Nout Wellink: European competitiveness – where do we stand and where do we go?

Speech by Dr Nout Wellink, President of the Netherlands Bank and Chairman of the Basel Committee on Banking Supervision, at the Conference "Towards sustainable European competitiveness: the role of business" organized in commemoration of INSEAD´s upcoming 50th anniversary by its Dutch alumni association, Amsterdam, 8 June 2007.

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Introduction

Let me start with some personal remarks. In the past few weeks, I visited successively Dublin, Tblisi, Athens and Buenos Aires. And as you probably know, I meet twice a month with my European colleagues at the ECB in Frankfurt. And as you probably don't know, I will become 65 next year and thus entitled to public pension benefits (AOW), although my term as president expires only in 2011. This is how my professional life looks like nowadays in a world marked by globalization, European integration and aging. However, these three trends are not only relevant for central bankers, they are relevant for everyone. Today, I will speak about the impact of globalisation, European integration and aging on European competitiveness.

Globalisation

Globalisation strengthens the interrelationships between national economies. Let me illustrate this by China's economic development. The rise of China gives an enormous supply shock to the world economy. Currently, 16% of total world production is made in China, which was only 4% in the beginning of the 80s. After the European Union and the US, China is now the third largest economy in the world.

China's economic development is noticeable for every European citizen. For example, electronics and textiles have become much cheaper due to cheap Chinese production. Inflated prices of raw materials and oil are a flip side of China's explosive growth. Everyone who regularly refuels his car, can agree on this. On balance, Chinese economic development has been beneficial for Europe. For instance, Dutch families have saved on average 300 euros per year due to cheap Chinese imports, according to a recent estimate by the Netherlands Bureau for Economic Policy Analysis (CPB)[1].

China's economic development certainly has an impact on European economies, but there are large differences across Europe. China has a comparative advantage in producing and exporting cloths, shoes, toys and consumer electronics. A country like the Netherlands has a comparative advantage in producing and exporting flowers, dairy products and food. Hence, the Netherlands currently has only limited competition from China in its export markets. However, a country like Italy, which is specialized in shoes and clothing, is confronted with severe competition from China. Consequently, Italy will have to restructure its shoes and clothing industries, something the Netherlands already did by the end of the 60s.

A key question for the future is whether Europe can sustain global competition with countries like China. The development of labour productivity is an important determinant of the competitive position. In this respect, it is worrisome that the growth of European labour productivity has been lagging behind its main competitors in the past years[2], although recently there seems to be a pick-up in trend productivity growth. Possible explanations for the low productivity growth in Europe are the lack of technological progress and an unfavourable business environment[3]. Let me take a closer look at both.

Concerning technological progress, there is evidence that Europe's relative weak productivity growth can at least partly be explained by its low research-and-development efforts. In the US and Japan,

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1 CPB (2006), China and the Dutch Economy; Stylised facts and prospects, CPB Document 127.

2 While annual productivity growth recently decelerated from 2.4% (1970-1995) to 1.3% (1995-2004) in the euro area, it accelerated from 1.3% to 2.4% in the US. Source: European Commission (2007), Annual report on the euro area.

3 Source: ECB (2005), Competitiveness and the export performance of the euro area, Occasional Paper no. 30.

R&D-expenditures[4] in total manufacturing are about 50% higher than in the euro area. A second factor which might explain our weak productivity growth, is the education of the European population. Over the last decades we have seen an increase in the level of educational attainment. But to create a knowledge-based European powerhouse, we need to unlock universities' potential. In a global context European universities are currently no match for American universities[5]. More competition between academic institutions, selective entrance exams and allowing more freedom in funding could spark a move to high-quality academic research. This is one of the things Europe needs to become "the most competitive and dynamic knowledge-driven economy" as laid down in the Lisbon agenda.

Concerning the overall business environment, there is evidence that Europe is in a less favourable position than its main competitors. Surveys among European businessmen suggest that this holds in particular for the tax system, labour regulations and the administrative burden. The average marginal tax rate on labour in the euro area is high and hovers around 15 percent points above the rate in the US[6]. Labour regulations such as employment protection legislation hinder job-to-job mobility in Europe. As a result, workers in the EU stay in the same job for more than 10 years on average, compared to less than 7 years in the US[7]. Concerning the administrative burden, the average cost of starting a business with up to 50 employees in the euro area is estimated to be 10 times higher than in the US, according to the World Bank. That is, if entrepreneurs have not given up starting a business in the meantime, as it takes on average 27 days to set up a new business in the euro area, compared to just 5 in the US[8]. I always had respect for entrepreneurs, but it's getting larger in view of the red tape they have to cut through.

Some reforms have recently been undertaken, both at the national and the European level. For example, personal tax wedges have been reduced and employment protection legislation has been relaxed in some European countries. And I fully support the current EU Commission initiative for measuring the cost of existing legislation and reducing the administrative burden on companies with 25 percent by 2012. Furthermore, the adoption of the European Services Directive by the European Parliament in 2006 will contribute to a level playing field in the services sector. This will foster competition in the services sector, which is needed given the lacking productivity performance. However, although these reforms are a step in the right direction, more reforms are needed to improve productivity growth in Europe.

Aging

Europe is aging more than for instance the US and China. Let me give you some figures to illustrate this. Currently there are on average 23 retirees for every 100 workers in Europe, in 2050 this will be 48. In the same period, this so-called old-age dependency ratio will increase to 34 in the US, and to 39 in China[9]. Thus, the relative share of workers in the population of Europe will be smaller than in the US and China in the coming decades. This will threaten Europe's competitive position.

Although all European countries are aging, there are large differences across Europe. For instance, Italy is aging more rapidly than the Netherlands. Concerning aging in the Netherlands, let me have a closer look at the two underlying demographic trends. First of all, we have fewer children. Until the mid 60s, Dutch women gave birth to approximately three children during their lives. After having fallen to 1.5 children in the mid 80s, this figure is now projected to be only 1.75 children in the coming decades. Secondly, we live longer. At the time the public pension scheme (AOW) was introduced (1957), the average remaining life expectancy at age 65 was less than 15 years. Nowadays, new AOW-beneficiaries expect to receive AOW-benefits for more than 18 years on average.

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4 R&D-expenditures divided by value added.

5 P. Kalaitzidakis, T. P. Mamuneas and T. Stengos (2001), Ranking of Academic Journals and Institutions in Economics, October 2001.

6 Source: OECD. Marginal tax on labour consists of income tax, employee and employer social contributions as a percentage of total labour costs of average worker.

7 Turmann, A. (2004), A new European agenda for labour mobility, CEPS Task Force Report.

8 World Bank (2006), World Development Indicators, Business Environment database.

9 Source: UN (2006), World Population Prospects: the 2006 Revision.

From an economic point of view, both demographic trends are basically good news. Having fewer children reduces the scarcity of finite natural resources, which has a positive effect on individual welfare. Living longer partly mitigates this effect as individuals use more finite natural resources the longer they live. However, living longer also increases an individual's potential earning capacity over their lifetime. Reaping the potential economic gains from living longer requires adjustments, in particular with respect to education and retirement. Let me take a closer look at both.

Living and working longer requires more attention for education both when young and old. Young people should be properly educated and the number of school drop outs should be reduced. Older people need to get additional education during their careers to keep pace with the latest technological developments. In this respect, it is good to note that this concept of life-long learning is one of the leading principles of education at INSEAD.

Living and working longer also requires an increase in retirement ages. Until recently, most European countries never increased their statutory retirement ages despite the increased longevity of their population. This threatens the sustainability of the pay-as-you-go financed European public pension schemes. Germany and the UK have recently announced a gradual increase in the statutory pension age to 67 and 68 respectively. Other European countries should also increase retirement ages in response to longevity developments if they want to keep a sound public pension scheme.

Given the prospect of dramatically increasing old-age dependency ratios, it is now definitely time to act. Moreover, gradual adjustments in the pension ages are much easier to deal with than large increases at once. Doing nothing implies either a dramatic future fall in public pension benefits such as AOW to avoid tax increases or a dramatic future increase in the tax burden to preserve pension benefits. The latter would have severe consequences for Europe's competitive position.

European integration

In a globalizing world economy, European integration can help to preserve Europe's competitiveness. Being the largest economic block in the world, a united Europe is more capable in defending its economic interests than a divided Europe. This applies for instance to the trade negotiations in the World Trade Organisation. More importantly, European integration has fostered the competitiveness of European companies, in particular by the creation of the internal market. This has made European companies better prepared for global competition. The euro is another important example of how European integration can foster Europe's competitiveness. Being a strong and stable currency, the euro is not as subject to exchange rate fluctuations as the individual European currencies used to be in the past. This reduces the economic uncertainty for European exporters.

A precondition for successful European integration is a proper governance structure to facilitate smooth decision making. This holds especially after the enlargement of the European Union to 27 Member States. Besides fostering democracy and transparency, the recently rejected European Constitution was aimed at improving decision making in the European Union. Surveys among the European public suggest that the resistance against the Constitution does not stem from the proposed changes itself, but from the process followed, which was considered as proceeding too fast and too unknown for the public. In this respect, the term "Constitution" might be misleading as it suggests the creation of a single European State. In my view, the rejection of the draft Constitution in France and the Netherlands demonstrated the need for a deeper dialogue with the public about European integration. In this respect, I fully support the recent attempts to draft a shorter and simpler version of the draft Constitution, maintaining its main components.

Despite the rejection of the draft Constitution, there is no need for pessimism concerning European integration. In the past, European integration has also halted from time to time before proceeding to the next landmark. Let me remind you of the crises with the European Monetary System in the early 90s. These crises did not prevent Europe from completing the process of monetary unification by the creation of the euro. It is as Willy Brandt once said: "The history of the EU is the history of its crises".

Concluding remarks

Let me conclude. Globalisation, European integration and aging do not stop after this conference. The question is whether Europe is able to deal with it in such a way that its competitiveness is safeguarded. Although there is certainly a need to adjust as I have just sketched, we shouldn't be too pessimistic about the ability of Europe to accomplish this. In the past, Europeans proved themselves to be more than capable of adjusting to new circumstances.