Guy Quaden: Challenges for the European economy

Speech by Mr Guy Quaden, Governor of the National Bank of Belgium, at the Foreign Bankers' Association in the Netherlands, Amsterdam, 27 May 2004.

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Ladies and Gentlemen, Members of the Foreign Bankers' Association in the Netherlands,

I am very pleased and indeed I think it is a great honour for me to have been asked to be the keynote speaker at the 2004 Annual General Meeting of your Association.

As you have noticed I have decided to talk about "Challenges for the European Economy" but of course I fully realize that I myself am facing a great challenge this evening, as I am aware that I am following in the footsteps of a large number of distinguished speakers you have invited for your previous lectures. I would only like to refer to Jean-Claude Trichet, Otmar Issing, Eddy George or David Dodge, colleagues or former colleagues within the Eurosystem or the G10 Governors' Group. I hope my presentation will be as interesting as that of my colleagues I have the greatest admiration for.

The European economy is facing many challenges: consolidating the current recovery, redressing public finances which have deteriorated in many countries, reducing unemployment which is still too high and preserving the social cohesion, preparing for the ageing process and in particular its financial consequences, but I think one of them is now the most important: improving Europe's growth potential. Its realisation is a prerequisite for meeting the other challenges mentioned.

From the outset I want to make it absolutely clear that I am neither a eurosceptic nor a europessimist. So, I fully acknowledge and admire the resounding success European integration has achieved in two fields over the past few years.

As a central banker I would of course first like to refer to the introduction of the euro which, as you all know, was brought about in two stages. On 1 January 1999 financial markets started using the euro while the single monetary policy of the Eurosystem was implemented. Three years later the introduction of euro notes and coins led to the general use of the single currency by all economic agents, thereby doing away with national currencies.

This changeover to the single currency was the final touch of European monetary integration and had a profound effect on the deepening of the single market through the elimination of the exchange risk, the reduction in transaction costs and the increase in price transparency. This improvement of the single market will enhance the overall efficiency of the European economy and, other things being equal, also its growth performance.

However, it is doubtful whether the population of our countries correctly perceived the latter advantage. Indeed, the introduction of the euro unfortunately coincided with a severe slump in economic activity: while in 2000 real GDP growth in the euro area reached 3.5 p.c. it declined during the following years to reach a mere 0.4 p.c. in 2003.

Earlier this month European integration achieved another major success.

Ten new member states joined the European Union, which now makes European reunification almost complete. However, this historic event occurred immediately after a period of sluggish economic growth which left the European economy somewhat weakened. Therefore, the enlargement, instead of generating enthusiasm, has in many instances given rise to misgivings among the population and even among the enterprises. The concern regards the possible delocalisation of enterprises and significant job losses.

At microeconomic and sectoral level, the integration of the ten new Member States will undoubtedly entail some adjustments and shifts but overall it should result in a win-win situation. The past decade has already brought a strong expansion of trading links between the old and new EU Member States. As purchasing power in those countries catches up and their markets become more accessible, European firms are set to expand their potential outlets while the continuing dismantling of trade barriers and harmonisation of the regulatory framework will gradually create a level playing field. The expansion of trade leading to increasing specialisation, and hence greater productivity, as well as consumers having a wider choice will produce benefits that are much larger than the costs of integration.

These two recent major events show that insufficient growth is a real cause for concern for the population in our countries which feels insecure about their employment. This factor obscures the achievements European integration has reached and so prevents people from believing in the dynamism of European unification. Therefore weak growth could be a factor entailing growing euroscepticism, especially in Western Europe.

For the coming months a reasonable optimism is justified. While the latest positive signals need to be confirmed by future developments, they underpin the expectation that the gradual recovery in the euro area will continue and will strengthen over time. The conditions are in place.

First, the global economic upturn continues to be robust and broadly based, both geographically and across sectors, and world trade has also strengthened. In this context of a favourable external environment, euro area exports are expected to grow significantly this year and the next.

Second, favourable financing conditions, improvements in corporate efficiency and earnings and the strength of global demand help investment. Over time, consumer spending should also be supported by growth in real disposable income and better labour market conditions.

The latest data point to a stronger than expected recovery of real economic activity in the euro area at the beginning of 2004. According to Eurostat's flash estimate, euro area real GDP increased by 0.6 p.c. quarter on quarter in the first quarter of 2004, after rising by 0.4 p.c. in the fourth quarter of 2003 (revised upwards from 0.3 p.c.).

Concerning the prospects, the slight decline in May in the two business confidence indexes which are the most closely watched in the euro area - the German IFO and the National Bank of Belgium index - does not question the strong improvement recorded since the end of last year.

Obviously the consolidation of the recovery is, as often, subject to some risks and uncertainties. Consumer confidence is still relatively weak in many countries and the strong rise of oil prices is of course not good news for the European economy. There is no free lunch. The strong growth in the United States and Asia has sustained economic activity in the rest of the world, but has also caused a rise in commodity prices. As regards oil, it is clear geopolitical uncertainties also contribute to rising prices. However one should not overdramatise either.The solidity of the euro exchange rate has limited rising oilbills for us. Moreover, owing to energy saving measures and the use of other types of fuel the relative weight of oil in the production of goods and services has declined markedly over the past thirty years.

On an annual basis, the latest public and private sector forecasts point to growth in the euro area of 1.6 p.c. to 1.7 p.c. in 2004 and more than 2 p.c. next year. This is however not a reason to be satisfied and complacent. In the EU or in the eurozone we speak of a recovery when growth is approaching 2 p.c. while in the US they speak of a recession when growth is falling to 2 p.c. ! And, on the other hand, while most of the rest of the world is already enjoying robust growth, the recovery in Europe remains gradual and overly dependent on booming international trade.

What is also needed are efforts to make the European economy more resistant to external shocks as those which have reduced its growth in the latest years and to increase its long term growth potential.

Europe has to cope with a structural problem of low economic growth. The growth performance of the euro area is weak from an international point of view, in particular vis-à-vis the United States: over the past 10 years the American economy has shown an average GDP growth of 3.3 p.c., while the euro area could only reach an economic growth of 2 p.c. The euro area only succeeded in achieving a higher growth rate in 2001 when the United States were hit by a severe but short slowdown. The following years the American economy however showed a much stronger recovery than the euro area and now again acts as the main growth engine for the world economy.

Yet it is important to note that data for the eurozone are averages for twelve countries and that a country like Finland in the euro area (and more generally the Nordic countries) has booked in the most recent decade performances in the field of growth and employment rates which are comparable to those of the US and are much better than those of countries like Germany and Italy.

Given an unequal population growth - it is higher in the US - a further analysis shows that the gap in real GDP growth between the US and the euro area that opened up in the mid-1990s is half the size if measured in per capita terms. The remainder is due to differences in productivity growth (the increase in overall labour productivity in the US, measured by real GDP per person employed, reached on average 1.9 p.c. in the last 10 years, almost twice as much as the 1 p.c. recorded in the euro area) and to a much lower level of labour utilisation in the euro area. In the euro area unemployment rates are currently around 3 percentage points higher, labour force participation rates more than 10 percentage points lower and annual hours worked per employed person lower by more than 300 hours.

Europe is of course not the US. It has its own specificities which should be taken into account. So at least part of the gap in average hours worked between the US and the euro area should be attributed to structural preferences rather than to structural rigidites.

However, when discussing this issue it has to be borne in mind that households also take into account the institutional environment, including tax, social security and pension systems when deciding on their labour supply.

Moreover, the problem to what extent the present European system is sustainable cannot be ignored. The so-called European model has come under increasing pressure from demographic factors. Further policy changes towards stimulating labour supply are inevitable if living standards and social cohesion are to be preserved.

Unlike social preferences and rigidities, macroeconomic policies m ust not be seen as an explanation of the weaker growth in the euro area.

First of all this holds true for monetary policy. As you know, the Treaty of Maastricht unambiguously provides that maintaining price stability constitutes the primary objective of the European Central Bank.

According to the definition of the ECB which was clarified about a year ago and which aims to create a stable anchor for price expectations, price stability implies an annual rise in the harmonised index of consumer price for the euro area below but close to 2 p.c. This objective must be maintained in the medium term. Central bankers can not prevent external shocks, such as a rise of commodity prices on the international markets, from resulting in a temporary rise of inflation. But, they have to preclude second-round effects.

In its conduct of monetary policy, the ECB has already gained a high degree of credibility with market participants as is shown by moderate inflation expectations. These expectations remaining in line with its target the ECB was able to cut its key interest rate to historically very low levels (2 p.c. in nominal terms and actually zero in real terms). Monetary policy thus made its own contribution towards stabilising economic activity in the euro area.

Ensuring price stability, as well as confidence in the euro, is the best contribution to higher and sustainable growth the ECB can make because it also allows for the advantage of low medium and long term market rates which in many European countries are still more important for the financing of investments by enterprises, households and government.

In the fiscal sphere, almost all the governments in the euro zone allowed the automatic stabilisers to take full effect during the recent slowdown, and that effect was often reinforced by discretionary measures. Between 2000 and 2003, the budgetary deficit of general government in the euro area has grown from 0.9 p.c. of GDP to 2.7 p.c. The deficits of some countries have even exceeded the threshold of 3 p.c.

Fiscal policy has thus not been an impediment to recovery. One might however wonder whether the stimulation of the economy intended by the fiscal easing in many countries was not eroded by the adverse impact which such a relaxation of discipline can have on the climate of confidence.

It seems that people in Europe more and more have a “Ricardian perception” of fiscal deficits. They are more aware of the enormous challenges and costs our ageing society entails. People in the different European countries are really worried about the long-term sustainability of public finances. High fiscal deficits will only worsen their anxiety and so incite them to increase their precautionary savings.

In this context, the rules of the Stability and Growth Pact are appropriate. It is not correct to describe it as a fiscal straitjacket. Starting from a budget in balance or in surplus at the peak of the cycle, a country can let the automatic stabilisers fully operate when the activity is slowing down. The main problem with the Pact is, I think, that better incentives are needed to respect fiscal discipline during good economic times.

So I hope that the forthcoming recovery will be the right moment for the European governments now facing budgetary difficulties, to put their finances again on the right track, so that in that field it will be possible to reconcile short time flexibility with long term sustainability. In that case fiscal policy may again become an element of the required lasting macroeconomic stability.

It is by paying more attention to the quality of public finances and by rendering the structure of taxes and that of expenses more growth oriented that Governments can contribute to stimulating Europe's growth potential. I refer to expenditures such as education and improvement of human capital, public investment in infrastructure and research and development. R & D could become a comparative advantage of Europe. At the moment Europe invests 1.9 p.c. of GDP in R & D and is thus lagging behind the US figures and the Lisbon target (3 p.c.).

Over the past years, European policymakers have become more aware of this growth problem Europe is facing. So, in March 2000, during the Lisbon summit, an ambitious strategy was adopted aiming to increase the rate of sustainable economic growth and even to enable Europe to become the most competitive and dynamic knowledge-based economy in the world in 2010.

In order to achieve such a strategic goal the Lisbon agenda has brought together the different strands of reform policies on product, labour and capital markets aiming at promoting a more efficient allocation of resources and at higher growth potential. Moreover, in order to facilitate monitoring of progress with reforms, quantitative targets have been fixed to measure progress in particular on the labour market in achieving for instance higher participation and employment rates.

The Lisbon agenda was excellent in terms of diagnosis. Until now it has however not been given a sufficiently powerful implementation.

One cannot say that there was no progress in the last years in the field of structural reforms, but much remains to be done. The pace of reform needs to be significantly stepped up if the Lisbon targets are to be achieved. The review carried out by the high level group chaired by former Prime Minister Wim Kok provides an excellent opportunity to accelerate the process.

Progress has been most tangible in deregulating and integrating product and financial markets.

Since the introduction of the euro, the pace of financial markets' reform has been impressive. This includes policy-induced reform, such as the Financial Services Action Plan initiated by the European Commission in the spring of 1999. Reform also covers market-led initiatives, as for instance the development of electronic trading platforms. As you know, the different financial markets have reached different levels of integration. So integration in euro money markets was achieved very quickly after the introduction of the new currency while for instance the euro area equity market, despite advances such as the setting up of Euronext, remains among the least integrated. Thus there is still need for continuation and completion. New progress should result from the cohesive and effective interplay of free competition, coordinated action by all market participants and policy enforcement by public authorities.

Much progress has also been made regarding the integration and level of competition in productmarkets. However substantial barriers to free competition continue to exist, particularly preventing the integration of services' markets and effective competition in network industries. Fostering competition in these fields should also contribute to a downward effect on prices. Further regulatory reforms should be accompanied by a sustained reduction in state aid - particularly if it constitutes economically questionable and sector-specific measures. In the end, this will promote the entry of new players, enhance innovation and reduce the tax burden.

High unemployment and insufficient employment rates are still preoccupying. The labour market participation rates of women and the youngest and oldest age groups remain too weak in many countries. Thus far, progress with the implementation of labour market reforms has been uneven in the euro area. In some countries, significant achievements in terms of lower unemployment are already visible. Others are lagging behind. It is important to enhance the flexibility of labour markets to make the whole European economy better able to absorb economic shocks. Reforms are also needed not only to reduce non-wage labour costs and increase incentives for job creation but also to ensure the sustainability of the social security systems.

The challenges are known and the analyses are completed. Now the implementation should be focused on. As I have said at the beginning of my speech, I am neither a eurosceptic nor a europessimist. So I believe Europe can implement the Lisbon agenda. The introduction of the euro was a splendid example of a not easy but successful structural reform. It can be and it should be followed by others.

The framework through which the Lisbon agenda is implemented relies largely on a peer pressure mechanism, mainly depending on goodwill of governments in individual EU countries. The pressure must be reinforced, including by clearly identifying and publicising successful and lagging country cases accross the EU and possibly industrialised countries more generally.

Communication must also be improved. The transition from the pre-reform to the post-reform equilibrium conditions normally takes time and we must recognise that within this period some uncertainty may occur. For this reason the implementation of social reforms requires a strong leadership and a continuous explanation effort. We have to convince our public opinion that our countries would be better off - with more growth and more jobs - if we could deliver the reforms of the Lisbon agenda.

I shall conclude with a last remark: the current recovery of economic activity, as welcome as it is, must surely not constitute a pretext for postponing a program of reforms, as its implementation is essential to achieve stronger and more sustainable growth in the long term.