Nout Wellink: Prospects for a unified Europe

Speech by Dr Nout Wellink, President of the Nederlandsche Bank, at the European Institute in Washington DC, 30 April 2001.

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Introduction

The European Institute has asked me to focus on the topic of economic diversity in Europe. It is a key issue, and I am glad to share with you some of my ideas on it. At the end of my speech, I will allow myself to take a broader view and consider the longer-term prospects for Europe. But first, I will discuss a more down-to-earth issue of immediate relevance to us all: the prospects for economic growth in Europe. The key question is: With declining US growth, will Europe be the white knight that rescues the world economy from slowing?

Growth prospects for Europe

The European economy is on solid ground. Real GDP growth in the euro area amounted to 3.4% in 2000, which is the highest growth rate of the past ten years; at the same time, the ECB remains successful in maintaining inflation at low and stable levels; employment growth has been higher than in the US for each of the last three years; and finally, high fiscal deficits have been eradicated, and are a thing of the past. So, the background is encouraging. In at least two respects, the euro area economy is currently less vulnerable than the US:

First, Europe has a positive rate of personal savings, serving as a buffer against unexpected contingencies, such as a sharp decline in equity prices. With a negative personal savings rate, as in the US these days, shocks in equity prices may have relatively large effects on consumer expenditure and, hence, economic activity. This is all the more so, as shares are more widely held in the US. In 1999, the average American family's equity ownership was worth 174% of its disposable income, roughly twice the German figure.

Second, and connected with the first observation, the current account position is stronger in Europe than in the US. The US current account has reached a record deficit of 4% of GDP. This reflects the fact that business investment in the US has become more and more dependent on foreign sources of finance. As a consequence, a change in international investor confidence away from the US is likely to aggravate a significant slowdown in economic activity, and thereby to lead to a downward spiral in the external value of the dollar. We don't see this right now, but it has happened before.

This is not to deny that the current US slowdown will affect Europe. The familiar truism that Europe catches a cold when the US sneezes still applies. Although direct trade links are limited, other channels are more important. In today's global economy, disturbances on US financial markets impact significantly on their European counterparts. A decline in US economic prospects will also undermine European producer and consumer confidence. But even if the uncertainties concerning the European economy materialize, domestic economic conditions in the euro area seem to be more robust than in the US. In 2001, euro area GDP is expected to grow more or less in line with potential, and faster than the US economy. Nevertheless, since imports of goods and services count only for about 16% of GDP in the euro area, it would be misguided to think that Europe could be the one-and-only power engine for the world economy. A buoyant global economy requires healthy growth in both Europe and the US.

Economic diversity in the euro area

So far, I have discussed the euro area as an economic entity. I will now talk about the euro area as a collection of 12 separate EU countries. Recall that the UK, Sweden and Denmark are EU member states not participating in monetary union for the time being. Taken on their own, these 12 euro area countries were small in comparison to the US. But with the establishment of monetary union, these countries have integrated important aspects of their economies into a single euro area economy. In many respects, the euro area and the US are comparable. For instance, the euro area has a population of 300 million people; the US has 270 million people. The share of the euro area in world

GDP is 16%, which is slightly less than the US share of 22%. On the other hand, the share of euro area exports in world exports is 19%, whereas the US share is 15%.

In spite of monetary union, economic diversity across the euro area has not disappeared completely. Growth differentials between countries have been more or less stable over the last decade; inflation rates have converged in the run-up to monetary union, but have diverged somewhat since. Divergences in Europe attract much more public attention than do regional differences in the US. This is striking, since in fact economic differences across the US do not vary greatly from those across Europe. Admittedly, the dominating position of large member states in Europe is unprecedented in the US. Germany counts for 32% of euro area GDP, France for 22%. Taken together, California, New York and Texas count only for a modest 28% of US GDP. But on the other hand, GDP in our smallest euro area member state, Luxembourg, is roughly the same as the share of small states like Vermont, South Dakota or Maine. Consider another example. In Europe, the Finnish economy is heavily dependent on only one sector, telecom. I am sure, the Nokia trademark rings a bell here, too. But take Texas: it is heavily dependent on the oil industry. Such differences in economic structure can cause differences in cyclical patterns among regions, both in Europe and in the US. These differences also explain differences in exposure between regions to economic shocks, a phenomenon well known in the US.

Maybe economic divergences in Europe attract much more public attention than in the US because the euro area has a very short history. Or maybe divergences in Europe catch the eye due to the fact that we are used to thinking about economic divergences in terms of sovereign countries. Probably, both answers contain elements of truth. But there is an additional reason why regional divergences in the US do not attract much attention. Regional differences in the US tend to cancel each other out in the medium term. It is common for a US state to have inflation and economic growth above the federal average in a particular year, and to have inflation and growth rates below average few years later. With only two years after the establishment of monetary union, we do not know whether this will also be the usual pattern in the euro area.

US states do not diverge persistently from federal trends. That is due to economic mechanisms that restore equilibrium. A very important mechanism is labor market flexibility. If there are lay-offs in one part of the US, people tend to move to other, more buoyant regions. Every year, more than 2% of the American population moves to another state to find a job. A further mechanism that contributes to restoring equilibrium in the US is income transfers by the federal government. To be honest, similar redistribution mechanisms to absorb shocks on an interregional basis are less developed in Europe. Labor mobility is limited across Europe, and even within countries. Fiscal transfers between countries would be politically difficult to implement and they lack public support. In addition, the current European Commission budget is very small in comparison to the US federal budget, and certainly too small for significant fiscal transfers. Instead, our system relies much more on the intertemporal absorption of shocks within individual countries. This works through automatic stabilizers in national budgets, which are large in comparison with US state budgets. According to the so-called Stability and Growth pact, member states should have fiscal surpluses in boom years in order to allow for possible deficits during economic downturns. They must also keep deficits below 3% of GDP; over the cycle, budgets of member states are required to be in equilibrium or in surplus. In the European context, the Stability pact is a much better mechanism for smoothing divergences than income transfers between countries would be.

As regards monetary policy in the context of economic diversity, an important consequence of monetary union is that varying national monetary policies and national exchange rates can no longer cause divergent business cycles or inflation differentials. Until the early 1990s, interest differentials and, more importantly, exchange rate disturbances often caused economic divergence. In the run-up to monetary union during the second half of the 1990s, more uniformity emerged. In 1999 a single monetary policy was established that took away these potential causes of regional divergences. From 1999 onwards, the ECB has aimed at low and stable inflation in the euro area as a whole. The single monetary policy is not in a position to influence the dispersion of inflation rates across the euro area. However, the ECB is aware of inflation and growth differentials. Large economic divergence could undermine public support for the single monetary policy of the newly created ECB, as divergences make a ‘one-size-fits-all’ monetary policy less appropriate for certain parts of the area. Again, like in the US, a second reason for our interest in regional divergences is that they can provide early signals of area-wide developments. In this respect, there is no major difference between the ECB and the Fed. The Fed reports regularly on US regional developments in its Beige Book.

The fundamental difference between the euro area and the US concerns market flexibility and economic stability. The European model has benefits associated with greater economic stability for economic agents than in the more dynamic US economy. Recall, for example, the more generous European social safety net. However, doing it the European way comes at a price in terms of less flexibility. For instance, the American model is more adapted to integrating new technologies. The major challenge for Europe is to increase market flexibility without risking the benefits of its current system.

European economic structures are improving. On 1 January 1993, Europe created a single market. Only six years later, the common monetary policy was put in place. Budgetary discipline has improved considerably over these years. More recently, Europe has abolished most barriers to competition in the telecommunication and energy sector. Reforms are under way on a broad front. For example, at the Stockholm summit of EU heads of government last month, new steps were announced to make Europe more competitive and knowledge-based. Several initiatives relate to removing obstacles to the mobility of workers between European countries. The most practical step forward was the agreement on proposals prepared under the chairmanship of Alexandre Lamfalussy aimed at taking away the last hurdles to a fully integrated European capital market. Subject to the energetic implementation of structural reforms, especially those in the field of labor markets and social security, Europe will be able to benefit more from new technologies, and trend economic growth will increase.

Many countries in Europe show encouraging signs that progress on structural issues is under way. Take France for example. Flexible work schedules have recently been introduced on a broad scale. The government has reduced the state’s stake in banking, air transport and telecoms. France has also made a first step in lowering the fiscal burden with a one percentage point reduction in VAT last year. There are also developments that point to another direction, for example recent government plans to double redundancy pay by employers. But, on the whole, France has moved from a vicious cycle of higher unemployment and welfare charges to a virtuous growth cycle.

Enlargement and closer cooperation across Europe

Taking a broader view across Europe, one can say that the coming EU enlargement to Eastern Europe bolsters prospects for structural reforms. Currently, negotiations are under way with 12 accession countries. Imagine how different the EU will look when they have joined. The EU will then consist of 27 countries; its population will increase by 30%, though GDP will increase by only 5%. It is difficult to imagine that enlargement to the East would occur without reforms leading to lower agricultural subsidies, fewer transfers from so-called cohesion funds and more efficient social security systems. The more so as our policies, in contrast to US policies towards their Latin American backyard, are aimed at full integration of accession countries in the EU. However, the new states that we want to welcome to the ranks of the EU must realize they have to bear the main burden of adjustment. Their first step is to enter the EU. In this context, they have to adopt European legislation, to implement EU environmental standards etcetera. When they subsequently prepare for joining monetary union, the accession countries will have to continue the adjustment process in order to successfully converge towards the standards of the euro area. This could take several years after EU entry. However, the potential for structural reform and, therefore, for additional growth is immense.

Apart from enlargement, closer cooperation in several policy areas is another major theme within the EU. In this respect, monetary union works as a catalyst for more cooperation on economic policies. For instance, tax structures are moving closer together across the euro area. Another sign in this field concerns the euro area Council of ministers of finance. They have an unprecedented power to fine member states with excessive budget deficits. This Council can also make recommendations to member states with economic policies that are inconsistent with broad policy guidelines. They made such a recommendation recently to Ireland. It is understandable that within the EU, euro area member states want to cooperate more closely. For example, the euro area ministers of finance have intensified their cooperation in the so-called euro group.

With closer European cooperation on monetary and economic issues, it is natural that cooperation on other policies will increase too. However, there is no ultimate goal for closer political integration. Some dream about the United States of Europe, but Europe will not be ready for this within the foreseeable future. Others think of a United Europe of States. Anyhow, there is a growing understanding among European political leaders that Europe cannot develop faster than the people want. As I see it, from time to time this can mean that there is a pause at the current level of integration. But there is no moving backward. As it stands, we have to be realistic and focus on issues that have to be resolved at relatively short notice. The main issue now is how to deal with enlargement to Eastern Europe in terms of decision-making processes. If we want to have both enlargement and closer cooperation on particular issues, there is a need for pioneering groups of member states that move closer together on these issues. That is unavoidable; whether you refer to these groups as ‘centers of gravity’, ‘avant-gardes’ or in the best tradition of Eurocrat-speak ‘member states of a multi-tiered Europe with variable geometry, in concentric circles with a hard core’. Last year’s Nice summit has cleared the ground for this flexible approach.

Concluding remarks

Let me conclude. European economic growth prospects are favorable. Euro area economic diversity is a fact of life, but not very different from the US situation. Admittedly, the European economy has considerable progress to make in structural reform. But the improvements so far are genuine and are likely to last. Closer European cooperation on economic and political issues is under way. If I may quote the American economist Lester Thurow from his 1992 bestseller Head to Head: ‘future historians will record that the 21st century belonged to the House of Europe’. End of quote. In this environment, a common European culture is emerging. As of January 1, 2002, euro notes and coins will give European citizens a concrete sign of their common identity. Nonetheless, some cultural differences will remain, just as in the US. Joe-six-pack as the average American is only virtual reality. I am sure that someone from New Jersey is very different from someone from Texas. Also in Europe, we will keep national traditions. I was born Dutch. Now I feel European, but a Dutch European. I am proud of that.