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Opening remarks by Klaas Knot at the panel “The Advanced Countries: Economic Challenges for the Medium Term” during the G30 34th International Banking Seminar Washington, 20 October 2019

On 20 October 2019, one of the panel sessions at the International Banking Seminar was called ‘The advanced countries; Economic Challenges for the Medium Term’. Klaas Knot was asked to deliver a short opening statement. In it, Mr Knot focussed on the challenges the Economic and Monetary Union faces over the medium term, concluding with three concrete recommendations.

I would like to start by thanking the organizers of the Group of Thirty for the chance to participate in this panel. In my introduction, I will focus on the challenges the Economic and Monetary Union faces over the medium term.

Let me start by saying that the concept of the 'medium term' is an intriguing one. From a political perspective the medium term is a place where one kicks the proverbial can to. From a monetary policy perspective, on the other hand, problems in the medium term would typically be cause for immediate action. This asymmetry in policy reactions might be at the core of the institutional frictions facing the Economic and Monetary Union since the global financial crisis.

The twenty years since the formation of the Economic and Monetary Union can be divided into two very different periods. The first decade was characterized by stable inflation and economic growth. In the second decade, our Union has faced a continuum of economic challenges, the seeds of which had been sown during the first decade of apparent stability. In this light, important design flaws of our monetary union have come to the fore. These design flaws left the EMU prone to the build-up of macroeconomic and financial instabilities and left it insufficiently resilient to shocks. The fact that half of the EMU's existence has been defined by these challenges has taken its toll on the public support for further European integration, but for not the euro. And although the clearest manifestation of this backlash is visible outside of the EMU in the form of Brexit, within the euro area the appetite for further far-reaching reforms is at a rather low point as well. This is not surprising if we look back and see how fast, sometimes contentious measures had to be implemented, in response to the sovereign debt crisis.
Strengthening of the fiscal rulebook and the introduction of the European Stability Mechanism were big steps towards further EMU integration. However, in a semi-permanent mode of crisis-management, policy makers had little to no time to involve their constituencies.

The magnitude of the euro area debt crisis was amplified by the fact that channels through which macroeconomic stabilization could take place, were insufficiently developed. As a result, a large part of the adjustment burden was placed on monetary policy. The interventions of the ECB have bought time to enhance the institutional framework and for individual member states to implement much needed reforms.

The question however is, has this time been put to a sufficiently productive use? I am afraid that asking the question boils down to answering it. The underlying economic performance clearly suggests this not to be the case. Since the start of the EMU, convergence was visible between high- and low per capita income member states. When taking a closer look, however, we see that real convergence before the crisis was mainly based on the activation of more production factors, in particular in terms of an inflow of external capital flows into the euro area periphery.

Developments in total factor productivity, on the other hand, had negligible impact on the convergence of real per capita income. As we know from economic literature, productivity growth is indispensable for sustainable GDP growth. After all, it is the only source of sustainable increases in prosperity. But the inflow of foreign capital had mostly stimulated activity in less productive, non-tradeable sectors, including real estate. When these macroeconomic imbalances adjusted during the crisis, real convergence largely reversed.

Whereas now, after the crisis, real convergence has resumed in some parts of the euro area, we see that this reflects mostly a recovery in labor markets, while the cross-border flows of capital have stagnated and there are again few signs of a more efficient allocation of production factors. This suggests that member states are still not reaping the full benefits of their participation in EMU and may leave their economies again vulnerable to shocks.

In this light the recent slowdown in euro area activity, albeit largely caused by external trade shocks, is a firm reminder: further strengthening of EMU is necessary. Without additional action, once more monetary policy will risk ending up as the only, and perhaps stuttering, engine supporting growth. Against this backdrop, I would like to finish my introduction with three recommendations, which I believe should be prioritized.

First, private risk-sharing between member states should be strengthened. This involves completion of the Banking Union, by means of a European Deposit Insurance Scheme. Furthermore, I look forward to new European Commission's proposals to move towards a Capital Markets Union.
The potential contribution of these initiatives is multifaceted. In successful monetary unions they bear the brunt of any adjustment to asymmetric shocks, thereby relieving the burden from public sector stabilization policies. They will foster more efficient and sustainable cross-border financing flows, that will support potential growth throughout the euro area. And they will contain the risk of future imbalances.

My second recommendation: it would be beneficial if future monetary and fiscal policy would, more so than in the past, move in the same direction. There is mounting evidence that monetary policy can reach it goals faster and with fewer side effects if it is aligned with fiscal policies. The combination of a unidirectional fiscal and monetary policy reaction to changes in economic conditions, can create an environment where both public and private investment can bolster economic recovery and support the growth potential.

And thirdly, I should note that, at least at the current juncture, the EMU's design remains a compromise between limited risk-sharing and a large degree of individual control and hence accountability. This implies that member states will remain subject to market discipline. And this places a distinct responsibility on the shoulders of member states, to create the preconditions that enable their economies to flourish within the EMU framework.

Judging by various measures of economic competitiveness, including ease-of-doing-business and strength of the legal system, structural and institutional reforms remain necessary to stimulate potential growth.

So in short, it is all about addressing institutional imperfections within EMU, improving the consistency between fiscal and monetary policies and kick starting structural economic reforms in member states. Notwithstanding the political intricacies of these issues, they can only be solved with credible commitment from public policy makers. Such commitment would enable the EMU to start reaping the economic benefits today from solving the issues that we know we will be facing tomorrow.

Or in terms of the proverbial can: picking it up today will save us cleaning up an undoubtedly bigger clutter in the future, while living in a tidier place in the meantime.

And on that positive note I would like to end my introduction.

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