

Banca Popolare di Sondrio

Finance for growth

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Growth

Italy has long strayed from the path of economic growth. Common sense tells us this is so and the data confirm it.

In the last six years the recession has doubled the rate of unemployment and eroded 11 percentage points from per capita GDP. But our problems go back much further than that: in 2008, on the eve of the financial crisis, the average amount of goods and services produced by Italian workers was basically unchanged from 1995. In the same period other countries, spurred by the technological paradigm shift of ICT, had seen their productivity rates soar.

The strong growth in employment that was nevertheless recorded in Italy in the pre-crisis years, favoured by the introduction of more flexible work contracts, proved insufficient to offset the effect of the stagnation of productivity on households' disposable income. At the outbreak of the crisis, for the average household this was at the same level as in the mid-1990s and only the progressive reduction of the saving rate had enabled modest growth in consumption.

The diminishing ability to generate income heralds a decline in living standards, both with respect to this country's past and to the world's main players. This is all the more worrying when one considers that in forty years' time the ratio of people of working age (20-69) to elderly retirees will have halved, from 4 to 2. Even just to maintain per capita living standards at their current levels would require an increase in labour productivity of 25 per cent.

More jobs, more output: but how to achieve both together? Certainly, the recession has been keeping Italian consumers and investors in a state of suspension for too long now, more because of uncertainty and poor confidence than a lack of income. Stimulus must therefore come from macroeconomic policy. At European level, monetary policy is already acting as a spur and is stepping up its action.¹ At national level, fiscal policy can only change the mix: fewer taxes, less unproductive expenditure. Most of the government's efforts should go to tackling the long-standing failings of our society, those that condition Italy's entrepreneurial spirit.

Jobs and productivity are only formed within businesses. The State cannot create them directly and would not know how to. The rules of good business have been neglected in Italy for almost half a century: by many entrepreneurs reluctant to expand their firms, and by public and political opinion prone to defending small and large rents.

A good business is one that researches and develops new products and new methods, and pursues new markets. In the globalized economy, dominated by technologies that convey information and alter consumer tastes at the speed of light, the small, mature firm that is typically

¹ ECB (2014).

Italian does not have a very bright future; sometimes it does not even have a present. Of the main European countries, Italy is the one with the widest productivity gap between small and medium-large businesses.² Businesses start out small everywhere, but then they either die or grow rapidly. In Italy, if they do not die, they remain in the small-size limbo for a long time: the proportion of small, mature firms (those in operation for at least ten years) is over 50 per cent here, compared with 45 per cent in Spain and 40 per cent in the United States and France.³

Encouraging new start-ups, convincing existing entrepreneurs to expand their firms by separating them from the founding family's fortunes, rewarding courage and inventiveness, and discouraging rents: these are the priorities of economic policy in Italy today. Reforming the bloated fiscal and legislative systems and unravelling the tangle of red tape that litters the path of entrepreneurs would enable Italy to move up several places in the global *Doing Business* rankings and spark a virtuous circle between favourable expectations that then become self-fulfilling; it would free the energies that this country still has in abundance.

Finance⁴

In the meantime, however, the recession is burning up resources and hopes. In the political debate reported in Italy's daily press, the hunt is on for the culprits of the failed economic recovery of these months. Banks are a recurring target, accused by some of denying credit to firms and households, thereby impeding the country's exit from the crisis. But for such an accusation to make sense, first the fact has to be established and then, to use the legal terms, it must be proved that there was negligence or malice aforethought, in other words that banks – currently lumped together in a general category – are refusing to lend to the economy either because they would rather use the money available for unspecified financial adventures (malice) or out of incompetence or laziness (negligence).

Let's look at the facts by taking two snapshots of the situation of bank lending, one at the end of June 2008, immediately before the financial crisis erupted fully, and the other at the end of June 2014. In this period total outstanding bank loans to Italian firms declined from €60 billion to €30 billion, a lower level certainly, but not by much. In the initial phase of the crisis, however, credit had risen to over €10 billion in December 2011, so the reduction with respect to the peak

² Based on data provided by the *Structural Business Statistics* of Eurostat, in 2010 added value per employee in Italian firms with more than 250 workers was approximately three times that of firms with fewer than 10 workers; in equivalent firms in Spain it was double that of firms with fewer than 10 workers, in Germany one and a half times, and in France more than one fourth greater.

³ Criscuolo, Gal and Menon (2014).

⁴ This section reprises and develops a line of thinking elaborated on in recent months by Visco (2013, 2014), Rossi (2013), and Panetta (2014).

was €80 billion. As a share of GDP (53 per cent), though, bank lending today is still higher than, say, in Germany and France. Lending to households, instead, expanded in the six years, from €20 to €600 billion. In the meantime, wholesale funding, primarily by foreign banks and large international investors, fell dramatically, from almost €800 to €50 billion, mainly owing in the last three years to the loss of confidence in Italy following the global markets' reassessment of our sovereign debt. Banks have managed to combat the drying up of foreign funding by increasing domestic retail funding and above all by participating in the long-term refinancing operations of the European Central Bank. Without these, the credit squeeze would have been much more severe.

This was not the main cause of the deterioration, however. Due to the persistence of the recession between 2008 and 2013 the total stock of non-performing loans to firms and households increased by just over €100 billion to €320 billion or by 16 per cent of total outstanding loans. As far as it is possible to understand from a comparison of data that reflect very different national definitions, this is higher than the average level in Europe. The outcome, partly owing to increased reserve requirements, has been a dramatic fall in bank profits, while the riskiness of firms' new credit demand has increased sharply.

Furthermore, in recent years the banks have had to strengthen their capital bases. They were prompted to do so even more than by regulations and supervisors⁵ by the recession itself (in that capital must be proportional to the riskiness of assets) and by the markets, where confidence in the banks most exposed to more risky sovereigns was faltering. Over the six years Italian banks expanded their core tier one capital by €50 billion, from €134 billion to €184 billion. This capitalization drive was sustained by raising equity on the market while at the same time retaining earnings – an arduous combination, as potential subscribers of the capital increases had to be offered the prospect of good future returns. The banks' shareholders were called on to bear the brunt of the problems of debtor firms, with loan write-downs totalling nearly €140 billion.

From the banks' standpoint, the situation can be summarized as follows: before the crisis bank credit was abundant because funding on the wholesale markets (mostly abroad) was easy and because given low borrower risk no massive loan loss provisions were required. With crisis and recession, both of these conditions vanished, so the rational course for a bank, in the interest first and foremost of the savers who entrust their resources for prudent investment, is to slow or reduce lending to the firms perceived as riskier and step up investment in other, less risky and more profitable assets, such as government securities. Banks' deleveraging was intensified by the sharp decline in credit demand from the less risky firms, many of which cut back or suspended planned investments.

⁵ Many European banks brought forward their adjustment to the new Basel 3 regulatory framework and then readied themselves for the comprehensive assessment exercise under the Eurosystem's Single Supervisory Mechanism.

This straightforward analysis excludes the highly imaginative theory of “malice aforethought”. Let us now consider a second hypothesis, namely “negligence”, i.e. the banks’ culpable incapacity for sagacious, farsighted assessment of individual borrowers’ creditworthiness. Here, judgment must be more nuanced. The heterogeneity of behaviour among banks makes generic, summary judgment inadvisable. If we nevertheless intend to consider the system as a whole, it would seem to me that Italy is in the grip of a perverse interaction between the structural characteristics of the corporate system and those of the financial system

In too many cases Italian firms are not only small but financially fragile and bank-dependent. Their financial leverage rose prior to the crisis and is now high by international standards (44 per cent). Two thirds of their debt is bank debt. These features are more pronounced among the smaller firms, precisely those most severely affected by the tightening credit supply. For that matter, the typical features of Italian small businesses – diminutive size, little commitment of shareholder capital, lack of transparency – make it nearly impracticable for them to access the bond and equity markets directly, even if they wanted to (which they rarely do).

For its part, the Italian financial system is notoriously bank-centred. At the end of last year bank loans accounted for 40 per cent of the total financial liabilities of households and firms (financial debt plus corporate equity), compared with 15 per cent in the United States, 23 per cent in France, and 30 per cent in the United Kingdom. Only Germany, another “bank-centred” economy, had a share comparable to Italy’s. Equity investment by venture capital and private equity funds, which specialize in start-ups and stimulating the growth of small businesses, amounts to 0.2 per cent of GDP in Italy, as in Germany, or half as much as in France and a fifth as much as in Britain.

For many years the Italian banking system favoured the family-based, fragmented structure of its business customers because this gave them positional rents, sheltering them from competition from other sources of funds, namely the financial and equity markets. Now the banking system has become polarized: on the one hand, major players that tend to concentrate on the largest customers, using quantitative risk measurement methods; and on the other, a vast array of smaller banks, serving mainly small customers whose accounts are often inadequate and opaque, and accordingly require direct knowledge of the business.

Such knowledge can be gained in two ways – by personal relationships or by analytical tools for assessing the firm’s technology and market characteristics. Both are useful, but each has a specific drawback. Personal relationships are more approximate and riskier, analytical tools costlier; in particular, as the latter have variable as well as overhead costs, they may be prohibitive where the business and the loan are very small. Add the consideration that in the event of default the inefficiency of Italian civil justice sometimes makes it uneconomic even to initiate a credit recovery action, so that banks will write off virtually the entire amount of a small non-performing loan, even

if the expected loss, measured objectively, is limited. This practice impacts on banks' lending decisions and the interest rates they charge.

This situation would appear to constitute a “market failure”. The private sector parties, borrowers and lenders, are incapable of making the credit mechanism work efficiently because each responds to incentives and disincentives that clash with the general interest. Small businesses want to stay as “opaque” as possible; indeed, they are accustomed to understating their actual earnings for tax reasons. And in some instances banks do not procure adequate facilities or methods for evaluating firms, it being more convenient, and in the short run less costly, to rely on personal relationships. The outcome is adverse selection and credit rationing.⁶ In some of the most pathological cases there have been outright bank failures. In short, if the hypothesis of “negligence” is well founded, it applies to both sides of the credit market.

This vicious circle, in which ultimately everyone loses and nobody gains, must be broken. It is a life-or-death question for the many Italian SMEs that, while severely strained by recession, still retain their markets, innovative capacity and technological assets, and have the potential to recover. Half of our GDP is produced by small to medium-sized firms with fewer than 250 employees. These SMEs must be helped to grow, not left to die when they are not in fact terminally ill.

First of all, they should be enabled to get off the IV support of bank credit alone and learn to raise funds in the market as well. This will take time. In the short term no more than a fraction of bank credit can be readily replaced. So this market failure must be remedied, to the benefit of all, by public intervention. But what form should that intervention take? In any case, public intervention must be respectful of the market and compatible with the budget constraints.

The main tools available are government guarantees⁷ and securitization. A very substantial contribution could also come from legislative and regulatory intervention to shorten credit recovery time by making bankruptcy procedures simpler and more efficient, and the securities collateral system more flexible.⁸

Public guarantees offset the information shortfall between lenders and SMEs without taking the former's place in assessing creditworthiness and without being a burden on the budget in the immediate, but only after bankruptcy is announced and within the limit of the ratio of insolvencies to the total guarantees granted. A good example is already provided by the Central Guarantee Fund operating under the aegis of the Ministry for Economic Development, which partially guarantees banks that grant loans to small firms and participates in the latter's screening. Since 2009 the Fund

⁶ See, among others, Panetta (2014) and the classic Stiglitz and Weiss (1981) cited therein.

⁷ *Agenda possibile* (2013), Panetta (2014).

⁸ Haselmann, Pistor and Vig (2010).

has granted guarantees on loans amounting to more than €40 billion. The scale of the Fund's operations could be further increased.

Securitizations serve essentially to distribute the risk inherent in bank loans to SMEs among a large number of bank and non-bank institutional investors. In view of the small size of the loans, it is necessary to create asset-backed securities, i.e. packages of loans in the form of bonds, of which it is not too difficult to assess the quality, and place the various tranches with different investors according to their risk appetite. Operations can be carried out by the originator banks themselves or by other financial entities. These instruments could also be backed in part by public guarantees. Notable among the possible investors are insurance companies, which are often hard put in the present phase of the cycle to find desirable investments for their technical provisions in terms of risk/return and maturity.

To develop such a market some regulatory problems must be overcome, firstly at international level. The global financial crisis has discredited instruments such as ABS, which were abused by pushing their complexity and opacity to the limit. But the abuses can be forbidden without eliminating the instrument itself, which retains its rational basis. The ECB has launched a very large programme for the purchase of simple and transparent ABS in order among other objectives to facilitate the financing of SMEs. The Bank of Italy and Ivass are following the matter closely. With great rapidity this summer Ivass drafted amendments to the regulations on insurance companies' investments consistent with the new legislative provisions introduced recently to increase the competitiveness of the Italian economy. The new prudential regulations, aimed at achieving greater diversification of risk, will also allow insurance companies to grant credit directly subject to well-defined limits and conditions. The second public consultation, made necessary by the innovations introduced during the conversion of the competitiveness decree law, is drawing to a close; Ivass will shortly issue the new regulations.

However, markets able to channel large volumes of financial resources from non-bank investors to SMEs cannot easily be created from one day to the next. Even when the regulatory questions have been settled, there will still be the problem of the information asymmetry between borrower firms and investors. Those who, better than others, know or understand the present and prospective conditions of firms, first and foremost the banks that originated the loans, therefore have an essential role to play.

It must not be forgotten, however, that in Italy, as I mentioned earlier, the main problem regarding the functionality of the system lies in firms' financial fragility. The most important task of public action is therefore to push firms towards equity financing rather than additional borrowing, using every possible means, regulatory and fiscal. But bank borrowing too can be made

more rational by examining its technical forms. For example, traditional overdrafts are so widespread in Italy that they stand out by international standards. The fact that they do not establish a time limit for the credit actually granted creates problems for the calculation of interest and lessens their eligibility as collateral; in order to accept such loans as collateral, the Bank of Italy has recently asked for the inclusion of specific contractual clauses.

Using finance to the advantage of growth

The question of what are the determinants of economic growth in the long term has been at the centre of economic analysis since this came into being as a separate science. More than half a century ago attention was focused on productivity and technical progress as the decisive factors for growth, demoting the accumulation of physical capital, which had previously been considered the motor of capitalist growth.⁹ Today a new conceptual leap is being attempted, moving up the scale of causes and effects; searching, in other words, for what determines productivity and technical progress, and finding it in the ability of a firm, an economy, a society to “learn” continuously,¹⁰ in dynamism, in endogenous inventiveness, in the taste for intellectual and entrepreneurial challenges.¹¹

Such ability may be found embedded in the culture and customs of a nation, as a result of a favourable historical confluence. Or it can be constructed, fed, by reasoned political action, as well as by entrepreneurs’ creative impulse. This is a complex task that involves all the different aspects of associative life, first and foremost the educational system; and not only this, but also the legal system, the condition of competition and the efficiency of the public administration.

And finance? The financial system can be an engine of prosperity or a cause of backsliding. The history of economies, both old and new, has given us examples of one and the other situation. The whole world is still reeling from the destructive potential that finance revealed six years ago. It chooses how and where to distribute the resources: the incentives that orient these choices influence economic growth.¹²

To be able to make these choices correctly, the financial system must “know” the corporate system. But what does financial system mean? For an Anglo-American it basically means markets,

⁹ Schumpeter (1934), Solow (1956, 1957). There then followed numerous theoretical and empirical refinements of Solow’s model, such as Romer (1990), Grossman and Helpman (1991) and Aghion and Howitt (1992).

¹⁰ As Stiglitz and Greenwald say (2014), starting from Arrow’s lesson (1962), “learn to learn, learning”.

¹¹ Phelps (2013).

¹² Levine (2014).

and the whole world of analysts, consultants, speculative investors and institutional investors that wheel about them. For a European, and even more for an Italian, it means banks. Markets and banks have different ways of knowing the firms that require finance. Markets can only gather and process data. Banks, in addition to data, can acquire direct knowledge of firms.

A mass of studies and analyses in the last quarter of a century have argued that a broad and sophisticated financial system is essential for economic growth. It is a literature that is considerably influenced by the Anglo-American model, which sees markets as the heart of the system. After the “big chill” brought on by the global crisis, the basic assumption – the importance of finance for growth – has not been eroded, but there have been increasing qualifications and some rethinkings, for example on the recognition of an important role for intermediation, especially in getting credit to SMEs.¹³

In Italy, as we have seen, the share of sources of funding other than bank credit is particularly small and should certainly be encouraged to grow. Our traditional banking activities can find new life, however, in a virtuous rediscovery of the mission to get to know firms, in particular the smallest ones. All the mechanisms for gathering and analysing data on firms need to be strengthened, including the ways in which that information is publicized and shared. Banks must increase their level of technical knowledge, including expertise in products, production methods, markets, about the firms applying for loans, particularly in this recession, when loan applications tend to be for generic purposes and less tied to investment plans, which are easier to evaluate objectively.¹⁴

We are moving towards a different financial system from the one we are used to. Policies, laws and practices must be geared to allowing firms – especially innovative ones – to have more of their own capital, paid in by the owners or from specialized funds, but also raised on the capital market.¹⁵ For this reason Italian SMEs must take a decisive step towards ensuring that information about their status is reliable and widely available. The level of bank debt will have to be reduced.

Banks in turn must accelerate a change that has already begun for some of them. They too are entering a new phase in which it is essential for them to be very well capitalized because of the risks of which we are now all well aware: they must therefore satisfy the general conditions of profitability, transparency and good governance that will allow them to obtain funding at competitive rates (to pass on to lending rates, reducing them) and, if necessary, to raise new capital rapidly and in sufficient quantity.

¹³ See, for example, Beck (2013) and CBI (2012).

¹⁴ Bain & Company and IIF (2013).

¹⁵ According to our calculations, today in Italy there are 500 enterprises that meet the criteria and would benefit by being listed on the stock exchange.

Besides improving their capacity to understand which companies to lend money to, they must also add financial consultancy to their traditional lending activities, thus helping firms to decide the best level and composition of their financial liabilities and supporting their entry to the markets. These new services could build income streams that would at least offset the loss of a part of traditional banking activities.

Conclusion

We Italians told ourselves from the outset that we were not to blame for the global financial crisis, and it was true: on the eve of the flare-up, we had a financial and a banking system that were largely immune to the problems famously discovered in the Anglo-American systems.

Our fault was another: over the preceding decade we allowed the economy to lose strength until it stopped growing, without taking steps to counter a trend whose deep and long-term nature we ignored despite warnings from some quarters. The outcome is before our eyes: we are one of the economies worst hit by the recessive effects of the financial crisis. We worry about the timing and strength of the recovery, about how our country will fare in ten years' time, about the employment prospects and future well-being of the generation on the threshold of adulthood.

A prosperous society knows how to ensure a constant improvement in the quality of life of its members. First and foremost by promoting employment, that is by creating the conditions so that anyone who wants to work, especially at the start of adult life, can find or create a job that is not too unpleasant or ill-paid and that as far as possible fulfils their vocation. Working allows people to plan their future, to access a variety of high quality goods and services, and to grow as a person.

This is what we should understand by “development”: a constant, innovative increase in the variety and quality of everything that makes life better, starting from a secure environment, cultural heritage and natural landscape. A well-designed statistical system can calculate national income in such a way as to include the quality of goods and services and not only their quantity. In any case, a static vision of a society that can be crystallized in an eternal present, maintaining resources and production capacity unchanged, is naive and has repeatedly been disproved by history. Stasis is not possible: either we go forward or we will decline, and only in the former case can we mitigate social inequalities.¹⁶

Economic policy today in the advanced countries must first distinguish the vicissitudes of the economic cycle from structural trends and act on both with the appropriate instruments. Employment is the first challenge. An important role in promoting employment and participation in

¹⁶ Picketty (2014).

the labour market and aiming for levels and trends in pay that reconcile competitiveness with workers' aspirations falls to both macroeconomic policies, aimed at restoring steady expansion of aggregate demand and the economy, and structural policies designed to remedy the age-old defects of the labour market and more generally of the economic system, which pre-dated the crisis and were merely aggravated by its assault.¹⁷ Structural problems and policies are particularly significant in a number of countries, including our own.

For our economy, the return to sustained development cannot be taken for granted, nor is it easily within our reach. Italian history from the Renaissance to the present has witnessed alternating periods of rapid progress and sometimes long phases of stagnation and decline. However, we have no lack of energy, ideas and projects. The financial system is central to the allocation of resources among alternative uses whose contribution to the productivity of firms and the system must be evaluated; this, as I have tried to show in these remarks, is another area of forthcoming structural changes to be assimilated and encouraged.

Confidence must be restored on all fronts, the tapestry of legislation, practices, and principles that govern economic activity must be regenerated. The process has begun. We must all become convinced that defending thousands of narrow individual interests, even when they are legitimate, has to take second place where the ability of a national community to generate its own progress is at stake.

¹⁷ This was the main point of discussion at the latest meeting organized by the Federal Reserve Bank of Kansas City on 22-23 August 2014 at Jackson Hole. See, in particular, the speeches by Yellen (2014) and Draghi (2014).

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