Guy Quaden: Prospects and challenges of the European economy

Speech by Mr Guy Quaden, Governor of the National Bank of Belgium, at the Swiss Chamber of Commerce, Brussels, 27 October 2004.

*   *   *

Ladies and Gentlemen,

I thank you very much for your invitation to speak this evening on the topic: "Prospects and Challenges of the European Economy".

The European economy is facing many challenges: consolidating the current recovery, redressing the public finances which have deteriorated in many countries, reducing unemployment which is still too high and preserving 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 (1999 and 2002). It was a huge political, economic and technological challenge and it was an impressive achievement.

The finalisation of European monetary integration 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 the following years to reach a mere 0.5 p.c. in 2003.

Earlier this year European integration achieved another major success.

Ten new member states joined the European Union, which now makes European reunification almost complete. With its 25 member countries, the EU now has a population of 455 million people. With the participation of Switzerland we would be still closer to half a billion people. But even without Switzerland the EU as a whole has the third largest population in the world (only after China and India) making it larger than the US and Japan combined. 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 the microeconomic and sectorial level, the integration of the new Member States will undoubtedly entail some adjustments and shifts - it would be naive to claim otherwise -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, Western 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 cost of integration.

These two recent major events show that insufficient growth is a real cause for concern for the people in our countries who feel insecure about their employment. This factor obscures the achievements European integration has reached and so prevents people from believing in the dynamism of the European unification.

For the coming months a cautious optimism is justified. Mainly driven by the strong growth in the US and Asia, economic activity has been higher than expected in the euro zone in the first half of this year. The conditions for a continuation of the recovery remain in place. Economic growth outside the euro zone should continue to support euro area exports. On the domestic side, strong foreign demand and firm activity growth should sooner or later revive investment and employment. At this stage, the signs pointing to a broader-based recovery are mixed, with non negligible variations across countries, e.g. the recovery has been stronger and broader-based in Belgium than in Germany as was confirmed again today by the publication of preliminary figures for the third quarter.

The scenario of an ongoing recovery is, as is frequently the case, subject to some risks. The main risk relates to oil prices. The recent rise in oil prices has been proportionally smaller than in previous episodes, particularly when expressed in euro, and since the 1970's, the oil intensity of production in the euro zone has fallen significantly. Nevertheless, persistently high and even further increasing oil prices would probably dampen both foreign and domestic demand.

Finally, the effects of oil prices on growth and inflation will not depend only on the amplitude and duration of the oil price rise, but also on the appropriateness of the responses of our authorities and economic agents. Lessons learned from the bad experience of the 1970's, when there were desperate attempts to compensate the consequences of the oil shock by lax budgetary and wage policies, must not be forgotten.

Most forecasting institutes expect for the euro zone this year and next year growth rates between 2 and 2.25 p.c. close to the growth potential of the zone. That would be good to have but that should not be a reason to be satisfied.

What is 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 compared to 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.

It is necessary to specify that given unequal population growth further analysis shows that the difference in real GDP growth is half the size if calculated in per capita terms (per head). The fact remains however that since the mid 90's the gap in product or income per head between the US and the euro zone has significantly widened.

Macroeconomic policies are not the explanation of the weaker growth in the euro zone.

First of all this is true for monetary policy. In less than six years the new ECB has gained a high degree of credibility. The euro zone has witnessed a period of low rates of inflation and low levels of short term and long term interest rates. For months the ECB's nominal central rate has been maintained at 2 p.c., that means zero in real terms, and the level of market long term interest rates (the most important rates in the euro zone for the financing of investments by enterprises, households and government), which has fluctuated around 4 p.c., is lower than in the US.

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 risen from 1.0 p.c. of GDP to 2.7 p.c. The deficits of some countries have even exceeded the ceiling of 3 p.c.

Fiscal policy has thus not been an impediment to recovery. One might in fact 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 so called "Ricardian perception" of fiscal deficits. They are more aware of the enormous challenges and costs our ageing society will entail. 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.

The differences in GDP growth per capita between the US and Europe are due to differences in labor utilisation and in productivity growth.The level of labor utilisation is much lower in the euro zone. Three elements stand out. First, labor force participation rates, especially of women and the youngest and oldest age groups, are substantially lower in continental Europe: more than 10 percentage points.

Second, unemployment rates are much higher: currently around 3 percentage points. Third: annual hours worked per employee are 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 rigidities. And in democratic societies people's preferences have to be respected.

However, when discussing this issue it has to be borne in mind that households also take into account the institutional environment and the system of incentives and disincentives in place, 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 will 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.

Last remark on the unequal growth between Europe and the US. At a certain time Europe was able to compensate a lower utilisation of labor through a higher labor productivity - a higher production per hour - but in the last decade its lead in that field has dwindled.

Since the mid-90's there was a marked and surprising acceleration in US productivity growth. The bulk of this acceleration reflects the production and use of information technology. The take-up of new technologies has been slower in most European countries which meant that Europe did not benefit to the same degree from the productivity boost that came from the technology revolution.

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 (I prefer to say modestly: one of the most...).

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 innovation and employment. Moreover, in order to facilitate monitoring of progress with reforms, quantitative targets have been set to evaluate progress in achieving for instance higher labor market 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. In particular progress has been tangible in deregulating and integrating some segments of product and financial markets. But the pace of reform needs to be significantly stepped up if the Lisbon targets are to be achieved.

Insufficient participation rates and high unemployment are still preoccupying and ongoing reforms on the labour market are needed not only to 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. I have generally referred to average data for the twelve countries of the euro zone but we must not ignore that a country like Finland (and more generally the Nordic countries in the EU) has booked in the most recent decade performances in the field of growth and employment rates which are absolutely comparable to those of the US and are much better than those of countries like, for instance, Germany and Italy.

Finally, 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 strong leadership and a timeless 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.