Benoît Cœuré: Structural reforms on the way to a complete Economic and Monetary Union

Speech by Mr Benoît Cœuré, Member of the Executive Board of the European Central Bank, at the International Conference on Structural Reforms in Advanced Economies, Hertie School of Governance, Berlin, 17 June 2016.

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

Introduction

Many people would like central bankers to remain quiet about the need for structural reforms. In the end, we have a clear and narrow mandate defined as price stability[1]. And in undergraduate-level economics we learn that inflation in the long run is always and everywhere a monetary phenomenon. So why do we bother? And why should we, unelected policymakers, venture into policy debates so obviously shaped by political considerations?

I agree that central bankers should tread very cautiously in other economic policy areas. But monetary policy, and particularly so in a monetary union, does not operate in a vacuum. Although central bankers take their decisions independently, they also have to take into account what other parties are doing. As I have already said elsewhere, monetary policy is independent and interdependent.[2]

In this respect, there are at least three reasons why central bankers cannot be indifferent to structural reforms. First, the combination of low potential growth and the debt overhang inherited from the crisis threatens the European social contract, a contract that was established in the post-war era and that was fair and affordable at that time[3]. This in turn is a threat to the sustainability of our social market economy, which is the environment in which our monetary policy operates. Second, factor reallocation over time and across sectors is necessary in order to adjust to shocks and therefore key to the smooth transmission of monetary policy. And third, convergence between economies is both an economic and political prerequisite for a well-functioning monetary union.

I will argue today that for structural reforms to successfully lift potential growth in a monetary union, they have to fulfil two important criteria: (i) they need to be comprehensive and well sequenced and (ii) all-encompassing.

"Comprehensive" means that a narrow focus on labour market reforms is not sufficient. Structural reforms are also about incentivising innovation, competition and fighting rent-seeking and monopolistic structures. They entail offering new income chances – particularly for the younger generations – by reducing and redistributing rents, and by encouraging economic players to adjust.[4]

"All-encompassing" means that reforms cannot focus only on addressing inefficiencies in Member States, but have to take into account externalities and inefficiencies at the level of the Union. This implies reforms in the area of economic governance, and progress in completing the Single Market. And they will form the basis for a better functioning Economic and Monetary Union.

Why do we need structural reforms?

Potential output growth in the euro area, as in other advanced economies, has been on a steady downwards trajectory for several decades. There are however a few things that make our situation even more problematic than that of other large economies. First, the decline in trend growth has gone much further here than in, for instance, the US: the European Commission estimates potential output growth in the euro area to be about 1% this year, half of the equivalent figure for the US. In contrast, the difference in 1992 was small: euro area potential output growth was estimated at 2.6%, compared with 2.8% for the US.[5] Although this is already a serious problem in itself[6], a close examination of the composition of potential output uncovers the full extent of the problem. Total factor productivity in the US has consistently outperformed the euro area for the last 15 years and is expected to continue doing also in the coming decade[7]**.** In other words, using Paul Krugman's famous words, the euro area trend growth risks becoming a product of "perspiration rather than inspiration"[8].

There are two issues associated with this observation. First, as we know from the growth literature, input-based growth risks incurring diminishing returns. Second, in an imperfect monetary union, it raises the question of how those inputs are being allocated.

Indeed, when it comes to allocating capital, we are still making a bad job of allocating and utilising existing resources[9]. The high-risk projects with high expected returns, which we would like to see giving a boost to potential growth, are more difficult to finance than in other parts of the world. This is mainly because of Europe's bias towards bank and debt financing as opposed to equity[10], and the persistent fragmentation of our financial systems, not to mention high administrative burdens[11].

And the reallocation of labour is hampered by rigidities in national labour markets as well as obstacles to cross-border labour mobility, such as the lack of transferability of social rights, language barriers and cultural differences.

And even when our firms have sufficient access to capital, they do not seem to be innovative enough and also do not fully exploit new technologies and working methods[12].

There are also several other reasons for the secular decline in Europe's growth. Consider the demographic "handicap". Over the next 15 years, the working age population will actually shrink substantially or at best plateau out in almost all euro area countries. Worse yet, in that same period, the most innovative segment of the population[13] will contract even more. Let me give you some data on this: according to the European Commission's ageing working group[14], the population between 26 and 50 – which several studies identify as being the most innovative – will shrink by 12% in Germany, 2% in France, 11% in Italy and by a whopping 29% in Spain. Not only is the share of young people declining in the euro area, but unfortunately, despite being the best-educated generation ever, they have more trouble in entering the labour market. Youth unemployment exceeds overall unemployment in all countries and for the whole area the difference is a staggering 12 percentage points. This is already harming the economy, because the young who are willing to work but unable to find a job are prevented from developing their skills. To avoid creating a "lost generation" we need to act quickly.

The younger generation is also being dragged down by the high level of debt it is set to inherit. A combination of negative demographics, weak productivity growth, poorly functioning labour markets and a steep increase in public and private sector debt burdens means that a dwindling number of young people in our societies will have to carry an increasingly heavy financial burden[15]. This limits their ability to be entrepreneurial, to innovate and compete in international markets.

The good news is that a lot can be done to improve that gloomy outlook[16]. Today, I won't be talking much about fiscal reforms, or about policy initiatives that could improve the demographic outlook, but I will instead focus on reforms that could boost medium- to long-term growth and employment.

Comprehensive and well-sequenced reforms

When you look at a range of OECD structural indicators, it is clear that most euro area countries are well down the league table for best international practice in one or several policy areas. Measured against the OECD's top three performers, the euro area is lagging far behind in both product and labour market efficiency, with no euro area country in the top three and with the largest euro area countries often underperforming the euro area average[17].

In recent years we have seen a number of important reforms, particularly in those countries that carried out economic adjustment programmes. The main focus has been on reforms in the labour market. The nominal and real labour market rigidities that we have traditionally lived with in Europe have resulted in what is being called the "European unemployment disease": persistently high unemployment rates and a limited ability to adjust to economic shocks. You get a very telling picture if you plot the unemployment rate in the euro area and in the US over several decades – say, from the 1970s. Every time there is a downturn in economic activity, the unemployment rate goes up in both regions. However, whereas the US quickly readjusts when the economy picks up, the euro area takes much longer to do so and once the unemployment rate actually starts falling it almost never seems to return to that previous low. The end result is that euro area unemployment has risen steadily for 40 years.[18]

That said, there is solid theoretical and empirical evidence showing that greater flexibility results in much lower equilibrium unemployment rates[19]. It is therefore very welcome that labour market reforms have recently been implemented in several countries where rigidities were considered to be particularly onerous, such as Spain[20], Italy, Portugal and Greece, and here in Germany too, some years ago. France is still lagging behind and although a labour market reform is now being discussed, whether it is sufficiently ambitious to significantly lower the equilibrium unemployment rate remains to be seen.

Although increased flexibility in labour markets will produce a better outcome in the medium term, some reforms may create losers in the short term[21]. It is only natural that such reforms are opposed by those fearing short-term personal losses, even when the reforms are eventually beneficial for society as a whole. We should take such concerns seriously. There are policies, however, that can help to mitigate or compensate for the negative short-term effects.

First, labour market reforms should be sequenced carefully, in such a way that a negative short-term effect on employment is ideally felt only when the recovery is gaining momentum. This could in practice mean that employment protection is liberalised only when reforms to increase nominal wage flexibility have been carried out. This can have a quick effect on reducing unemployment even shortly after its implementation[22]. Second, active labour market policies can help to reallocate workers across sectors of the economy while an adjustment is taking place. Third, expansionary fiscal and monetary policy can also dampen the negative short-term impact of labour market reforms. The current low interest rate environment and the mildly expansionary fiscal stance on aggregate in the euro area provide a good opportunity for governments to minimise the short-run costs of labour market reforms. Finally, there are reforms in other areas of the economy that can compensate for some of short-term loss in disposable income that households might suffer in bad times[23].

Indeed, having the right sequence is a point often made: if you have to implement product and service market reforms *as well as* labour market reforms, then hold back with the latter[24]. The underlying reason is partly that the short-term negative macroeconomic effects are much greater when a liberalisation of, say, employment protection leads to a spike in unemployment than when product market reforms decrease excessive rents margins, to the immediate benefit of consumers. Another argument made is that product market reforms should be prioritised since they boost output regardless of the overall economic situation, and because they do not weigh on public finances.

Why then have we seen exactly the opposite sequence in the euro area countries that have gone through significant reform in recent years, that is, labour market reforms before product and service market reforms? It's because, unlike in the labour market, where a few changes can often produce major results, product and service market reforms are in practice made up of a huge array of small reforms. Moreover, many product and service sectors are represented by powerful lobby groups with vested interests that sometimes conflict with the interests of consumers and society as a whole. The Greek programme is one example; the authorities there faced strong resistance from pressure groups[25]. I have absolutely no doubt that one would meet similar obstacles when reforming, say, the German or French product and service markets. In fact, both these countries have been opposed to wider service sector reform at European level. And Germany is one of the countries that has realised the smallest share of potential benefits from the Services Directive according to the European Commission[26].

Strengthening the single market and governance

If we view the euro area as a single economy and not as the sum of its 19 national members, we must have a common growth strategy based on identifying our structural weaknesses. The key words must in my view be “productivity” and “employment”, which are positive-sum games – not “competitiveness”, which could end up as a zero-sum game. The Member States will not lend much support to euro area growth by merely competing for their neighbours’ market shares. We have to act together to raise productivity and employment.

Improving the functioning of the service market in the euro area is therefore important not only because of its large share of overall gross value added, 65% on average in the euro area, but also because 75% of the total labour force is employed in this sector. Even though there has been a steady shift towards more service production, we are still lagging behind other advanced economies such as the US and, to a lesser extent, Japan, which have higher production of services per capita. In particular, it is striking that service sector output per capita (in PPP terms) is 33% higher in the US than in the euro area, which is the main reason for a smaller difference in overall GDP per capita levels (26%)[27].

To a large extent this is due to old-fashioned restrictions that prevent competition in many countries in the euro area. The European Commission has estimated that an ambitious implementation of the 2006 Services Directive would have the potential to increase euro area GDP by around 2.5%. The latest estimates show that only around 0.8 percentage point of this has been realised – and this is ten years after the Directive entered into force. Also, bear in mind that these figures significantly underestimate the gains from a wider service market reform, given that some of the most important sectors – for instance health care – are completely excluded from the Directive. Another factor in services that is sometimes overlooked is that of scale. In today’s fragmented service market in Europe, there is insufficient pooling of resources to drive large-scale R&D initiatives, new distribution platforms and to increase competition between market participants.

We therefore need to take a step back and consider what can be done to complete the European Single Market for services. To give an example, the original idea of applying the so-called country of origin principle should be reconsidered. This would mean that the regulation of the exporting country is applied. The benefits from such a change are straightforward: first, it becomes easier for a service provider that no longer has to deal with the regulations of 28 countries when exporting across the Union. Second, it would incentivise countries to put in place efficient and well-functioning legislation. In addition, the Single Market for services should be expanded to additional sectors: there is, for instance, no good economic reason for excluding health care.

As I said earlier, reforms are also about improving economic governance. When the first European Semester was launched in January 2011, it marked a sea change in the economic governance of the euro area. With this new tool, Europe recognised that *ex ante* coordination of economic policies – and not only fiscal policies – at European level was necessary. Later in the same year, the Macroeconomic Imbalance Procedure (MIP) strengthened the European Semester further. For the euro area, the corrective arm of the MIP even foresees sanctions in case of non-compliance.

The European Semester and the MIP are powerful tools that no doubt have made the euro area stronger. Yet – five years later – we have to admit that the sun does not shine everywhere. The implementation record for country-specific recommendations (CSRs) was not very high from the start and has declined further recently. In 2015 only 4% of CSRs were fully implemented, down from 7% in 2014. In some countries excessive economic imbalances persist and could harm other Member States. More can be done to improve national implementation and I see a lot of merit in the IMF's proposal that CSRs should be linked to outcome-based benchmarks that are concrete, measurable, and clearly linked to the ultimate reform objective[28]. The dismal implementation record of the CSRs nevertheless suggests that a governance framework that envisages European economic policy priorities being legitimised and implemented at national level has its limits. Looking forward, we will need to engage in a process at European level, based on shared institutions, that provides both economic resilience and the appropriate legitimacy. In such a process, consensus would be needed on (i) the policy areas that are crucial to preserve the resilience of the euro area, and on (ii) designating those policy areas as shared competences with democratic legitimisation at European level. And as I have said before, getting there will require both economic and political convergence.

The success of the Single Market is one of the few uncontroversial achievements of the EU. It has shown that shared competences can be used to implement economic policies that lead to greater prosperity in each country and, at the same time, ensure greater resilience of the euro area and the EU as a whole. We should build on it if we want to make further progress.

Conclusion

It is sometimes argued that the current expansionary monetary policy discourages governments from undertaking the necessary structural reforms in the euro area. But that begs the question: why weren't these reforms carried out when interest rates were higher? We have to stop searching for reasons why structural reforms are not being addressed.

To lift potential growth and strengthen the underpinnings of our Economic and Monetary Union, we need comprehensive, well-sequenced structural reforms in national Member States, as well as at European Union level. And we need them now.

European citizens started losing trust in the European Union and its institutions when they started losing sight of their tangible benefits, that is, the impact of the integration process on their jobs and standards of living. Rapidly vanishing trust in turn prevents those steps towards European integration from being taken which are indispensable if we want to meet today's challenges. The burden of breaking this deadlock cannot be borne by the people of Europe: the burden must be borne by the EU and its institutions and by European governments. Indeed, the best way to respond is to identify a sequence of reforms for creating jobs and growth. If carefully designed, such a sequence can gradually recreate trust and lead us to where we want to be: to the point where a discussion on the future of Europe, and the degree of sovereignty which needs to be shared to secure it, is again possible.

This is not low-hanging fruit. Overcoming entrenched scepticism and resisting vested interests will always be challenging, all the more so as the reforms are comprehensive. But such an approach would hit several birds with one stone. It would provide a positive impulse for employment and growth. And it would form the basis for future institutional change which would put our Economic and Monetary Union on a solid and permanent footing.

I thank you for your attention.

[1] See last year's discussion at the "ECB Forum on Central Banking" in Sintra, Portugal. https://2015.ecbforum.eu/en/content/programme/overview/programme-overview.html.

[2] See Cœuré, B. (2016), "Time for a new Lamfalussy moment", Lamfalussy Commemorative Conference, Budapest, 1 February 2016.

[3] See Cœuré, B. (2013), "The three dimensions of the euro area crisis", Asia-Europe Economic Forum conference on "European troubles, Asian worries", Brussels, 21 January.

[4] See Blanchard, O., and F. Giavazzi (2003), "Macroeconomics effects of regulation and deregulation in goods and labor market", *The Quarterly Journal of Economics*, Vol. 118, No. 3, pp. 879–907.

[5] See European Commission (2013), “The growth impact of structural reforms”, Quarterly Report on the Euro Area, Vol. 12, No. 4. This report provides a good overview of productivity developments in Europe and in the US.

[6] See Cœuré, B. (2014a) “Structural reforms: learning the right lessons from the crisis”, speech at the Economic conference, Latvijas Banka, Riga, 17 October.

[7] According to European Commission estimates, the average annual contribution from TFP to growth in potential output was 0.6 p.p in the euro area and 0.9 p.p in the US between 2001 and 2015. The equivalent figures for capital accumulation are 0.5 and 0.8 p.p., while labour contributed by 0.2 p.p. in both cases.

[8] For a similar argument made in a different context, see: Krugman, P. (1994), “The Myth of Asia’s Miracle”, Foreign Affairs, 73:6.

[9] See Cœuré, B. (2014b), “Credit and Investment in the European Recovery”, speech at the IMF/Banka Slovenije high-level seminar on “Reinvigorating Credit Growth in Central, Eastern and Southern European Economies”, Portoroz, 26 September.

[10] See Hege et al. (2009), “Venture Capital Performance: The Disparity Between Europe and the United States”, The paper provides evidence for the existence of a gap between the value generated by US venture capital investments and European investments that is statistically significant and very large in economic terms.

[11] See ECB (2016): “Financial Integration in Europe”, https://www.ecb.europa.eu/pub/pdf/other/financialintegrationineurope201604.en.pdf.

[12] See, for instance, Pellegrino and Zingales (2014), “Diagnosing the Italian Disease”, available at http://www.haas.berkeley.edu/groups/finance/Diagnosing.pdf. The paper says that the slowdown in Italy’s labour productivity is also associated with its failure to take full advantage of the ICT revolution.

[13] See Jones, B.F (2005): “Age and Great Invention”, NBER Working Paper No. 11359.

[14] See European Commission (2015), 2015 Ageing Report.

[15] For a thorough analysis of the crisis- and demographics-based burden of young generations, see the European Commission’s 2015 Fiscal Sustainability Report: http://ec.europa.eu/economy_finance/publications/eeip/pdf/ip018_en.pdf.

[16] See for an overview ECB (2015), “Progress with structural reforms across the euro area and their possible impacts”, ECB Monthly Bulletin, February.

[17] See Koske, I., I.Wanner, R. Bitetti and O. Barbiero (2015), “The 2013 update of the OECD product market regulation indicators: policy insights for OECD and non-OECD countries”, OECD Economics Department Working Papers, No. 1200, and “Protecting jobs, enhancing flexibility: A new look at employment protection legislation”, Chapter 2 of the 2013 edition of the OECD Employment Outlook (2013)

[18] The official Eurostat aggregate for the euro area unemployment rate is unfortunately only available from 1998, but back-data can be estimated based on individual country data. A good analysis, based on a long historic sample is given in the IMF’s “Chronic Unemployment in the Euro Area: Causes and Cures”, WEO 1999:1.

[19] See IMF (2016a), “Time for a Supply-Side Boost? Macroeconomic Effects of Labor and Product Market Reforms in Advanced Economies”, World Economic Outlook, Chapter 3, April, pp. 101-142

[20] See Font, P., Izquierdo, M. and Puente, S. (2015) “Real wage responsiveness to unemployment in Spain: asymmetries along the business cycle”, IZA Journal of European Labor Studies, Springer, 4:13, June.

[21] See Cacciatore, M., R. Duval, and G. Fiori (2012), “Short-Term Gain or Pain? A DSGE Model-Based Analysis of the Short-Term Effects of Structural Reforms in Labour and Product Markets”, OECD Economics Department Working Papers No. 948, OECD Publishing. This study provides useful insights into the short-term effects on structural reforms.

[22] See Vansteenkiste, I. (2016), “Did the Crisis Permanently Scar the Portuguese Labour Market?: Evidence from a Markov-Switching Beveridge Curve Analysis”, forthcoming.

[23] See OECD (2016) “Going for growth”. Chapter 2 of the report gives a good overview of the literature on reform priorities in a difficult macro context.

[24] See IMF (2016a), op. cit.

[25] A good example of the depth and detail of the Greek reform programme is given in “The Second Economic Adjustment Programme for Greece Fourth Review – April 2014”, European Commission Occasional Papers, 192, April 2014.

[26] See Monteagudo et al.: “The economic impact of the Services Directive: A first assessment following implementation, European Commission Economic Papers 456”, June 2012.

[27] According to European Commission AMECO database. The latest observation is 2013.

[28] See IMF (2016b), "Euro Area: Staff Concluding Statement of the 2016 Article IV Mission", 16 June, and Banerji, A. et al. (2015), "Building a Better Union: Incentivizing Structural Reform in the Euro Area", IMF Working Paper, WP/15/201, September.