European Semester Conference

Inter-parliamentary conference on stability, economic coordination and governance in the EU

Strategic investment and reforms in view of enhancing EU's growth potential

Opening keynote by Pierre Wunsch, Governor of the National Bank of Belgium

AS PREPARED FOR DELIVERY

- It is an honour to open this session on strategic investment and reforms to boost EU's growth potential. In these uncertain times, this is an even more daunting challenge than ever before.

- It is of course impossible to do justice to the richness and complexity of the matter in ten minutes. I can therefore only be impressionistic as Monet, the painter, would have been.

- At least since the turn of the century, Europe has been keenly aware of the structural constraints impinging on its economic dynamism. Typically, the policy response has been framed in terms of multi-year plans implying "more Europe" supported by a grand vision and very often big funding announcements in support of transformative projects or policies.

- Some of us remember the objective of the Lisbon Strategy, adopted in 2000, which ambitioned to turn the EU into (I quote) "*the most competitive and dynamic knowledge-based economy in the world.*" All this was to be achieved by 2010 thanks to coordinated and ambitious structural reforms. A similar approach was behind the "Europe 2020" agenda in 2010 or the Commission's *Investment Plan for Europe* in 2014 (or Juncker Plan) which aimed at encouraging more than 300 billion euro in additional investment over 3 years.

- The most recent incarnation of that think-big-spend-big paradigm are the NGEU and Fit for 55 ambitions. Once again, a cocktail of massive investment and structural reforms should make the EU world champions, this time on the climate front, while still boosting growth and sustainable public finances.

- Now, do not get me wrong: we do need structural reforms, and more investments and sound public finances, as much as we need a banking union, a capital market union, a fiscal union, and what not.

- But there is a growing feeling, impression, and maybe even a consensus that we are lagging behind… Behind our own ambitions, but also behind the US and others when it comes to investment, innovation and growth.

- Recently, the title of an article was reading (I did not read the article, one does not do that anymore, but I should have tweeted about it): "The US innovates, China imitates, and Europe regulates."

- This might be unfair, but there is certainly a widespread impression that this is, at least partly, true. And indeed, data do not look great.

    - Data on public and private investment,as well as GDP per capita, shows that despite our many plans, the EA has trailed the US.
    - Looking at a more granular level, we seem to be stuck between the US (with its digital champions and cheap energy) and China (with its significant cost advantages on the very green technologies we wanted to foster: solar panels, EVs, and even windmills.); all this with no obvious positioning between the two.
    - On the energy front, US natural gas is at 10€/MWh. Before the war in Ukraine, we were at around 20€/MWh. The new normal for us is now between 30-50€/MWh… to which we must add an additional 20-30€/MWh for carbon capture and/or blue hydrogen. That is 5 to 8 times higher than in the US. So, yes, one might ask : is there a future for EU energy intensive firms ?

- Clearly, the challenges presently facing the EU are truly transformative. They require extensive reallocation of resources across sectors, the rapid adoption of new technologies, and disruptive innovations. All three involve ample funding and significant risk taking.

- If history is any guide, though, Europe's economy is bad at reallocations (the old sclerosis story) and slower than its competitors at embracing new technologies. We are by now used to the fact that the digital giants of this World are all American (or Chinese). If anything, the fact that Tesla was born in the US came as a shock. But then again, Elon Musk has a way of doing things that is not quite European.

- What I am saying here is that, to some extent, what you see in Europe may be the result of our deep preferences. By that I mean a greater risk aversion than our competitors. And maybe also a stronger preference for leisure? As European elections loom, I detect a fear of greening, a fear of war, a fear of China, and a fear of demographics fuelled by the aging-migration nexus.

- Is Europe doomed then? I don't believe so, but the path to our big goals is relatively narrow and fraught with uncertainties.

- European economies are still rich and resourceful; and they still have some time to take advantage of their current wealth in a way that secures future prosperity.

- However, when thinking about the transformative period ahead of us, a few facts and lessons from the past seem useful to keep in mind.
    - First, throwing massive amounts of money at problems just to mitigate their effects is not a panacea. It might be OK for short-term crisis management, as the response to the COVID-19 pandemic showed. But this is not a longer-term strategy.
    - Second, there is no funding problem. Overall, we still live in a world where too much savings chases too little investment, as shown by interest rates that remain very low when you factor in inflation (the so-called real rates). Debt is not as cheap as it was, but it remains very affordable. The question is why is there too little investment? What are the binding constraints? To be sure, it is not funding.

  - Third, I believe we do have a real issue with our regulatory burden (as well as permitting on the climate front). Even as a central banker, how many times have I not heard: "Well, if we follow the opinion of our legal department, then we just cannot do it". And we are not building anything, just working with computers and data.

Faced with the uncertainties of the day, the name of the game cannot be more protection (of our people, our firms, and our markets). And yet, people will demand it. It is a very difficult political equation.

- The way out is to provide a vision credible enough to change the mindset. This is far more easily said than done, especially in a fragmented society where individuals can choose information sources that suit their subjective priors.

- In my humble opinion, the new mindset will have to recognize some of the difficult trade-offs we are facing. Navigating these trade-offs inevitably creates winners and losers in the short to medium term.

- The new mindset will also have to shift from one where easy money can solve all problems (typically after they happen) to one where we have realistic plans to handle difficult transitions (climate, digital, demographic), as well as communication strategies that better recognize the challenges ahead.

Let me try to briefly illustrate these considerations with climate policies.

Only a small minority lives in denial of the need to act. And I believe that Europe got it right. Its strategy is in my view more credible than the US IRA, which is incredibly costly and detrimental to the US trade partners. [After all, as John Hassler quipped: "If the problem is overfishing, subsidizing chicken will not make it"].

- So where do I see issues in Europe?
- First, and I would say as usual in Europe, the debate has been largely framed as one of "finding" a lot of money, while at the same time reassuring citizens (and voters) that it would not cost much.
- The emphasis on "finding money" is misplaced. It is a matter of spending priorities, for the public as well as for the private sector. A combination of adequate regulations (adequate meaning "credible and predictable") and carbon pricing should shape everyone's incentives to achieve our climate ambitions.
- Second, I think we could and should rethink the official communication around the climate transition. We should be more candid. Specifically:
  - Don't lure people into thinking that greening carries positive opportunities that could augment GDP and create millions of well-paid jobs. As a macroeconomist, it is my job to tell you that the climate transition is a negative "supply shock," one that will reduce our growth potential.
  - So you heard me, this transition is not going to make us collectively richer.
  - To be sure, there will be winners, but also many losers. And we should say it because if public authorities are caught living in denial, they will lose their most precious asset: credibility. Without credibility, the first concrete signs of emerging problems will encourage popular anger and protests. Just look at farmers...

- Admitting what I just said then forces us answer two difficult questions: how much will it cost and who will pay? In providing answers, we must be clear on the uncertainties surrounding our estimates and the policy contingencies we are prepared to activate if problems materialize.
- There is a growing consensus that the costs of the transition are similar in magnitude to a (significant) oil or energy shock, but spread over 26 years, not weeks, as in the 1970s.
- So I am one of those who believe that the aggregate shock to our collective wealth should be manageable.
- But we should still do our homework on the “who will pay ?” part of the question. This requires a granular and realistic understanding of the costs per sector, but also of other political and technical constraints. Think about gas boilers in Germany...

As I am about to close, I must mention the elephant in the room: geopolitics. Everyone understands that global warming is… well, global; and that the EU emits only a small fraction of greenhouse gas. So, the question of who will pay is as much about the different groups in our societies, as it is about other countries around the world, especially the US and China.

In the old world of rules-based international relations, a reasonable hope would have been that international policy coordination could provide a satisfactory solution. However, the recent COPs have dashed my hopes. I will not risk my reputation anticipating what the outcome of the strategic interactions between the 3 big players might be. I will only share a few worries and unanswered questions.

- First, I am worried about the faith one seems to be putting in the Carbon Border Adjustment Mechanism and in industrial policies of all breeds. As I already mentioned, energy prices in Europe put us at a serious disadvantage compared to the US, which have access to cheap energy, do not intend to tax carbon, and have opted to subsidize clean energy. While we could expect a cheaper euro to correct for part of Europe’s competitiveness gap with the US, a weak currency is not a permanent solution.
- Second, although Europe probably never was the most innovative economy, it was good at incremental technological progress, but much less at the disruptive type, which is becoming more important. Besides, looking beyond quantum, superior quality is often associated with our continent: the quality of the products we make, but more broadly, the better quality of life and greater social equity we achieve given a lower GDP per capita than the US. I would nevertheless caution against the sense of complacency that might come out of this line of thinking. Permanently trailing our competitors will ultimately undermine our welfare. That will not be acceptable to the people.
- Third, in the great power game now underway, Europe’s traditional foreign policy doctrine comes under stress. While EU countries operate well in the safe environment of rules-based international relations cemented by international organizations and strong transatlantic ties, it seems to be less effective in establishing a “rapport de force” to its advantage in today’s multipolar and transactional world. The readiness to be shrewd, or even disruptive, on the global stage is not something a politically fragmented EU can hope to deliver any time soon.
- This leaves us with important open questions: How can we preserve our single market while competing with the US and China? How can we be at the same

time agile and rule-based? How can we fulfil our ambitious climate objectives, while being candid about their implications?

At the end of the day, it is all about politics. So, my job is easier than yours. Let that be clear between us.

Thank you very much for your attention.