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Panel on "Job and investments in Europe (Juncker plan)"

Intervention of Francesco Papadia.

Since the beginning of the crisis in 2008 the unemployment in the EU has grown, particularly in the countries of the South, despite the strategy of Lisbon (2000 -2010) and the Europa 2020 program (2010 -2020). The growth of the unemployment is connected to the reduction of investments, not only for the countries in crisis that had to apply strong austerity measures, but also in Northern Europe with "budgets in equilibrium" and commercial surplus.

Ending the crisis, create jobs, face the international competition of the emergent countries and China require a strong European Investment policy. Commission's President Jean-Claude Juncker proposed such a plan. Will it be sufficient?

Financial crisis or crisis of the investment? Is it a problem of Credit Gap or a capitalism problem?

I. The first issue I wish to address is whether there is something special about investment or whether the investment problem is one specific aspect of the general economic malaise of the European economy.

I was convinced by the economic analysis carried out by the IMF that the dearth of investment is more a result of the anemic, and until some time ago even worse than anemic, state of economic activity in Europe, than something idiosyncratic to investment. Of course, investment has decreased during the crisis 2 or 3 times as much as income, but this is normal in a recession. It is just that the recent recession has been so much deeper than previous recessions and therefore the fall of investment has been particularly intense. This means that we have to expand the analysis and the cure to the entire economy and do not treat investment in isolation. Still, I will present below a partial exception to the conclusion that the investment problem is just a part of the more general economic problem. This partial exception applies in particular to peripheral Europe, therefore to Italy as well.

II. Of course the fact that one should not look at investment in isolation does not mean that the focus of the Juncker plan on investment is wrong. I guess there is a quite unanimous view that it goes in the right direction, acting on an important variable like investment. The doubts surrounding the plan, which I somewhat share, are about its quantitative impact, connected to its size. There are two issues here, first whether the leverage that the Commission assumes, from about 15-20 billion € of, let´s call it ‚seed money, to 315 bn € of total envelope is realistic. Second, whether the amount of 315 billion over 3 years in an economy of about 13.5 trillion € (less than 1% per year) can have the desired quantitative impact.

III. Capital Market Union. I think the jury is still out on these two quantitative issues about the Juncker plan and I do not want to make a strong point out of them. Let me say, however, that I see more long term potential in another initiative from the Juncker Commission, the so called Capital Market Union (CMU). As Commissioner Hill recently said, Europe has a capital market not proportionate to the size and sophistication of its economy and significantly les developed than the American one. This raises a risk and an efficiency issue. The risk issue is that we have seen, during the crisis, the problems arising from having put all the intermediation eggs in the single banking basket. When this intermediation channel be ame impaired there was little substitution possible from the capital market. The efficiency issue is that bank credit is appropriate for some activities (e.g. established SMEs, residential lending) but not for others (large firms, infrastructure, innovative start-up and scale-up firms).

The issue is whether the potential in the CMU will be fully exploited. The EU Commission and Commissioner Hill in particular insist on realistic objectives, the low-hanging fruits, that can be obtained quickly, putting on the back-burner more long-term objectives, such as changes in bankruptcy laws. This may be the best possible available strategy, taking into account the political constraints. Still it may not be just good enough to revitalize the European economy. From what I understand, the only two concrete initiatives will consist of an attempt to re-launch the market tor Asset Backed Securities and simplify the prospectus directive. Important and useful as they are, these initiatives fall short of a fully-fledged CMU. Once more the EU suffers from the contrast between what is needed and what it can deliver. And I will give you below the reason or this.

IV. Financing constraints in periphery. I advanced the view that the investment problem is just a part of the bigger issue: the poor performance of the European, and in particular the €-area, economy. There is, however, one exception to this general point, which the IMF confirms: “This finding is consistent with the view that a weak financial system and weak firm balance sheets have constrained investment.” in the periphery of Europe. I do not want to sound too optimistic, but there are signs that this problem is being surpassed. Please pay attention to my tense: I am not saying the problem has been surpassed, I am saying it is being surpassed. My evidence is that bank credit, in particular to non-financial firms, is gradually recovering from the negative levels where it has been languishing for long time and that its cost is coming down. The reason of this is, I believe, the cleaning of balance sheets carried out in the autumn of last year by the ECB before it took the responsibility of supervising the 130 most important banking groups in the €-area.

Is this crisis due to the absence of an EU economic government and economic policy (and significant budget)? If so, what could be done?

V. Intergovernmental approach.

The previous point about the difficulty of the EU to deliver what is needed can be seen as a special issue of a wider, institutional problem: the insufficient federal approach in the governance of the €-area. One recurrent observation is that the European Central Bank (ECB) is the only game in town, meaning that when action is needed it is the ECB that is called to the rescue. There are two possible explanations: either the people working at the ECB, starting from Draghi and ending with the cleaning people, are better than those working in the other EU institutions, or that the institutional set-up of the ECB allows it to deliver quicker and more effective policy action than the other institutions. I have a lot of respect for my former colleagues at the ECB and I know that they are first class professionals. But I have also a lot of respect for the staff of the other institutions and they are also first class professionals, so I am in favour of the second explanation. In a way it would be surprising if, after having created a federal institution, with adequate means and an effective decision making procedure that institution would not deliver. In the Governing Council the President of the Bundesbank expressed his opposition to QE. The great majority of the Governing Council listened, I imagine, with interest, at his arguments, was eventually not convinced and decided to go ahead. In the other institutions, such an opposition could have stopped the entire action. The only institution that, as far as I know, has a decision-making system analogous to that of the ECB is the European Court of Justice (ECJ). Hence the overburdening of the ECB and maybe also that of the ECJ.

VI. What about macroeconomic policies? The prime minister of Japan, Mr. ABE, has launched the attention-grabbing image of the three arrows of economic policy: monetary, fiscal and structural. It is my sense that a lot was done in Japan on the monetary side since Mr. Abe announced the policy, nothing much could be expected on the fiscal side and that too little has happened on the structural side. But it not of Japan that I want to speak, but rather of the application of the three arrows paradigm to Europe. Draghi has not used, as far as I know, the three arrows expression but his approach is, in my view, analogous and I share it: the € area needs action in the monetary, the fiscal and the structural area to get out of its catatonic economic situation. Let me look very briefly at each of these three components.

First, on the monetary side, the ECB is doing a lot. Saying that it is using “unconventional” tools is something of a euphemism: the ECB is really doing unprecedented things. On interest rates, I just published a post in which I show that the close to zero interest rates that are supposed to prevail for a decade or more in Europe have hardly any precedent in the history of humanity. As far as we know, it is very difficult to find such low rates in either Babylonian, Egyptian, Greek, Roman, Medieval, Renaissance and Modern times. In quantitative terms, to find analogous precedents to the expansion of the balance sheet of the ECB resulting from its long term lending to banks and its Quantitative Easing one has to go to the crisis times of the two world wars!

A lot may not still be enough, though. It is not clear, at this stage, that the ECB will manage to get back to its close-to-2% objective over the medium term that it identifies, in practice, with price stability. I think there is a fair probability of success, but a fair probability means 50% and so there is also a 50% probability of failure. But we listen to message coming from Frankfurt and understand that the ECB is willing to do more, if needed. This apparently means doing more on QE, which is not my favorite course of action, as I would prefer something more specifically targeted to inflation, such as intervention on the derivative market for inflation, but this is a second order issue. The important thing is that the ECB is willing to do more, if it will turn out to be needed.

Second, on the fiscal side, the margins for maneuver are limited, especially in countries like Italy that have a huge burden of debt. Let me say, en passant, that I find it a little curious that representatives of a country like Italy, which clearly has had problems for decades in managing its public accounts, would lecture other countries on the proper way to conduct fiscal policy. Still, I believe that, in retrospect, the fiscal action in EU and in particular the €-area could have been subtler, better taking into account its negative repercussions on domestic demand. Let me be clear: strong fiscal adjustment was needed, but, in retrospect, we had too much of it too quickly. Let me also add that the huge current account surpluses of Germany and the Netherlands are a clear sign of insufficient domestic demand, which could be invigorated by infrastructure spending in these two countries. I also believe that German workers deserve being paid more, which would also favour consumption in that country and lower the bar for other countries to regain competitiveness.

Thirdly, the structural side is, in my view, the one with the greatest potential. There is a lot to be done in the €-area to increase the growth potential. More competition, more incentives to take risk, more support for working women, better opportunities for older workers, more funding for start-up and scale-up firms (see the point on CMU), a flex-security welfare state, where the worker and not the work place is protected, better education, especially at the tertiary level, would go a long way to increase the dismal growth potential of Europe and reduce the gap with other parts of the world which risks relegating the old continent to a second rank position.

The Investment and unemployment problems are more pregnant in the Southern countries. Is this problem linked to Maastricht rule and to the application of the Fiscal Compact (Cf. Italy from 2016 onwards)?

VII. The need of deep structural policies applies in particular to Italy, which has practically stopped growing over the last two decades, with the result that its income per head, which was higher than the EU average until 2005, is now much lower.

You do not explain such long-term stagnation with monetary or fiscal variables. There is something deeper at work here and if you just have a look at Italian society and economy there are things that jump to your eyes. The Italian society knows a level of corruption that finds hardly any comparison in advanced economies, education, especially at tertiary level, is poor, demographics are terrible, women participation to the labour force is, because of low support to working women, one of the lowest in advanced economies, public administration hinders more than helps the economy, the justice system is slow, the move towards flex-security is so limited as being close to invisible, all sort of rents are rampant, connections more than merit dominate job opportunities for young people. Is this not enough to explain a dismal economic performance?

Of course, one has to answer the criticism that these weaknesses are much older than the worsening of the performance of the Italian economy. If these are structural, long-term factors, how can they explain what has happened most clearly in the last couple of decades? The answer to this criticism is that these structural weaknesses did not allow Italy to adapt to the global changes taking place in the last decades, in particular the integration into the world economy of China and of Eastern and central Europe. It was the joint effect of long-term weaknesses and deep changes at global level that made Italy poorer than the average EU country while it was richer before.