Mario Draghi: Structural reforms in the euro area

Introductory remarks by Mr Mario Draghi, President of the European Central Bank, at the ECB conference "Structural reforms in the euro area", Frankfurt am Main, 18 October 2017.

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It is my pleasure to welcome you all to this conference on structural reforms in the euro area.

As you know, “structural reforms” has become something of a contested term in recent years. For many, it describes a pragmatic policy agenda to raise long-term growth and accelerate adjustment to shocks, which is essential for countries in a monetary union.

But for others, the term is viewed as a “catch-all” for a wide range of policies, some of which have potentially negative short-run costs and adverse distributional effects.

In view of these discussions, it is important to assess – first – whether countries with more flexible structures and more resilient institutions do indeed recover more quickly from shocks and grow faster over the cycle.

Second, we should evaluate how the design of reforms and the overall policy mix affect the impact of structural policies, especially during a downturn.

And third, we should assess the distributional effects of reforms, and consider how we can ensure that they benefit everyone in society.

These are the themes I will focus on in my remarks this morning.

Economic structures, adjustment to shocks and long-term growth

First of all, the crisis has helped us better understand a key question for the euro area: are economies that are more flexible also more resilient to adverse shocks, and do they experience faster recoveries and higher long-term growth?

By and large, the experience of the crisis has shown the answer to be “yes”. What we have seen is that more economic flexibility and sound institutions do lead to more resilience and higher long-term growth, including when countries face a common shock.

Indeed, euro area economies that were more flexible at the start of the crisis – as measured by the World Bank Doing Business Indicator in 2009 – subsequently showed a stronger recovery. GDP per capita rebounded faster and unemployment fell more.[1]

And looking at the last 15 to 20 years – so over the full cycle – euro area countries with sound economic structures at the outset have shown much higher long-term real growth.

Confirming this relationship, countries that reformed their product and labour markets during the crisis have also seen good results afterwards – and the full effects are still materialising.

Focusing just on the labour market, a number of countries have implemented reforms in recent years which have helped to reduce unemployment – most visibly Spain and Portugal, but also Italy. [2] These reforms also seem to have made unemployment more responsive to growth.[3]

Structural policies are a main factor explaining these positive developments. But of course supportive financial and macroeconomic policies have been vital, too.

New research also finds that labour market reforms in the euro area reduce the dispersion of unemployment and GDP across member countries following a common shock, making the

single monetary policy more effective for everyone.[4]

But it is clear that, to get the best results, there has to be some broad coordination among countries. Labour market reforms can emphasise more wage adjustment or more employment adjustment, and countries will only converge in their response to shocks if they have a broadly similar mix. [5]

This underscores why the European Semester process is crucial – not only for encouraging structural reforms, but also for ensuring some degree of beneficial consistency between them.

Lessons on the composition of reforms and their interaction with macro policies

Still, even if some countries have had positive experiences with reforms during the crisis, we know that for others it has been more difficult. This brings me to my second theme about the design and implementation of reforms.

There are three key areas where lessons can be drawn: the packaging of reforms, their scope and the macro-policy mix that accompanies them.

First, the packaging of reforms is crucial for reducing their short-term adjustment costs.

Unlike what happened in the years even before the crisis, labour market reforms must be preceded – or least accompanied by – product market reforms, otherwise wage adjustments will not be fully passed on to prices. Instead, profit mark-ups will rise and the purchasing power of households will fall, thereby worsening the economic conditions of consumers and aggravating any recession.[6]

During the crisis, because of powerful vested interests, labour market reforms were not accompanied by product market reforms in some countries, and so wages fell and prices did not adjust in tandem.

The key question is then: how do we make sure that product market reforms do indeed take place? While there are no easy answers, IMF research suggests a central part of the answer may be carefully designed fiscal incentives to soften the blow for those affected. In the past, Germany, Ireland and the UK have all successfully used such incentives to bring about these reforms.[7]

The second area where we have learned lessons from the crisis is the scope of reforms.

Much of the focus in the reform debate has been on product and labour markets. But what is often forgotten is the scope for progress by reforming public administration and the business environment.

These reforms are effective at all points of the cycle, since they entail very few short-term costs. In fact, lessening the time it takes to open a business, or speeding up judicial processes, should yield immediate net gains. And institutional reforms also act as a multiplier for other reform efforts by improving the implementation and enforcement of those measures.

In light of this, many countries have successfully introduced more broad-based reforms during the crisis. But there are still large gains that could be achieved.

Published research and internal Eurosystem simulations show that improved economic structures and institutions could result in significantly higher GDP in the long run, depending on the specific reforms and approach used.[8] It has also been estimated that sound economic structures could reduce the probability of a severe recession by around 20%.[9]

The final area where we have learned about reform strategy is the overall policy mix.

The crisis has lent weight to the view that a supportive macro-policy mix leads to improved reform implementation.[10] The IMF finds that, where countries have fiscal space, temporary public spending can ease the transitional costs of some reforms. This is then paid for in the medium term when the growth benefits of those reforms kick in and fiscal positions improve.[11]

Fiscal incentives have also been shown to improve the effectiveness of reforms. The Italian "Jobs Act" in 2015, for example, has been followed by an increase of almost half a million in the number of people employed with a permanent job contract, in large part because hiring subsidies encouraged firms to take on more people under the new open-ended contract.[12]

Perhaps more controversial in recent years has been the question of the interaction between monetary policy and structural reforms. It is often said that monetary policy discourages reforms by taking the pressure off governments to act during crisis times.

But ECB research finds no convincing evidence that high interest rates lead to more reforms, if one controls for the business cycle and other factors. In fact, the opposite is more likely to be true: lower rates tend to promote reforms, since they lead to a better macroeconomic environment.[13] This is especially useful for countries without the fiscal space to support demand.

The challenge of pairing reforms with inclusiveness

But we have also learned something else from the crisis: highlighting the benefits of reforms in terms of growth is not enough to make them widely acceptable to the public. We also need to take into account the inclusiveness of economic policies.

As we all know, there is an increasing perception that growth in the past has not been sufficiently inclusive, and was not always associated with rising living standards for everyone. This has fuelled the belief that some have been "left behind" by the spread of market forces.

In this context, the case for structural reforms needs to go beyond their efficiency benefits. We need to show that reforms can contribute to both efficiency and equity.

One way this can be achieved is by focusing more on reforms with positive distributional effects.

Tackling rent-seeking in some product markets tends to benefit those at the lower end of the income scale, since such reforms lead to lower prices and increased consumption choices, and therefore improve the welfare and purchasing power of poorer people in particular.[14]

Addressing tax avoidance and evasion would also help reduce inequality. Indeed, the payoff of efforts in this area can be significant. In 2015, EU countries lost around 12% of total expected revenues in value-added tax, partly because of tax evasion and inadequate tax collection systems.[15]

Still, some reforms will always have negative distributional effects, at least in the short term.[16] But in these cases we can do more to reduce inequality by ensuring that flexibility is combined with security. Inclusive labour markets are ones with well-functioning active labour market policies that allow people to reskill, and proactive macroeconomic policies that shorten job transitions.

Before the crisis, several countries introduced labour market reforms to increase flexibility, but did little to make their labour markets more secure. This ended up disproportionately penalising young people, who had weak job protections and meagre support during unemployment.

As I said in a recent speech in Ireland, young people do not want to live on subsidies. They want to work and expand their lifetime opportunities.[17] So we should never think that simply compensating the "losers" of reforms is enough. Public policies have to be designed to help people back into work, and into jobs where they can develop and refine their skills.

Given the ongoing polarisation of skills in labour markets, this points to the crucial importance of strong education and training systems. Job polarisation is not just putting increasing pressure on workers with mid-level skills, but also complicating the possibilities for unskilled workers to find more skilled jobs, meaning that they continue to be trapped in low-paid jobs.[18]

The main answer is education and training that disseminates marketable skills more widely. Otherwise, there is a risk that, rather than being seen as an agent of jobs and opportunity, structural reforms are seen as a catalyst for a low-wage, precarious economy.

Conclusion

Let me sum up.

The crisis has confirmed that more flexible economies are more resilient, especially for countries that are part of a monetary union. Lessons about how to design and implement reforms so as to maximise their benefits and minimise their short-term costs should be put into practice.

Reforms have to take into account equity as well as efficiency. Vested interests have to be tackled and those who have lost out given proper support.

With monetary policy being accommodative, we now have a window of opportunity to take these measures. I hope the insights at this conference can move this agenda forward.

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[1] This holds true for both the countries that joined the euro area early on (by 2001) and the former communist countries that joined later. However, for a given "Doing Business" level (World Bank measure of business regulations) the latter group seem to have generally outperformed the former, possibly due to their larger catching-up potential.

[2] See Banco de España (2015), "Competitive adjustment and recovery in the Spanish economy", *Annual Report*, Box 2, pp. 39-63; Vansteenkiste, I. (2017), "Did the crisis permanently scar the Portuguese labour market? Evidence from a Markov-switching Beveridge curve analysis", *Working Paper Series*, No 2043, ECB, Frankfurt am Main, April; and Sestito, P. and Viviano, E. (2016), "Hiring incentives and/or firing cost reduction? Evaluating the impact of the 2015 policies on the Italian labour market", *Questioni di economia e finanza (Occasional Papers)*, No. 325, Banca d'Italia, March.

[3] Based on a static relationship between changes in the employment rate and percentage changes in GDP for the period between the first quarter of 1999 and the second quarter of 2015. The period of the recovery analysed is from Q2 2013 to Q2 2015. See the article entitled "What is behind the recent rebound in euro area employment?", *Economic Bulletin*, Issue 8, ECB, 2015.

[4] Calculations based on estimation results from Abbritti, M. and Weber, S. (forthcoming), "Reassessing the Role of Labor Market Institutions for the Business Cycle," *International Journal of Central Banking*.

[5] Abbritti, M. and Mueller, A. (2013), "Asymmetric Labor Market Institutions in the EMU and the Volatility of Inflation and Unemployment Differentials," *Journal of Money, Credit and Banking*, Vol. 45(6), pp. 1165-1186.

[6] See Blanchard, O. and Giavazzi, F. (2003), "The Macroeconomic Effects of Regulation and Deregulation in Goods and Labor Markets", *The Quarterly Journal of Economics*, Vol. 118, August, pp. 879-907.

[7] Banerji, A. et al. (2017), "Labor and Product Market Reforms in Advanced Economies: Fiscal Costs, Gains, and Support", *IMF Staff Discussion Note*, March.

[8] Simulations based on ECB staff research (Masuch, K., Moshammer, E. and Pierluigi, B. (2016), "Institutions, public debt and growth in Europe", *Working Paper Series*, No 1963, ECB, Frankfurt am Main, September) show

that enhancing institutions towards average practices in the EU could lift long-term real GDP per capita for some countries by between 5% and 18% (in the course of about ten years).

[9] Sondermann, D. (2016), "Towards more resilient economies: the role of well-functioning economic structures", *Working Paper Series*, No 1984, ECB, Frankfurt am Main, November.

[10] For an early example of this view, see Gordon, R. (1996), "Macroeconomic Policy in the Presence of Structural Maladjustment", *NBER Working Paper Series*, No 5739, National Bureau of Economic Research, September.

[11] Banerji, A. et al., op. cit.

[12] Between the first quarter of 2015 and the first quarter of 2017, see Eurostat's European Union Labour Force Survey. See also Sestito, P. and Viviano, E. (2016), "Hiring incentives and/or firing cost reduction? Evaluating the impact of the 2015 policies on the Italian labour market", *Questioni di economia e finanza (Occasional Papers)*, No. 325, Banca d'Italia, March.

[13] Dias Da Silva, A., Givone, A. and Sondermann, D. (2017), "When do countries implement structural reforms?", *Working Paper Series*, No 2078, ECB, Frankfurt am Main, June.

[14] For more on this mechanism, see Fajgelbaum, P. D. and Khandelwal, A. K. (2014), "Measuring the unequal gains from trade", *NBER Working Paper Series*, No 20331, National Bureau of Economic Research, July.

[15] Center for Social and Economic Research (2017), "Study and Reports on the VAT Gap in the EU-28 Member States: 2017 Final Report".

[16] The OECD finds that: "Social protection and labour market reforms are the sources of most of the trade-offs between growth and equity objectives. Reductions in the generosity of unemployment benefits and social assistance are found to leave poor households behind" (see Causa, O., Hermansen, M. and Ruiz, N. (2016), "The distributional impact of structural reforms", *Economics Department Working Papers*, No 1342, Organisation for Economic Co-operation and Development, November).

[17] Draghi, M. (2017), "Youth unemployment in the euro area", speech for the Henry Grattan Lecture Series at Trinity College, Dublin.

[18] OECD Employment Outlook 2017.