

## **Ignazio Visco: Accounting for the long-term costs of the recession**

Remarks by Mr Ignazio Visco, Governor of the Bank of Italy, at the IEA-ISI Strategic Forum 2014, Final Roundtable “Accounting for the long-term costs of the recession”, Rome, 23 September 2014.

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1. The legacies of the Great Recession are many and multifaceted; they not only affect current cyclical developments, but may also have permanent bearings on our economies. However, today’s difficulties and opportunities, as well as tomorrow’s prospects, are the result of deep underlying forces that were already reshaping the functioning of the world economy well before the Great Recession began.

### **A. Crisis legacies for economic growth**

2. In advanced countries such as the US and the UK, GDP (imperfect an indicator as it may be, especially in the face of the increasing role of digitisation) has now overtaken its pre-crisis level: however, the growth rate remains lower than before 2008. In the euro area as a whole, current GDP still remains below its pre-crisis level, to which it might return late next year. It should also be underlined that the weak recovery is no longer confined exclusively to stressed countries of the area.

3. What is more worrying is that the crisis may have left lasting scars. The high correlation between the increase in estimated output gaps since 2007 and the fall in the (estimated) growth rates of potential output suggests that lower investment and higher unemployment (or under-employment) may have had an impact extending well beyond the current cycle.

4. This is particularly worrisome for countries with high public debts, whose sustainability requires a return to steady economic growth, and which may also suffer, as is presently the case in the euro area, from excessive disinflation. And this is why structural reforms and accommodative monetary policy are so much in demand these days.

5. That the legacies of the crisis go well beyond the short term is best epitomized by ongoing talks about risks of hysteresis (the extent to which cyclical developments affect an economy’s longer-term dynamics) and the revival (by Larry Summers) of Alvin Hansen’s 1930s hypothesis of secular stagnation. In essence, this hypothesis relates to factors that generate permanently higher savings and lower investment, in a context where monetary policy is unable to reduce the real interest rate to the required (negative) equilibrium level because of the zero lower bound.

6. A second version of the secular stagnation hypothesis, more than focussing on the demand side, contends that the most productivity-boosting innovations have already been invented. Critics of this version reply by underlining that the digital revolution has yet to deploy its effects on productivity or that the potential from frontier research fields such as robotics and genomics is powerful.

### **B. Technological progress and the labour market**

7. This brings us to the role of technology, and to the other major structural forces that were changing the world economy well before the Great Recession: globalisation and demographic trends.

8. The labour market is where we can best see the intertwining between structural changes and effects of the crisis. The latter has resulted in a dramatic increase in unemployment: although in the US and the UK the labour market has recovered, with unemployment rates back to around 6 percent, in the euro area unemployment remains only slightly below its peak levels, at 11.5 percent in July 2014. In Italy the unemployment rate has more than

doubled from 6 to over 12 percent since 2007. Youth unemployment has shot up from 20 to over 40 percent.

9. Furthermore, there is also a broader tendency in advanced countries of employment rates to decrease. Between 2007 and 2013 employment has fallen in the US from 72 to 67 percent of the working age population; in Italy from 59 to 56 percent (from 25 to 16 percent among the youth).

10. The critical point, from a policy perspective, is to what extent the rise in unemployment is structural rather than cyclical. In principle, fighting the former is more difficult than sustaining aggregate demand, as it normally implies the reallocation of labour across sectors (and countries): many displaced workers may find that their skills are no longer in demand in the aftermath of the crisis. Long-term unemployment in the euro area doubled from the pre-crisis level, to over 6 percent of the workforce. Globalisation and technological progress are eroding labour demand in Europe.

11. In the last two centuries, technological progress has generated widespread wealth and new employment opportunities. Product innovations and automation may have caused job losses in the innovative sectors in the short term, but quickly created new employment opportunities for the economy as a whole, in a virtuous sequence of cost reductions and productivity increases, income growth, increased demand for new goods and services.

12. Today, however, while recognizing the great benefits for society as a whole that technological progress generates in the longer term, a distinctive property of the innovations triggered by the digital revolution is being emphasized: the high speed with which new technologies tend to reduce the use of labour, with a major impact, both qualitative and quantitative, on employment. In other words, “technological unemployment” is placed among the various driving forces behind the currently high unemployment rates and sluggish wage and income developments.

13. New information and communication technologies are complementary to managerial and intellectual jobs but provide a substitute for more routine jobs. The ICT revolution has resulted, in the US and in other countries, in a polarisation of professions, with job increases concentrated either in the low-paying service sector or in the high-paying, highly educated job positions, at the expense of the middle-skilled jobs. Furthermore, there are expectations that automation in the future will lead to a new wave of technological revolution not only from areas such as robotics or genomics but also from artificial intelligence developments that may further challenge the demand for both lower- and higher-skilled jobs.

14. Given the country’s specialisation in traditional products, Italy has so far suffered the most from the impact of globalisation, and the ensuing surge of competition from emerging markets, rather than from technology. But Italy is of course not immune to the challenges posed by technology. A frequently cited 2013 study by Oxford University economists, Carl Frey and Michael Osborne, estimates that 47 percent of current jobs in the US would be at risk of being automated possibly in a decade or two. By applying the risks of computerisation generated by this work to data on European employment, estimates have been recently extended to European countries in a recent paper by Bruegel’s fellow Jeremy Bowles. With all the caveats that such suggestive exercise necessarily requires, Italy finds itself among the countries where a larger number of jobs would be vulnerable to computerisation: 56 percent versus 51 percent for Germany, 50 for France, 47 for the UK. We may not yet have seen the full impact of technological innovation.

### **C. Investment**

15. This consideration must be seen against the substantial slowdown in the accumulation of capital since the crisis erupted. Public and private real investment fell in Italy by over 30 and 25 percent, respectively, between 2007 and 2013, well above the already high average of 20 percent recorded for the euro area as a whole.

16. Despite the low interest rates allowed by the accommodative monetary policy, widespread uncertainty about prospective demand growth and the deleveraging by over-indebted firms have held back private investment. In stressed euro-area countries, these difficulties have been compounded by limited access to credit, because of balance sheet repair in the banking sector, and the increased cost of capital, owing to financial fragmentation. Fiscal consolidation has often implied massive cuts in public investment, which may cast a shadow on potential future output.

17. Investment is the linkage between today's demand and tomorrow's supply. Reviving investment – public and private, national and European – would thus go a long way towards addressing both cyclical weaknesses and structural challenges to future potential growth. Indeed, as it has been suggested inter alia by Barry Eichengreen, lack of investment in infrastructure, education and training is another possible source of secular stagnation.

#### **D. Concluding remarks**

18. In many respects, we are travelling through uncharted territories. Refocusing economic policies on sustaining aggregate demand, in particular stimulating investment, is a necessity. On the other hand, the forces of technological progress imply that much of capital accumulation may further save on labour inputs. Be it the legacy of the Great Recession or the outcome of more engrained trends, some of our traditional policy tools appear to be increasingly ineffective.

19. Central banking has devised new innovative ways to respond to the crisis. Much closer attention is now being paid to the responsibilities of monetary policy for financial stability and, more generally, to interactions and possible conflicts between policies that foster price and financial stability. Macro-prudential policies now feature highly on the agenda of financial authorities. With policy rates in major advanced economies virtually at the zero lower bound, unconventional monetary policies are increasingly considered.

20. Yet, the main challenge is posed by the developments in the real economy. It is here that we must exercise our ingenuity. The business environment must be made more conducive to private investment. And investment in infrastructures has to return to be high in the policy agenda. In the euro area, policies should aim at keeping the cost of capital low, developing capital market sources of finance to complement bank loans, implementing structural reforms to improve expectations of more favourable aggregate demand going forward, reducing policy uncertainty.

21. In Italy, the most urgent interventions are those which safeguard legality and efficiency in public administration. To repeat what I said last May in my concluding remarks to the Bank of Italy's meeting of shareholders: "Corruption, criminal activity and tax evasion not only undermine the community but also distort the behaviour of economic agents and market prices, reduce the effectiveness of government action, increase the tax burden on those who do their duty, and restrict productive investment and job creation. Well-functioning public administration improves the operation of markets and competition, reduces firms' costs, and is reflected in the quality and cost of public services and thus on the tax burden. The efficacy of the reforms depends on it."

22. These policy actions should not be eluded. For them to be effective, they must be seen as a part of a fully-fledged strategic reasoning on the prospective functioning of our economies. More generally, while we try to better understand the challenges posed by structural and technological change, there are questions that it is fundamental to address. Among them: How should the education system adapt to enable the teaching of those skills essential to keep up with new technologies? How can we enable displaced workers to acquire skills which will not become, or are less likely to become, redundant through computerisation? How can public policy smooth the social impact of technological progress and allow a wider distribution of its fruits?