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EUROSYSTEM

# The outlook for reform: cementing growth and delivering sustainable employment

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Speech by Peter Praet, Member of the Executive Board of the ECB, at the Ludwig Erhard Lecture, organised by the Lisbon Council, Brussels, 30 November 2017

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The solid and broad-based economic recovery in the euro area is continuing<sup>[1]</sup>. We have now seen 18 quarters of positive growth and the short-term economic indicators all point to a continued economic upswing with above-trend growth.

The breadth of the expansion is notable. The dispersion of growth rates across both countries and sectors is at its lowest level for two decades, reflecting a convergence of growth rates around higher levels. This is reassuring for the growth outlook because recoveries tend to be firmer and more robust when they are broad-based.

Progress in the euro area recovery has been mostly home-grown, with a virtuous cycle increasingly taking hold between rising income and spending in both the corporate and the household sector. An important driver behind the good performance of domestic demand is the very favourable financing conditions for firms and households, which are heavily contingent on our policy measures.

However, the positive developments also reflect the pay-off from years of balance sheet repair, institution-building – at both national and Union level – and structural reforms.

In the banking sector, enhanced regulation and supervision have steered the sector towards safer business models and stronger capital profiles. Euro area banks have shored up their capital positions with average Common Equity Tier 1 capital (CET1) having increased from 7% in 2007 to 14.1% at present. Banks have also disposed of non-core assets, reduced their exposure to market risk and generally refocused their activities on more traditional business models. These measures imply that banks are today in a much better position to intermediate between those who save and those who want to invest, thereby supporting the recovery. Banking sector repair has also been helped by structural reforms. A number of euro area countries have, for instance, enhanced the effectiveness of their insolvency regimes. In corporate debt restructuring, experience to date shows that an effective insolvency regime is critical to facilitate the early rescue of viable firms and the speedy exit of non-viable ones. Internal ECB analysis has confirmed that EU countries with better insolvency frameworks deleverage faster and are able to adjust their non-performing loans more rapidly than countries with weaker regimes. In turn, this has been shown to lead to easier financing conditions for companies, to stronger entrepreneurship and to higher productivity.<sup>[2]</sup>

Reforms have generally been stepped up in the euro area. The OECD's Going for Growth – which identifies and reviews progress on five key priorities in areas including labour, product markets, and tax and transfer systems as well as on financial sector reform for all OECD countries – shows an increase in the reform momentum in most euro area countries since the start of the crisis. Results from the European Commission's labour market reforms database (LABREF) show a similar trend. In addition, the Commission has assessed that at least “some progress” has been made on around two-thirds of the country-specific recommendations issued between 2011 and 2016.<sup>[3]</sup>

Even more important, an increasing number of empirical studies confirm the positive economic impact of these reforms. For instance, in Italy the introduction of a new permanent contract in 2015 led to a 5% increase in new gross hires.<sup>[4]</sup> Along similar lines, the Spanish labour market reform is found to have increased the likelihood of exiting from unemployment to employment, while the direct transition from temporary to permanent positions is also eased by the reform.<sup>[5]</sup> Meanwhile, evidence based on micro-data for Portuguese firms shows that the liberalisation of product markets has lifted the productivity of downstream industries, even in the short run. And research has shown that even smaller-scale reforms and in particular those that can reduce the fixed costs of firms, such as measures to reduce red tape, can have significant positive effects.<sup>[6]</sup>

These positive developments should not mask the long-term challenges that the euro area is still facing. Our estimate of potential growth has declined substantially over the past two decades – in part due to the decline in multifactor productivity growth. The public sector debt ratio remains elevated, while our population is ageing. Overall, structural indicators still reveal substantial gaps, both between euro area countries and relative to best performers.

This matters not just for welfare and social cohesion within individual countries. It also matters for the functioning of Monetary Union. If countries have very different economic structures, their business cycles will diverge when faced with common shocks: some will return quickly to trend growth and full employment, while others will require a longer period of recession for prices and quantities to fully adjust. By contrast, better, mutually compatible economic structures among countries support growth on a sustainable basis and produce less dispersion when recessions hit. Reforms which improve economic structures make countries more resilient and the single monetary policy more effective.

The current economic expansion offers a unique window of opportunity to make further progress in Europe's reform agenda. During good times, countries can better afford the adjustment costs of reforms and may have more fiscal space available to compensate losers (see OECD, 2012). As Christine Lagarde recently reminded us: “*the time to repair the roof is when the sun is shining*”.<sup>[7]</sup>

History, alas, suggests that this rarely happens. In good times, reforms tend to face strong opposition, which only breaks down during times of economic demise, either following a long period of economic decline or in the wake of a severe crisis.<sup>[8]</sup> Evidence of crisis-led reforms is plentiful: for instance, not just the Latin American trade reforms in the 1980s and 1990s, but also the most recent experience in the euro area goes in this direction.

So how can we do things better in future? Structural reforms are nothing new in Europe's policy debate. They have been discussed since the 1970s, when European growth and employment started to fall behind that of the United States. The substantial step-up in reform momentum during the crisis has revived this debate along three dimensions: the trade-off

between short-term costs and long-run benefits, the distributional incidence of structural reforms, and finally the scope of the reform agenda.

First, the trade-off between short-term costs and long-run benefits. The long-run benefits of reforms are largely undisputed<sup>[9]</sup>, but the potential short-term costs have increasingly been highlighted. Such undesirable effects can materialise through a number of channels. Reforms that enhance competition can displace workers and capital in the short run. In bad economic times, there is a risk that these factors of production will not be absorbed by new entrants, thereby aggravating the recession. Reforms that lower wages can depress consumer demand in the short term if not rapidly offset by employment gains and the prospect of future productivity-related income gains that would materialise in normal times.

To ensure that the expansionary effect of reforms dominates in the short run, both the sequencing of reforms and the policy mix matter. As regards sequencing, research has shown that outcomes may be better if product market reforms precede labour market reforms<sup>[10]</sup> and if product market reforms focus on reducing entry barriers in service sectors with large pent-up demand.<sup>[11]</sup> As regards the policy mix, if there is fiscal space, IMF research<sup>[12]</sup> has underscored the beneficial effects of carefully designed fiscal packages which can overcompensate for the short-run cost of reforms.

Second, the distributional effects of reforms. That growth is not necessarily distribution-neutral already drew some attention towards the end of the 1960s. The macroeconomic disruption that followed the oil crisis of the mid-1970s, however, completely overshadowed distributional issues, as research priorities shifted towards macroeconomic stabilisation and structural adjustment of inefficient economies.<sup>[13]</sup>

Recent experience and research have however shown that growth is actually more difficult to achieve without equity.<sup>[14]</sup> Moreover, highlighting the benefits of reforms in terms of macroeconomic growth is not enough to make them socially acceptable.<sup>[15]</sup> The distributional costs of reforms have triggered heated debates and in some quarters the term “structural reforms” is even perceived as “toxic”.<sup>[16]</sup>

The feeling that growth in recent years has become less inclusive is borne out by the data. Income inequality in OECD countries stands at a historical high and household disposable incomes across most euro area countries remain below pre-crisis levels, especially for the poorest members of society. Social transfers continue to play an important role in dampening the effects of inequality, although they have become less effective since the mid-1990s.<sup>[17]</sup> In such an environment, we must ensure that the distributional impacts of reforms are not ignored. One way to do this in practice is to focus on reforms that entail a double dividend: increasing equity while lifting growth. Examples include measures that facilitate the accumulation of human capital, reduce labour market dualism or abolish product market regulations that stifle competition.<sup>[18]</sup> Back in 2006, the Lisbon Council think tank<sup>[19]</sup> already flagged the importance of raising and enhancing human capital in its policy brief *“Innovation at Work: The European Human Capital Index”*. In particular with “routine-biased technological change” increasingly permeating and transforming the world of work, high-quality education and training systems are vital to ensure that workers can withstand the disruption caused by this change and benefit from it. Another way to account for the distributional impacts of reforms is – for those reforms that have unavoidable negative distributional costs – to work out “smart redistribution” packages. Smart redistribution does not necessarily take the form of a fiscal transfer. What laid-off workers most want is to have

a new job. Hence public policies could focus on helping people back into work, and into jobs where they can develop and refine their skills.

Finally, the third dimension relates to the scope of the reform agenda. Structural reforms should not be limited to product and labour market reforms. Strong institutions and a well-functioning financial sector at national and euro area level are necessary conditions to ensure that the impact of other reforms actually materialises. Our reform agenda should be sufficiently broad and tackle the binding constraints in the economy. This requires country-specific and country-tailored solutions which allow each Member State to find and exploit their comparative advantages in the Single Market.<sup>[20]</sup> But it does not mean that countries can reform independently of each other.

Indeed, to ensure convergence, countries do not necessarily need to have the same economic structures, but they do need to ensure that their economic structures foster resilience and contribute to a more homogeneous transmission of common shocks. For example, if one set of countries focuses mainly on reforms to make wages adjust more quickly in response to shocks, and another on reforms to produce adjustment through employment, the first group will recover more quickly than the second. Research<sup>[21]</sup> has shown that countries will only converge in their response to shocks if they have a broadly similar mix of labour market institutions – or to put it another way, broadly similar Phillips curves. Encouragingly, this research finds that changes in labour market institutions since the creation of the single currency have actually contributed to a more homogeneous transmission of common shocks. However, the dispersion could still be considerably reduced.<sup>[22]</sup>

From a euro area perspective, it is thus vital to ensure sufficient resilience and convergence among countries so that all can benefit from Monetary Union, but not so much as to interfere with national social choices.

So this brings me to the question: what role can European institutions play in ensuring resilience and convergence among euro area countries? While the responsibility for structural reform has so far primarily been at national level, European institutions have a strong coordinating role to play.

However, relying merely on rules and coordination to achieve mutually beneficial outcomes may not always be sufficient. In some areas, such as banking sector policy, moving from a system of rules and guidelines for national economic policymaking to a system of further sovereignty-sharing within common institutions has been highly beneficial for the Union and its Member States.

Over recent years a quantum leap forward has been taken by moving from decentralised banking supervision and resolution to the Single Supervisory Mechanism and the Single Resolution Mechanism, based on the single rulebook. These steps have created the conditions for deep and durable financial integration. It remains essential to complete the banking union in all its dimensions. To underpin confidence in a durable way in the area-wide financial system, both supervisory responsibility and the fiscal backstop need to be at European level. Just as necessary is the establishment of a European Deposit Insurance System.

Strengthening Economic and Monetary Union (EMU) will, over time, require us to make progress in all policy areas. In a monetary union, no policy area can be seen in isolation. Each interacts with and affects the others. After years of reform efforts, there is an increasing risk

that fatigue is setting in: both “reform fatigue” and “integration fatigue” may increasingly reduce the willingness to fix the flaws in the design of EMU. This reluctance may be further intensified by the current good economic times, which reduce the sense of urgency. This is why it is so important to resolutely pursue the debate on completing our Economic and Monetary Union.

To conclude, the euro area is currently in a broad-based and solid expansion. While monetary policy still plays an important role in sustaining the recovery, it is not “the only game in town”. Years of balance sheet repair, institution-building – at both national and supranational level – and structural reforms are all supporting the recovery. However, let us not yet declare victory and “*bask in the warmth of the recovery*”<sup>[23]</sup>: more needs to be done to lift growth on a sustained basis and to reduce the euro area’s vulnerability to shocks. Looking ahead, well-crafted reforms that combine growth with equity and take account of the macroeconomic backdrop will be pivotal, both at national and European level.

<sup>[1]</sup> I would like to thank Isabel Vansteenkiste for her support in the preparation of this speech.

<sup>[2]</sup> See, for instance, Davydenko, S. and J. Franks (2008), Do Bankruptcy Codes Matter? A Study of Defaults in France, Germany, and the U.K., *Journal of Finance* 63(2): 565-608.

Ferrando, A. et al. (2015), **Creditor protection, judicial enforcement and credit access**, ECB Working Paper No 1829. Lee, S.-H. et al. (2011), How do bankruptcy laws affect entrepreneurship development around the world?, *Journal of Business Venturing* 26(5).

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<sup>[3]</sup> See: European Commission: **2017 European Semester: Country-specific recommendations**.

<sup>[4]</sup> See Sestito, P. and E. Viviano (2016). **Hiring incentives and/or firing cost reduction? Evaluating the impact of the 2015 policies on the Italian labour market**, Bank of Italy Occasional Paper No 325.

<sup>[5]</sup> See García-Pérez, J. and J. Mestres Domènech (2017). **The Impact of the 2012 Spanish Labour Market Reform on Unemployment Inflows and Outflows: a Regression Discontinuity Analysis using Duration Models**. Universidad Pablo de Olavide de Sevilla, Working paper 17.02.

<sup>[6]</sup> See, for instance, Amici, M. et al. (2015). **Red tape reduction and firm entry: evidence from an Italian reform**. Banca d’Italia Occasional Paper No 285.

<sup>[7]</sup> See J. F. Kennedy: **Annual message to the Congress on the State of the Union. January 1962**

<sup>[8]</sup> See Rancière, R. and A. Tornell (2016), **Why Do Reforms Occur in Crises Times?** USC-INET Research Paper No. 16-19 and Dias Da Silva et al. (2017), **When do countries implement structural reforms?** ECB Working Paper No 2078

<sup>[9]</sup> See Berger, H. and S. Danninger (2007), **The Employment Effects of Labor and Product Market Deregulation and Their Implications for Structural Reform**, IMF Staff Papers Vol. 54, No. 3; and Nicoletti, G. and S. Scarpetta (2005), **Product Market Reforms and Employment in OECD countries**, OECD Working Papers No. 472.

<sup>[10]</sup> See Blanchard, O., and F. Giavazzi (2003), **Macroeconomic Effects of Regulation and Deregulation in Goods and Labor Markets**, *Quarterly Journal of Economics*, Vol. 118.

<sup>[11]</sup> See OECD (2016), **Economic Policy Reforms 2016, Going for Growth Interim Report**.

<sup>[12]</sup> See Banerji, A. et al. (2017), **Labour and Product Market Reforms in Advanced Economies: Fiscal Costs, Gains, and Support**. IMF Staff Discussion Note 17/03.

<sup>[13]</sup> Bourguignon, F. (2001). **The distributional effects of growth : micro vs. macro approaches**.

<sup>[14]</sup> According to OECD (2015), an increase in inequality by 1-Gini point reduces cumulative growth by 0.8 percentage point in the following five years. See OECD (2015), **In It Together: Why Less Inequality Benefits All**, OECD Publishing, Paris. Other studies have found that higher inequality reduces both the pace and the sustainability of growth. See for instance: Ostry, J. et al (2014), **Redistribution, Inequality, and growth**, IMF Staff Discussion Note 14/02.

<sup>[15]</sup> See Draghi, M. (2017), **Structural reforms in the euro area**, introductory remarks at the ECB conference “Structural reforms in the euro area”, 18 October 2017.

<sup>[16]</sup> See Pithon, S. (2015), **Structural reforms: why did the term become so “toxic”?** CEPII.

<sup>[17]</sup> See OECD (2011), **An Overview of Growing Income Inequalities in OECD Countries: Main Findings**, in: *Divided We Stand: Why Inequality Keeps Rising*.

<sup>[18]</sup> See OECD (2012), **Reducing income inequality while boosting economic growth: can it be done?** Economic Policy Reforms 2012, Going for Growth.

<sup>[19]</sup> See: **The European Human Capital Index**.

<sup>[20]</sup> See Draghi, M. (2014), **Stability and Prosperity in Monetary Union**, speech at the University of Helsinki, 27 November.

<sup>[21]</sup> See Abbritti, M. and A. Mueller (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.

<sup>[22]</sup> Calculations based on estimation results from Abbritti, M. and S. Weber (forthcoming), “Reassessing the Role of Labor Market Institutions for the Business Cycle,” *International Journal of Central Banking*.

<sup>[23]</sup> See J. F. Kennedy: **Annual message to the Congress on the State of the Union. January 1962**

**European Central Bank**

*Directorate General Communications*

*Sonnemannstrasse 20, 60314 Frankfurt am Main, Germany*

*Tel.: +49 69 1344 7455, E-mail: [media@ecb.europa.eu](mailto:media@ecb.europa.eu)*

*Website: [www.ecb.europa.eu](http://www.ecb.europa.eu)*