Benoît Cœuré: Interview in Risques

Interview with Mr Benoît Cœuré, Member of the Executive Board of the European Central Bank, in Risques, conducted by Messrs Jean-Hervé Lorenzi, François-Xavier Albouy, Arnaud Chneiweiss, Pierre-Charles Pradier and Philippe Trainar, on 4 February 2019 and published on 2 April 2019.

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Is it true to say that we're in a more risky world today than we were ten or fifteen years ago?

We're in a period of political and technological change. This change is accelerating, especially in the field of technology, and market participants are probably underestimating it. In certain industries, including the financial industry, rapid technological change can lead create risks as well as opportunities. Political risk is also evolving; it's moving into developed countries. I've just returned from meetings in South Africa with African central banks. My African colleagues were saying: "We Africans have always known that we had to manage economic and developmental challenges and challenges stemming from political transition. But that was in an environment where we had some stability and an overview of what was happening in Europe, the United States and China. But now the instability is coming from the United States and, to a certain extent, from Europe and China. So now we have to learn to become a pillar of stability ourselves." That line of thinking, which is new for Africa, is one we in Europe have been following since 1957: how, with our own economic and political tools, can we become self-sufficient and a pillar of stability ourselves?

Ever since Frank Knight's work in the 1920s, economists have made a distinction between risk (which is based on quantifiable probabilities) and uncertainty (which doesn't lend itself to being quantified). To take up this distinction again, you could say that we also find ourselves in a world where there is more uncertainty than risk, because the issues have become political in nature: uncertainty about the relationship between the United States and China – with all its trade, security and intellectual property consequences; uncertainty about Brexit… Market participants are at a loss to form opinions in these circumstances. In fact, everyone is! This creates non-diversifiable risk which has no market price and leads to heightened anxiety. So it's not surprising that markets are turning to the public sector, in particular central banks such as the Federal Reserve System and the ECB, for reassurance.

One of the sources of uncertainty for insurers (and others, too) is interest rates. In particular, quantitative easing, or QE, which affected the entire yield curve. Aren't interest rates gradually eluding market participants' expectations, leading them to wonder what sort of market equilibrium will exist at these rates? What constraints could affect the ECB's decision-making? Isn't this a strong driver of cycles and uncertainty?

Market participants can see the benefits of central banks managing the yield curve, because it fosters economic activity and stability. It is true that part of how interest rates are set is eluding market mechanisms. Nevertheless, we have to put this discussion into perspective. On the one hand, it's nothing new: by design, monetary policy always has an impact on interest rates. On the other hand, since the start of QE and in all market segments, including sovereign debt as well as corporate debt, the ECB has always taken care not to suppress the price formation mechanism. As an example, this is one of the reasons why the ECB does not purchase more than 33% of a sovereign issuance.

Central banks now have a strong influence on the entire yield curve, over a very long horizon. The counterpart to this is to be transparent towards the market and to provide visibility and predictability concerning how we are going to act. That's the purpose of our forward guidance, which clarifies our reaction function. Forward guidance is not an unconditional commitment about what we are going to do. That's not something we would be able to do and we wouldn't be credible, as we necessarily react to new information flows we receive. It does, however, provide clarity about how our monetary policy incorporates these information flows. If we explain this reaction function to the markets clearly enough, then they can incorporate it into the price formation mechanisms. And we feel that this has worked rather well. The markets find the way we conduct forward guidance useful.

Today, particularly in the United States, there is a debate about whether forward guidance should be abolished and replaced with completely opportunistic policy that could be fairly arbitrary.

This discussion makes sense when monetary policy normalisation is at a more advanced stage. After all, our monetary policy before the crisis did not include forward guidance and that seemed perfectly normal to everyone. Once monetary policy has completely normalised, the reference tool will once again be the interest rate and not the size or composition of the central bank's balance sheet. So it is valid to wonder whether forward guidance then still serves a purpose. But that is not the situation the ECB is in. The normalisation of our monetary policy will depend on economic indicators and, in any case, it will be a very long and gradual process. So forward guidance will be needed for a good while yet – for as long as this normalisation process takes.

For economists who have taught courses on monetary economics, this is all very surprising. Nobody would have imagined that central banks could affect long-term interest rates and that the huge pool of liquidity wouldn't stoke inflation. This assumption is being fundamentally challenged. It goes well beyond the monetary aspect.

We are in a period where theory is lagging behind reality, as has already happened in the past. In recent years, monetary economics has progressed significantly. For example, we have a substantial body of theoretical work on quantitative easing from Curdia, Woodford and others. We have also made a lot of progress in incorporating financial frictions into the models used by central banks. This began in the United States before spreading to Europe. It's also an opportunity to revive monetary schools of thought that had disappeared. Discussions about negative interest rates, for example, have provided an opportunity to revisit the work of Silvio Gesell and his theory of banknote demurrage, which had become a theoretical oddity but is becoming significant once more. The crisis was an opportunity to test the vitality of economic theory and its responsiveness, and I think this was a positive thing for this field of study.

The euro is 20 years old. What conclusions can we draw so far? What is missing that would enable Europe to be more than just a pillar of stability; that would enable it to be a pillar of growth?

The euro has provided price stability, which is a necessary condition for growth. And it has protected countries that would have been more severely affected by the financial crisis if they hadn't been part of the euro area. Contrary to widespread public opinion, purchasing power has been better protected since 1999 than it ever was before then. On average, inflation has been lower since 1999. So one of the euro's concrete objectives, to control inflation, has been achieved. But it was a mistake – or false hope – to think that the euro would, in and of itself, create long-term growth. Euro area governments would have had to take advantage of the stable environment provided by the euro to implement more investment and education policies, and reform policies focused on long-term growth. For example, in France at the time the euro was created there was a rather naive belief that the euro would automatically generate convergence between the participating economies. But that was not at all what happened; the euro actually created divergence, rather than convergence, because it lacked supporting policies, which, for the most part, were a matter for the national level.

Eventually we grew to understand that good monetary policy, while clearly necessary, isn't enough on its own. The euro area needs a much more structured economic policy, with instruments that we still don't have today, and it needs responsible fiscal policies. That's the part that still needs to be completed.

The situation in Europe is not just linked to stability or the lack of industrial policy. The countries with declining populations are not driving forces. What are the positive signs for Europe?

The ECB's diagnosis of the euro area economy is the following. The slowdown we have seen since 2018 didn't come as a surprise. 2017 saw a very strong cyclical recovery supported by dynamic global trade and strengthened, somewhat artificially, by a mistimed fiscal boost in the United States. We knew that it couldn't last. Growth is now returning to rates that are closer to potential, albeit sooner and faster than expected. In the last quarter of 2018, GDP grew by 0.3% in France, so we're a long way off from a recession. Even assuming that growth remains at similar levels in the coming quarters – which is not in line with the ECB's staff projections, which expect growth in the euro area to rise from 1.1% in 2019 to 1.6% in 2020 – that is, even if growth in France were to stabilise at around 1.2%, that would probably be fairly close to the potential growth rate in France, which corresponds to productive capacity. Potential growth is weaker than it was before the crisis, because a lot of investment and human capital has been lost. It will take time for potential growth to recover, and in the meantime the demographic slowdown continues.

A topic that is attracting increasing attention in the academic debate in the United States, and one that Europe should look at more closely, is the link between competition and productivity. Several economists, such as Thomas Philippon, are now saying that there is not enough competition and profit margins are too high in the United States, and that this has been bad for productivity gains. We need to look at this topic in Europe; and it may be that we reach different conclusions for different sectors. The link between competition and productivity isn't the same for manufacturing and services. In the services sector, opening up regulated professions increases competition and improves productivity, while for the manufacturing sector, which is already very exposed to international competition, the question is a more open one. Relatively little is known about these topics, but they have a significant bearing on the diagnosis for potential growth.

On the same subject, there is a debate in France about whether reductions in the cost of unskilled labour need to have a limit. In the very short term, this would create more jobs, of course, but isn't it just as important to lower the cost of high-skilled labour, which is a driver of economic growth?

My view as an economist is that we need to support both types of employment, but with different instruments. We need a strong services sector because there is a social demand for low productivity services, in particular human services, and because there need to be jobs for low-skilled workers. But we also need to support the manufacturing sector, because it is manufacturing that creates productivity, exports, and so on. That doesn't mean that we have to use the same instrument. Empirical studies have shown that cutting payroll taxes is more effective at the lower end of the wage scale. That doesn't mean that the manufacturing sector doesn't need any support, but it's better to target support towards research and development (R&D), as well as training, rather than lowering payroll taxes far above the minimum wage, which would push up wages instead of creating jobs.

It isn't the ECB's responsibility, but why hasn't there been enough employment and growth in the euro area? It's a question of labour, linked to cutting costs. In all advanced economies, we have recently seen that the wave that hit low-skilled labour is starting to hit routine skilled jobs. And these routine skilled jobs are not at the minimum wage.

In the 1990s, and up until China joined the World Trade Organization, there was a general acceptance that the unchecked globalisation of trade and finance – the Washington consensus – was the best way of creating prosperity. Any remaining reservations on the subject were abandoned. Economists and politicians gave it their blessing and, in developed economies, made an incorrect diagnosis that went along the following lines: it's no problem, for sure technological progress and globalisation will destroy low-skilled jobs, but we will still have an advantage, because we're going to invest in R&D and education, and the goods and services we produce will be of better quality and we will sell them to less advanced economies. But it didn't work that way, and there are two reasons for this, in my view. First, emerging economies, and China in particular, have seen much quicker improvements in quality than expected, and at the same time technological disruption has meant that technical progress hasn't just destroyed low-skilled jobs, it is also destroying medium-skilled jobs and maybe soon, as a result of artificial intelligence, start affecting high-skilled jobs. Second, we didn't manage to invest in education and R&D that would have enabled us to stay ahead. Education is an area that is particularly concerning and one of the big challenges for France, looking at the findings of the OECD and of the public think tank France Stratégie.

By 2030, one in five people will be over 65. Is it possible that, at some point in the future, there will be quantitative easing for financing of the voluntary sector? For the kinds of investment in associations which, since they provide support for elderly people and employ large numbers of people, are known to generate wellbeing, health, and so on?

I disagree, but for institutional reasons rather than economic ones. It's clear that significant demographic developments change the structure of our economies and, thus, the way in which we conduct monetary policy. For instance, the Japanese presidency of the G20 has made demographic change one of its priorities for 2019. We've had seminars, among central banks too, on its impact on relative prices, inflation and the structure of production. But the ECB doesn't have a mandate to finance adjustments in the economy. Money creation holds a certain fascination, and there is always a temptation to project public policy failings onto the ECB by asking it to remedy them. There is the same debate about adjusting to climate change, which some expect the ECB to finance. But asking the ECB to finance adjustment to climate change, to finance demographic transition, to finance infrastructure… that would mean giving a technocratic institution the power to set priorities for public spending, which is the essence of political debate. And some people, sometimes the same people, already accuse the ECB of acting politically! Politicising the central bank is the best way of weakening its actions. Our contribution is to have created a monetary environment that is conducive to such investments. The current environment, with rates at zero or close to zero, also at a very long horizon, is exceptionally favourable. The question of how this favourable environment should be put to use – by investing in climate-related matters, ageing or something else altogether – that is a political debate for parliaments.

Your experience means that you are just as familiar with the German economy as with the French economy. The recent social unrest in France has revealed a divergence between Paris and the regions that isn't seen at all in Germany, where the regions are extremely developed. Can you explain this phenomenon? In France, all regional development policies have failed.

You're right, one advantage of having European experience is that it makes it possible to stand back and look at the French situation a bit more objectively! The field of operation of the French elite is geographically very concentrated. The German elite are more dispersed: they hold positions in large corporations, in foundations, in the world of politics. They are spread quite widely in Germany. In France, most of them are based in Paris and have graduated from the same elite universities ("grandes écoles"), not to mention the lack of diversity with regard to background and gender, where Europe lags far behind the Anglo-Saxon world. So it is not surprising if the system of administration and economic support is organised in such a way as to benefit first and foremost certain large companies and significant players, which in turn holds back innovation and growth.

The European insurance market is very fragmented. The Spanish market leader, for example, is unknown in France. Why have markets remained national in the insurance sector?

The ECB has no competence in the field of insurance. In fact, it's one of the things that the Treaty forbids it to do. So it's not a sector that we follow very closely. But if we look at non-bank financial intermediation more generally, there is still a high degree of fragmentation. There has not been the institutional integration that we have seen in the banking sector. This will take time, because once you get into non-bank territory, you very quickly come up against non-financial barriers related to corporate law and different legal traditions. National laws differ, especially – but not only – with regard to bankruptcy, and there are 27 different approaches to mobilising collateral, and so on. These are all barriers to capital markets integration. We need a legal environment that allows integration, and this presupposes far-reaching changes to legal traditions.

When you joined the ECB, did you expect such an environment, including the dynamism? Quantitative easing was something that was unimaginable for our generation.

When I joined the ECB in 2012, some people said to me that it would be interesting from a technical and human point of view, because the world of central banking operates on a very high level in intellectual and human terms, but that it would be a bit boring. As you can probably imagine, it has not once been boring since 2012! The most cherished dream of central bankers is for their profession to become boring again, but we haven't got to that point yet...