August 2015

Central bank advocacy of structural reform: why and how?

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In his introductory speech Mario Draghi (2015) not only argued forcefully in favour of structural reforms in the euro area. He also explained why he considers it legitimate for the European Central Bank to relentlessly push governments into more and more ambitious reforms.

This is a controversial position, not because reforms are unnecessary – they are indeed indispensable – but for two related reasons: first, because the central bank is a specialised institution with a narrowly defined mandate that does not include structural reforms; and second, because many reforms amount to changing the economic and social institutions underpinning a society and therefore involve choices that only an elected body can make. It is not by accident that reforms of the labour market, of competition laws, of bankruptcy procedures or of pensions, to name just a few, require legislation and therefore decision by parliament.

As argued by Willem Buiter (2015), standard economic and political economy arguments rather suggest that independent central banks would be better off sticking to their mandate and refraining from making statements about policies that do not fall within their remit. This is typically the attitude of the Federal Reserve System or the Bank of England (things are somewhat different in Germany and Italy, but mainly because these central banks enjoy considerable prestige inherited over time). So why should the ECB behave differently? This is a question of major importance for the policy system of the euro area.

Related questions can actually be raised for the other EU institutions. Since 2010 structural reform in the euro area has increasingly been the focus of policy attention. Conditional assistance programmes have involved extensive reform requirements; the macroeconomic imbalances procedure (MIP) has been introduced; annual country-specific recommendations (CSR) are being issued within the framework of the European Semester; in 2011 the heads of state and government of the euro area countries and six other countries agreed on a reform-centred Euro Plus Pact; in 2012-2013 discussions were held on German-inspired "contracts for competitiveness and growth"; in its January 2015 recommendation on the best use of flexibility within the Stability and Growth Pact, the Commission proposed to take reform efforts into account when assessing a country's public finances; and finally, the Five Presidents' report of June 2015 emphasises the need to strengthen the coordination of reform policies and the MIP, while streamlining processes to favour better ownership. A consequence of the crisis has unequivocally been increased EU involvement in policy areas that primarily belong to national

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competence.

Again, this attention is natural in the light of the magnitude of imbalances across countries and of their non-fiscal dimensions; it is also indisputable that the weakness of potential output growth in nearly all countries calls for remedial action. But these are hardly sufficient justifications for EU involvement in policy areas that are deeply national and for EU recommendations that may conflict with domestic social choices. To put it bluntly, why is economic underperformance in a particular country a matter for EU concern? If labour market institutions are organised such that unemployment is structurally higher in that country, what is the justification for requiring a change to these institutions? Why should the corresponding reform choices not be left to the domestic decision-makers?

This short paper includes two sections. In Section 1, I discuss whether the particularities of the euro area provide a rationale for departing from central bank neutrality, or at least prudence as regards national structural reform policies. In Section 2, I examine the structure of reform discussions between EU institutions and national governments and examine how they could be improved.

1. Should the ECB get involved in the setting of structural reform priorities?

There is surprisingly little clarity in the official literature on the issue of structural policy coordination. Article 121 of the Treaty on the Functioning of the European Union, which applies to all EU members, includes the strong, but unspecific statement that "Member States shall regard their economic policies as a matter of common concern and shall coordinate them within the Council". Article 136, which refers to the euro area members, is equally vague. It stipulates that the Council shall "set out economic policy guidelines for them, while ensuring that they are compatible with those adopted for the whole of the Union and are kept under surveillance". Drawing lessons from the crisis, the Van Rompuy Task Force report of 2010 advocated making the framework for policy coordination more enforceable to ensure that unsustainable policies "do not put stability in EMU at risk" – an important reference to a vital public good. Finally, the Five Presidents' report justifies coordination by the fact that "euro area members depend on each other for their growth" and adds that "it is in each member's common and self-interest to be able to cushion economic shocks well, to modernise economic structures and welfare systems, and make sure that citizens and businesses can adapt to, and benefit from, new demands, trends and challenges. It is equally in each member's interest that all others do so at a similar speed" – a rather general statement that could equally apply to the G20.

The case for international coordination of supply-side policies is generally considered weak. Tabellini and Wyplosz (2004) reviewed the main arguments in a paper on the Lisbon strategy. Their conclusion is that because they are not beggar-thy-neighbour policies, supply-side policies are best dealt with at the national level, without coordination. They argue that externalities involved are generally positive (higher productivity in country A improves real income in country B) and are in any case pecuniary. Furthermore, they consider that from a political economy standpoint, policy competition is desirable because it favours learning and creates incentives to overcome political obstacles to reform. Overall, they find limited scope for reform coordination; beyond the single market, the case for it is strong only in fields related to labour mobility or higher education and research.

Mario Draghi however puts forward in his speech two arguments for departing from neutrality, the first of which has to do with the resilience of the euro area and the second with its growth performance.

The resilience argument has a technical side; only reforms can limit asymmetry within the currency union and prevent or correct internal divergence. They are therefore indispensable to the proper functioning of the euro area. The absence of a coordination of structural reforms can contribute to divergent labour and product market developments, real exchange rate misalignments (Allard and Everaert, 2010) and large current account imbalances. Conversely, coordinated reforms would help reduce divergences in response to shocks and limit asymmetry in the transmission mechanism of monetary policy. Tighter market integration would also strengthen the equilibrating mechanisms through the competitiveness channel and contain the risk of protracted divergence.

This argument can be read as a restatement, in the context of the euro, of the long-standing rationale for IMF surveillance: oversight of national supply-side policies is justified because divergence within the currency union could ultimately cause external instability.

It is indisputable that asymmetry and divergence are bound to reduce the benefits of participating in the euro. Critics object, however, that national governments are perfectly capable of making informed choices and correcting their policies accordingly. For them, the ECB has no place in the corresponding discussion. Should a country fail to rise to the challenge and to put in place policies that are needed to enable it to thrive within the currency union, the consequences should be borne by its citizens alone. It should not count on its partners' solidarity.

This is a logically coherent view, but its consequences must be spelled out explicitly. It implies limiting mutual support mechanisms, so that the costs of failure are not borne by euro area partner countries. This in turn requires putting in place a sovereign debt resolution scheme, so that private creditors pay for the insolvency that is likely to result from lack of growth. And according to the same logic, a country that is unable to perform within the euro should ultimately be allowed to exit, or be driven to the exit.

This is where the political side of the argument fits in. The logic of accepting that a euro area member performs miserably assumes that other member countries and the euro area as a whole can be protected from the potential consequences of such behaviour, including from those of an exit. But if the ECB regards itself as having the responsibility of maintaining the "integrity" of the euro area (to quote from Draghi's speech), it follows that it must also have a view on the actions that member countries must carry out in order not to risk jeopardising this integrity.

There are, in other words, two logically coherent views. One regards monetary union as a framework within which member countries are free to perform or fail. Should they fail, they should not count on the support of their partners and they should possibly exit. The euro area framework should accordingly be reformed to ensure that insolvency within and exit can both be managed. The other starts from the notion that the integrity of the euro area is a common asset that must be preserved, because exit would have far-reaching damaging consequences. The implication is that countries that underperform represent a potential threat to common prosperity. This justifies the involvement of the EU institutions and the ECB itself in the setting of priorities for structural reforms.

The tension between these two views underpinned the July 2015 debate on the handling of Greece. The fact that the choice was made to keep Greece inside the euro area may be read as a vindication of the second.

The growth argument, which largely rests on collective-action reasoning, is more oblique. Draghi gives three reasons for why low growth is problematic, but only the last two are related to monetary policy: excessively low potential output growth would first make the private debt overhang persistent (hampering the transmission of monetary policy); and it might also result in an excessively low, potentially negative equilibrium real interest rate (making standard monetary policy ineffective). Both point to a relatively specific case for reform coordination that would apply fully in current conditions but less so in normal times.

The picture is somewhat more complex, both because there are reasons for coordinating supply-side reforms in a monetary union in normal times and because the case for doing so in a zero lower bound environment is more ambiguous than has been suggested by Mario Draghi.

The case for coordination in normal times relates to the adverse short-term effects of structural reforms; in a stand-alone country, monetary policy endogenously exploits the room for demand-side expansion generated by potential output-enhancing supply-side policies. But this does not apply in the euro area, which may result in a disincentive to reform. Reform coordination is thus needed to overcome the collective-action problem and to restore the incentive (Everaert and Schule, 2008). Applied to exceptional times, however, the same argument suggests advocating caution with reforms because when the policy rate is at the zero lower bound, monetary policy cannot respond to increased supply, which would aggravate deflation (Eggertsson, Ferrero and Raffo, 2014).

The Eggertsson et al. point is important but less compelling than it may seem, first because a number of growth-enhancing reforms do not have short-term deflationary effects, and second because the existence of such effects has more implications for the design of reform strategies than for their coordination. Cœuré (2014) even considers that structural reforms can foster growth in a context where demand-side policies are either constrained (by high public debt) or are of limited effectiveness (because high private debt limits the effectiveness of monetary policy and because dysfunctional markets hamper the positive supply response to a demand stimulus). He argues that supply-side policies are necessary to “empower demand”.

The upshot from this short review of the debate is that participation in a monetary union has deep implications for the relationship between structural reforms and monetary policy. Unlike in a stand-alone country where the central bank can let the government know about its reaction function and "stick to its guns", the ECB is necessarily part of an overall conversation about the priorities, the intensity and the degree of coordination of supply-side reforms.

2. How should the reform discussion be structured?

It would be interesting to conduct a systematic analysis of the speeches by members of the ECB's Governing Council to see what they mean by structural reforms. My suspicion is that one would find that certainly the members of the ECB's Executive Board, but probably also the governors of the national central banks, have been quite unspecific in their reform advocacy. There is a good reason for central banks to limit themselves to general statements; as independent and specialised institutions they should not interfere with social preferences, so they cannot be too specific. But this caution involves the risk of having little impact on actual decisions; the repetition of an unspecific mantra is unlikely to be effective.

Worse, as pointed out by Patrick Honohan, structural reforms can easily be caricatured as an implicit plea for a particular policy agenda involving the reduction of employees' protection and cuts in welfare entitlements. This is not a fantasy. In the eyes of public opinion, "structural reform" has already become toxic. All this implies that the issue of granularity in the recommendations is a delicate but an important one.

A natural solution for the ECB would be to rely on other European institutions that have legitimacy for spelling out in more detail what the structural reform agenda should be. However, they also face difficulties. The European Commission has struggled to work out reform priorities in a way that ensures traction at the national level. Members of national parliaments are finding it difficult to decipher the various EU procedures and what they imply for their country. A cursory glance at the country-specific recommendations suggests that they suffer from a bias (fiscal and labour market dimensions take precedence, while issues having to do with equality of opportunities, human capital and the distribution of income are played down, if not overlooked), they are mostly geared towards strengthening competitiveness on a country-by-country basis (the common euro area dimension is not absent, but the euro area CSR is very general), and they are largely repetitive from one year to the next. Boeri and Jimeno (2015) strongly criticise the EU recommendations for lacking granularity and for failing to take into account the interaction between shocks and institutions. More generally, it is clear from a national perspective that the design of feasible structural reforms requires immersion into a second – or third – best world that is hardly accessible to outsiders.

Furthermore, the choice of reform priorities by the EU authorities does not rest on an explicit definition of the objectives to be pursued at the euro area level as well as at the national level, and it lacks a transparent methodology for defining priorities. Unlike the OECD in its Going for Growth reports, the Commission does not start from a precisely stated goal, from which priorities can be derived for each country. The upshot is that reform recommendations are neither coherent enough to provide a reference framework for individual country choices, nor granular enough to be part of the national policy conversations.

How can the situation be improved? How could the discussion on reform priorities be better structured? There is certainly no magic bullet, but three directions are worth exploring: first, a case can be made for a new approach consisting of building bridges between euro area level reform requirements and national decisions; second, the ECB should use the opportunity presented by this new approach to clarify its own assessment of the policy priorities for the euro area and its member countries, and the way it is communicated to national authorities; and third, thoughts should be given to a more incentive-based approach to reforms.

Decentralisation is on the agenda because for action to be taken at the national level, awareness of the constraints emanating from participation in the euro should be increased at that same level. One step in this direction could be the creation of national institutions that would help increase consistency between euro area-wide requirements and national decisions. The model has already been adopted in the fiscal field; national fiscal councils have been created that are able to provide independent assessments of the economic and fiscal perspectives and to contribute to the preparation of national fiscal choices. Following proposals by Wolff and Sapir (2015) and Bénassy-Quéré and Ragot (2015), the Five Presidents' report of June 2015 endorsed the idea of replicating the model by creating national competitiveness councils entrusted with the task of monitoring wage developments and assessing progress made with economic reforms.

The precise remit of entities of this type needs to be thought out and is, at any rate, likely to differ somewhat from country to country, depending on the nature of labour market and, in particular, wage-setting institutions. What is important is that they could serve as bridges between euro area institutions and national players. They could, for example, follow a common template for the analysis of competitiveness, thereby ensuring that adding-up constraints are respected, and translate the implications of common directions so that they can be adapted to the various national contexts. This would require a much more detailed approach of the determinants of wages and prices, taking into account skills, sectoral, regional and at any rate institutional dimensions. The same method could be applied to potential growth.

This paper is not the place to discuss in detail the mandate, composition and functioning of such councils (or authorities, to use the terminology of the Five Presidents' report). However, since they would constitute a network and would presumably work as such, their creation should help the ECB to define its voice in the discussion of the reform agenda. For example, the Eurosystem could provide these councils with mutually consistent assessments of the competitiveness position of all participating countries. This would imply estimating real equilibrium exchange rates on the basis of a coherent methodology, something that the IMF is doing for its member countries, but which the ECB has so far refrained from publishing for the euro area countries. A scoreboard of this sort would help to decide which countries need to depreciate in real terms and which need to appreciate.

The creation of competitiveness councils should also provide the ECB with an opportunity to be more transparent in its assessment of the economic challenges facing the euro area and the answers it expects from governments. National authorities and governments should know precisely how the Governing Council assesses the potential for growth and employment in the euro area and how this will affect monetary policy. They should have a clear idea of what they can expect from the ECB, depending on their own behaviour – in other words they should be able to reach an informed judgement on its reaction function. And they should also know what outcome (rather than the precise measures) the ECB expects from national decision-makers. A network of competitiveness bodies could usefully serve as intermediaries between the macro requirements expressed by the ECB and the granular reforms needed in each particular country.

Finally, ways should be found to incentivise national reforms. The very fact that these reforms involve externalities is a justification for an incentive-based approach. The question is how it should be implemented. One way, already proposed by the Commission, is to make use of the existing flexibility within the Stability and Growth Pact. The problem is that it applies neither to countries in a sound fiscal situation (because they do not need it) nor to those in a dire situation (because they do not have access to it). So this approach is intrinsically too limited in scope to provide a response to the problem.

Another possibility would be to rely on the "contracts for competitiveness and growth" floated by the German chancellery. The idea starts from the accurate observation that all governments face political constraints at home and that they would therefore prefer to agree on a menu of reforms that correspond to their preferences and takes into account their constraints than to be presented a laundry list of things to do. But the problem is that such contracts could easily be pictured as Troika-light programmes, which would immediately make them unacceptable for national governments.

Tito Boeri and Juan Jimeno propose a new approach based on what they call "positive conditionality", for which they propose a few examples. The key in this respect should be to create euro area or EU-wide schemes, access to which would be limited to countries fulfilling minimum requirements (Pisani-Ferry, 2013). Such schemes could involve transfers (in the case of a common unemployment insurance) or not (in the case of an additional employment contract). Access to them would be conditional on domestic reforms ensuring that national policies do not contradict the aims of the common scheme. So there would be no overall conditionality, rather there would be "local" conditionality.

The differences as compared with the competitiveness contract would be threefold. First, governments would not be told what is good for them. The EU or the euro area would instead set its own goals and pursue them. Second, the schemes would not single out particular countries. The choice of priorities would imply a focus on some of them (as a scheme intended to remedy long-term unemployment would necessarily target countries where long-term unemployment is high), but this would only be de facto. Third, conditionality would not consist of a comprehensive laundry list, rather it would in each case be targeted towards significant roadblocks to the achievement of specific goals.

Bridge building, transparency in the advocacy of reforms and positive conditionality are modest proposals because, when it comes to pro-growth reform, there is no magic bullet. There can be no centralisation, and coordination always risks becoming murky. But the measures recommended here would serve to build a more decentralised, predictable and incentive-based policy regime. They are worth a try.

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