the aim of the failed Lisbon Agenda. And indeed, it was the context for a famous quote about the apparent inconsistency between reform and re-election.

What is new today, however, is the urgency for action. We are facing the risk of a structural set back in growth. We can therefore no longer afford to delay, nor should we over-burden monetary policy. Structural reforms are a must.

For this reason, the apparent contradiction between reforms and re-election may now be moot, simply because citizens want growth, and without reforms it will not materialise. There is no country in the euro area that has delayed reforms and achieved economic outcomes with which their citizens are content.

When I think of the euro area today, I am reminded of Winston Churchill's line about "always doing the right thing… after exhausting all the alternatives". We have spent two decades exhausting all the alternatives in Europe – and so now I trust that the only path left to us is the right one.