Nout Wellink: Prospects for the European economy

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Wellink is optimistic on the prospects for the Dutch and European economy. Structural reforms and budgetary discipline should be continued.

Prospects for the European economy: the only way is up

Ladies and gentlemen, according to your website, one of the reasons to join the Canadian Netherlands Business Association is “to celebrate cultural heritage through special events such as Sint Nicolaas and rijsttafel.” While I fully appreciate such events, I suggest to focus tonight on the prospects for the European economy. After all, given your business interests in the Netherlands, you will probably be most interested in the developments in economic prosperity in the Netherlands and in Europe at large, although I could certainly recommend a rijsttafel to you, if you do not know this yet. I will first address the growth perspectives in the Netherlands and Europe. Then, I will discuss two important preconditions for sustained growth: the continuation of structural reforms and the maintenance of budgetary discipline.

Growth perspectives in the Netherlands and Europe

Being here in Toronto, it is tempting to compare Canada with the Netherlands. Both are open economies and relatively dependent on economic developments in their big neighbouring country, the United States and Germany, respectively. One thing that strikes me is that, whereas after a number of booming years the Dutch economic growth performance deteriorated substantially over the last few years, the Canadian economy proved exceptionally resilient in the face of the global downturn, including in the US. This good performance owes of course much to the straightforward implementation of structural reforms and budgetary consolidation since the beginning of the early nineties. However, a number of other factors have also played a role in sustaining economic growth in Canada. Domestic investments and household consumption remained robust, the latter partly caused by ongoing gains in real estate prices. Moreover, export demand remained supportive to growth. The absence of these latter supportive factors is an important explanation for the sharp downturn that has occurred in the Netherlands.

Indeed, from the best performing European economy, the Netherlands turned into the worst performer. To put the current slump into perspective, let me first go back to the end of the nineties. During the period 1994 to 2000, the average annual growth rate of GDP in the Netherlands was 3.5%. This was well above the potential growth rate of the Dutch economy and 1 percentage point above the average of the so-called eurozone, the economy of the 12 countries that have adopted the euro as legal tender. The current cyclical downturn thus was - to some extent - to be expected after a prolonged period of economic expansion at a speed above potential. It is worthwhile to look into the reasons for this over performance, as they might give a clue for the subsequent downturn. Mostly, the seeds for downturns are sawn during the upturn.

The main growth engines during the upturn were, firstly, rapid consumption growth due to among other things a booming housing market. Secondly, exports thrived as a result of a substantial improvement of our international competitiveness as well as favourable global economic conditions. The robust growth subsequently led to a tightening of the labour market, culminating in an unemployment rate of only 2.4% in 2001, compared to 8% for the eurozone as a whole. Incidentally, employment figures in the Netherlands are as flattered as in other European countries, such as Germany: in our own country because of the relatively large number of inactive people as a result of initially generous disablement insurance schemes. In Germany , the existence of subsidised jobs cloud the picture. Nevertheless, the labour market developments in the Netherlands caused a strong increase in unit labour costs, for which we ultimately had to pay the price. The eventual significant loss in price competitiveness, in combination with the global economic downturn, stalled our exports. Moreover, the disappearance of wealth effects due to the stabilization of house prices has taken their toll on households' disposable incomes, and as such on consumption. To give an example of the magnitude of these forces: the annual contribution to GDP growth from housing wealth has turned from an annual 1%-point impulse between 1998 and 2000, into a negative contribution of half a percentage point in the past three years. Taking these wealth effects stemming from the housing market into account scales down the present growth gap between the Netherlands and the eurozone.

Another possible downward effect on growth in the short term stems from the significant budgetary adjustment the Dutch government is implementing. Nevertheless, this adjustment, which is larger than in most other eurozone countries, is necessary not only to adhere to the European budget rules but also to enhance durable growth recovery. I will come back to the need for budgetary discipline at the European level at the end of my speech.

For the future, I am optimistic. We have passed the turning point in the cycle. For this year, I expect growth to be 0.7%, rising further to 2% in 2005. An important driving force is the global recovery, which will stimulate our exports, even though we have to regain competitiveness. Nevertheless, the strength and sustainability of this recovery will to a large extent depend on the persistence and speed at which the reforms that have already been set in motion are pushed through. In particular, next to the substantial budgetary consolidation efforts, the continuation of wage moderation to foster price competitiveness is essential. The tripartite agreement that was reached last autumn to freeze nominal wage rises in the next two years is a positive development in this respect, as it clearly shows that the importance of wage moderation is now in the minds of both employers and employees.

Turning to the economy of the eurozone, it is clear that the slowdown has been less steep but more prolonged than in the US. In the US, economic growth deteriorated with 3.5 percentage points from 2000 to a virtual standstill in 2001, after which it quickly regained speed with a growth rate of 2.5% in 2002. In the eurozone, the slowdown was much more gradual, with a fall in economic growth of 3 percentage points over a period of three years, from 2000 to 2003. This pattern of the slowdown - a gradual deceleration of growth, rather than a sharp fall in output - may have meant that the immediate pressure on corporations to adjust their balance sheets and labour force was less intense, delaying the adjustment process. High debt levels in comparison with those in earlier cycles may also have contributed to this relatively prolonged downturn. Nevertheless, for this year, the economy of the eurozone is expected to grow with 1.6% and with 2.4% in 2005. Like in the Netherlands, this turnaround has been mainly driven by rebounding exports due to the recovery of global trade.

In addition to the strengthening of external demand, domestic expenditures in the eurozone will take their part in the recovery. With respect to household spending, both short-term and long-term interest rates are at historical lows, which have eased debt servicing costs of households. Of course, the fact that interest rates are so low, also raises the risk of renewed increases in the future, with possible adverse effects on households' debt profile. Furthermore, although the appreciation of the euro that has taken place is not conducive to export growth, it will, all other things being equal, gradually feed into a further decrease in inflation which in turn will raise real disposable income of households. In this context, simulations within the Nederlandsche Bank show that a permanent appreciation of the effective euro exchange rate of 10% will have a short term negative effect on economic growth in the eurozone of 0.35%. However, the effect of a 10% euro appreciation turns positive in the longer term, cumulating to 0.7% after six years, partly due to an increase in consumption. Corporate investments can gain momentum too, due to the pick-up in foreign demand in combination with the limited degree of excess capacity in the manufacturing industry. Also, corporations have improved their financial position by bringing down the share of short-term debt. Moreover, low interest rates, low corporate bond spreads and the recovery of the stock markets have improved the financing conditions for European corporations.

Being a central banker, it is part of my duty to draw your attention to the downward risks as well, which could dampen the pace of the recovery. These risks mainly stem from the persistent and significant budgetary and external imbalances in the US economy. But there is no need for undue pessimism with regard to the cyclical upturn in Europe. Whether this upturn will prove to be sustainable, however, depends, like in the Netherlands, to a significant extent on the continuation of structural reforms and the maintenance of budgetary discipline. I will now turn to these two issues.

Continuing with structural reforms

In March 2000 in Lisbon, Europe 's leaders committed themselves to turn the European economy into the most competitive and dynamic knowledge-based economy in the world by 2010. To accomplish this, they agreed on implementing far-reaching reforms of labour, product and capital markets, on completing the European Single Market, and on enhancing Europe 's innovative capacity. Clearly, this structural reform agenda, also known in Europe as the "Lisbon strategy", was and still is quite an ambitious challenge.

Nevertheless, structural reforms are no end in itself. By removing bottlenecks and obstacles in the European economy, these structural reforms enhance the economy's capacity to generate sustainable growth rates, with low unemployment and sound public finances. Let me give an impression of the quantitative effects of these reforms. The OECD has recently calculated that continuation with product and labour market reforms would lead to higher productivity and employment growth, which would over the medium term boost potential per capita output growth of the eurozone from 1.75% to 2.25% a year, the same as the US growth rate.

Moreover, reducing red tape and creating more flexible and integrated labour, product and capital markets, promote cross-border activities by, and financing of European companies. Looking ahead, the opportunities for businesses are likely to expand further. Recent research conducted for the European Commission shows that a materialization of a fully integrated European financial market will eventually contribute to a reduction in the cost of equity and bond finance of 0.5, respectively 0.4, percentage points. The assumption behind this projection is that trading costs could fall sharply as a result of full financial market integration, due to greater depth and higher liquidity of these markets. These lower trading costs would allow investors to accept lower returns on corporate equity and bond issues, which would translate into lower financing costs for firms. However, not only European corporations, but also corporations from outside the EU gain from the reform process in Europe. The existence of a single system makes access to the EU market much easier for firms from third countries, which is for instance reflected in the steep increase of foreign direct investments into the EU since the establishment of the Single Market. Finally, structural reforms benefit European consumers, by reducing prices and increasing the choice and quality of services.

So much for the theoretical gains of structural reforms. Allow me some remarks about the progress in implementing these reforms. There are clear signs that European governments are increasingly aware of the need of putting structural reforms at the top of their policy agenda. The Netherlands, for instance, have already implemented three-quarters of the reform measures agreed in Lisbon. In the three largest European economies, Germany, France and Italy, together constituting almost 70% of the GDP of the eurozone, a wide ranging and impressive reform program has been enacted, encompassing reforms of labour markets, pension and health care systems. The labour markets reforms are aimed at reducing rigidities and improving incentives to work. Germany, for instance, will implement in the context of its so-called Agenda 2010 an easing of its stringent job protection legislation and a reduction of the unemployment benefit duration. In another area, that of pension and health care, reforms are being implemented that constitute a structural break towards containing the financial consequences of an ageing population. To this end, the Italian government proposed, for example, that as of 2008, workers will need 40 years of pension contribution, instead of the current 35 years, if they want to retire before the statutory retirement age. With the same perspective, France has aligned the shorter contribution period for civil servants to that of the private sector. Finally, in order to increase economic dynamism, reform measures such as a relaxation of shop opening hours, a simplification of tax law and bookkeeping obligations for small and medium sized enterprises, and a reform of the civil service have been initiated in these countries. These measures may sound strange or self-evident to you, but they constitute a significant culture change in parts of Europe .

True, these reforms will not be implemented overnight and their effects will only become tangible after a number of years. Moreover, in a number of areas, such as strengthening the innovative capacity of the European economy, completing financial market integration and integrating services markets, further progress is still needed. To give a few concrete examples in these areas, to further a knowledge-based economy, the level and effectiveness of spending on research and development in Europe, which is currently lagging behind the US and Japan, could be increased. Another important challenge is to integrate the still fragmented system of clearing and settlement of securities transactions in Europe, to foster an efficient operation of security markets. Also, legal and administrative barriers should be dismantled further, in order to enable a completely free movement of services across Europe , such as in engineering and consultancy. Therefore, the Lisbon target of 2010 indeed looks very challenging. But there is no doubt that the modernization of the European economy has taken off and is moving forward decisively.

Maintaining budgetary discipline

I now come to the final part of my speech on the need to maintain budgetary discipline. It is widely acknowledged that fiscal discipline contributes to long-term sustainable economic growth, by creating a stable macro-economic environment, which for instance allows for undistorted consumption and investment decisions. Also, budgetary consolidation, in addition to the pension and health care reforms I mentioned earlier, is important to prepare for the financial consequences of the ageing European population, which is expected to reach its peak in the middle of this century. While these two arguments apply in fact to any country, the need for fiscal discipline in a monetary union, like the one we have in Europe, is even higher. An important reason for this is that the negative side-effects in the form of higher interest rates of expansionary budgetary policy in one country, are not entirely borne by this country alone. Instead, these are widely shared by all their fellow participants in the monetary union.

To guarantee budgetary discipline and to strengthen mutual trust in each other's budgetary policy, a fiscal policy framework has been established in Europe. This framework basically consists of two rules. The EU Treaty stipulates that Member States should avoid excessive deficits, which are defined as deficits above 3% of GDP. The so-called Stability and Growth Pact gives a further refinement of the Treaty, by requiring Member States to achieve and maintain a budgetary position of close to balance or in surplus in the medium term. By abiding to this latter requirement, a country creates enough budgetary room and flexibility to ensure that public finances can absorb normal economic fluctuations without breaking the 3% deficit limit. As such, this framework combines budgetary discipline with country-specific flexibility.

Clearly, the budgetary problems in especially Germany and France over the last few years are not encouraging. These problems culminated in the decision by the Council of European Finance Ministers in November last year to deviate, for the time being, from the formal budgetary procedures of the Stability Pact for both countries. Instead of adopting the proposals by the European Commission under the Stability Pact, the Council made recommendations to Germany and France to correct their deficits outside the framework of the Stability Pact. To put these developments into perspective, allow me to take you a number of years back in history.

Between 1991 and 1995, before a monetary union in Europe was considered to be a realistic prospect, the average budget deficit of the eurozone was 5% of GDP. The subsequent pressure for fiscal discipline emanating from the desire to qualify for Economic and Monetary Union, resulted in an average budget deficit of 2.3% of GDP at the end of 1998. After qualification for EMU, governments of the participating Member States were obliged to adhere to the central prescription of the Stability Pact, namely to reach balanced budgets over the cycle. Due to the gradually deteriorating economic growth, the European Finance Ministers decided in 2002 that countries that had not yet reached a balanced budget, were given a few years extra to attain this position. However, prolonged economic weakness and insufficient budgetary consolidation efforts during the preceding economic upturn, have ultimately resulted in some countries not only breaching the Stability Pact requirement, but also the 3% deficit limit.

This clearly is a highly unfortunate and disappointing development. At the same time, however, we should keep in mind that despite these problems, a significant improvement in European budgetary discipline has indeed been attained in the course of time. It might in this respect also be illustrative to look at the United States , which experienced a downward swing in their federal budget deficit of 6.5 percentage points between 2000 and 2003, although this was partly due to special factors, such as the war in Iraq .

How can we solve these problems, or in any case make sure that they do not arise again in the future? In 1992, the EU Treaty that laid down the path towards Economic and Monetary union was signed in the Dutch city of Maastricht. Although it was clear that a potential conflict exists between a single monetary policy and decentralised fiscal policies, it was also clear at that time that establishing a political union, or in other words an independent European fiscal authority, to supplement the monetary union was a bridge too far. Instead, a rather artificial solution in the form of the Stability Pact was created. However, the experiences with implementing the Pact over the last few years have made it very clear that governments are reluctant to accept constraints on national sovereignty through limitations on budgetary policy. This holds especially true in times of subdued economic growth. Discussions about fundamentally improving the adherence to the European budgetary rules are in my view therefore inextricably linked to discussions about curtailing national budgetary sovereignty, and as such to forming a political union. Although I realize that this obviously will be a realistic solution only in the long term, we should not hesitate to bring this under discussion.

To a certain extent, the discussion on the appropriate role of national budgetary sovereignty has already started. Recently the European Commission decided to challenge the decision by the Council of European Finance Ministers in November to deviate from the Stability Pact, by bringing legal action before the European Court of Justice. The reason for this decision is not to challenge the substance of the decision, as in fact there is no major difference between the budgetary consolidation path under the proposals by the European Commission and under the eventual recommendations by the European Council. Rather, the aim is to seek legal clarity regarding the fundamental question that emerged from the Council decision in November, that is whether the European budgetary framework ultimately is of a supranational or of an intergovernmental character.

Of course, a fundamental discussion like this should not distract us from the search to find solutions to improve the enforcement of the European budgetary rules in the shorter term. A contribution towards such a solution is to deny countries with excessive deficits their voting rights in the Council of European Finance Ministers, when decisions are taken on another country with an excessive deficit. This prevents countries from taking their own budgetary problems into consideration, when votes are casted on countries that face the same problems. A more far-reaching contribution is to give objective and independent institutions, such as the European Commission and the European Court of Justice, a much stronger role in enforcing the implementation of the budget rules. The role of the European Court of Justice in this case is not to judge the procedural elements as such, but rather to enforce that individual countries stick to their budgetary commitments. The Dutch government is actively striving to incorporate these changes to the budget rules in the new European Constitution, and I fully support their efforts.

Summing up

Let me sum up. I am optimistic about the prospects for the European economy. We clearly passed the turning point in economic growth, both in the Netherlands as in Europe as a whole. Moreover, the conditions for sustainable growth recovery are favourable. Firstly, European governments are increasingly living up to their promise made in Lisbon to implement far-reaching structural reforms, although it remains to be seen whether the deadline of 2010 will be reached. Secondly, it is clear that Europe currently faces budgetary difficulties. This holds not so much for the sheer size of the budget deficit as such, although the still more limited flexibility and the more gradual recovery of the European economy compared to the US, implies that reducing deficits might take a longer period of time than in the US. The main difficulty, however, stems from the deficiencies in the European institutional budgetary framework. To overcome these deficiencies, discussing drastic solutions, most notably the eventual establishment of a political union, should not be avoided. From this perspective, the current problems, although unpleasant, should in my view be seen as occasional and temporary setbacks on the road to an increasingly integrated Europe. I am confident that this integration process brings benefits to both European citizens as their partners outside Europe.