Towards sustainably higher growth in Europe

Speakers

Klaas Knot
De Nederlandsche Bank , President

1. Introduction

Ladies and gentlemen, welcome to Amsterdam.

It is an honour and privilege to hold the opening speech of the Spring 2016 Eurofi seminar.
I have participated with great interest in several Eurofi conferences before, and it feels good to have this conference now in my home town, the beautiful city of Amsterdam.

I hope you won't mind if I dwell awhile on the history of this city. I want to do so as I think there may be a lesson to be learnt from it for us modern-day Europeans.

This city is known the world over for its canals and canal houses. The grandest of those were built in the 17th century, our Golden Age. They were designed to provide room for a fast-growing elite of merchants; entrepreneurs that had amassed wealth from trade with far-flung corners of the globe.

We can only marvel at what downtown Amsterdam must have looked like at the height of its glory days.
But to help your imagination along, think of Hong-Kong and New York, multiply that by at least two, and you have a fair approximation of the dynamics of this bustling and thriving mini-metropolis four centuries ago. Nowhere in the world did more money change hands on one single day, and nowhere in the world was more money being kept in bank vaults.

Obviously, all the ingredients were there for Amsterdam to develop into the financial capital of that day and age. And that is just what it did, making it the birthplace of financial innovations, such as shares and a stock exchange.

It was clearly a time when we didn't shrink from pursuing our wildest ambitions – a bold mindset, to which our grand canals and the mansions lining them are silent witnesses.

As you'll understand, this city, known for its freedom of religion and speech, worked like a magnet for artists, artisans, and labourers all around Europe and beyond. This made Amsterdam perhaps the most international city of that era.

2. Treaty of Amsterdam (1997)

Given this Dutch tradition of international trade, tolerance and openness to the outside world, it cannot be mere coincidence that the Treaty of Amsterdam from 1997 deals with these topics as well. Although not as well-known as the Treaty of Rome or that of Maastricht, the Treaty of Amsterdam is of remarkable present-day significance.

Under the Treaty of Amsterdam, member states of the European Union agreed on new rules across diverse areas, including on immigration (!), and foreign and security policy.

The Treaty also paved the way for expansion of the European Union. The expansion has been a success, at least in numerical terms. Since 1997, the year that the Treaty was agreed upon, 13 new countries have joined the European Union.

3. European Union in difficult phase

Today, the European Union is going through a difficult phase. Geopolitical tensions at the borders, large migration inflows and threats from terrorism touch upon issues like solidarity and security. Two weeks ago, a referendum in my own country showed that skepticism about further EU integration is on the rise. And the United Kingdom is even questioning its EU-membership in an upcoming referendum.

4. Sustainable economic growth needed in Europe

In this context, I would like to address the issue of how we can raise economic growth in the European Union in a sustainable way. Looking back at the almost 65 years since we began to build the European project, much has been achieved. Higher living standards, a single market and a monetary union.

However, in the wake of the financial crisis, the contribution that the European Union can make to higher living standards is in doubt. Many EU countries are struggling to find sustainable growth after the crisis. Unemployment is estimated at 9% in the European Union as a whole this year, and even at 10.5% in the euro area. From this perspective the skepticism is understandable.

Nonetheless, the majority of member states that joined the EU in 2005 and 2007 are doing quite well, even though they started at much lower income levels. Since 1999 their annual per capita GDP grew by 3.4% on average.

In stark contrast, the 12 countries that originally joined the monetary union when it was formed in 1999 are now lagging behind. Annual GDP per capita grew by only 0.8% on average in these 12 countries. The hope that also the monetary union would contribute to convergence of living standards did not materialize in this group. Quite the contrary.
The countries that entered EMU with a relatively low GDP per capita, such as Greece, Italy, Portugal and Spain, only fell further behind. Their relative GDP per capita decreased from 97% of the EU average in 1999 to 82% in 2015.

It is obvious that the situation needs to improve. European countries need better economic performance, while new member states should ensure that their performance can continue. In other words: the European convergence machine needs fixing.

5. Explanations for low growth

What are the reasons behind this low growth?
Part of the explanation is related to the imbalances that developed before the crisis, such as housing market bubbles, eroded price competitiveness, current account deficits and high public and private debt.

Second, some reasons for low growth may be related to the design flaws in the monetary union, which were exposed during the European sovereign debt crisis. Examples are the negligence of these imbalances within EMU.

It was erroneously thought, for instance, that current account imbalances would be irrelevant in a monetary union.
Another flaw is the lack of compliance with the stability and growth pact. During the period 1999-2014, Luxembourg was the only country of the current 19euro area Member States that managed to keep its budget deficit below 3% of GDP. Seven countries have failed to achieve this in over half of these 16 years. And out of all 19euro area countries, only one, Belgium, managed to lower its public debt between 1999 and 2014.

Third and finally, an important part of the growth problem is structural. Many EU-countries simply have very low potential growth rates. The European Commission projects potential growth in the euro area at only 1.1% per year.
Partly, this very moderate growth potential is the result of structural headwinds, which many developed countries inside and outside the EU are facing.

These include ageing populations and a gradual decrease in the growth of labour productivity. Also, some economists fear that new technological innovations will not yield the same productivity gains as past innovations.

Yet another part of the explanation for low growth is more policy-related, as several countries have failed to adapt their economies to the changes in the economic environment in recent decades. While structural convergence was clearly what was needed, structural differences between euro area countries only widened.

6. How to raise economic growth

Now, if policymakers want to increase growth in a sustainable way, a mix of instruments is needed.

One of them is monetary policy. Unfortunately, the Governing Council of the ECB will convene shortly, which has two dire consequences.

I will have to leave you right after my speech to catch my flight to Frankfurt, Secondly, on the eve of these meetings, Governors, including me, cannot make any comments that may influence expectations about the decisions to be made by the Governing Council.

I will therefore restrict myself to referring to the debate in the media about the limits of monetary policy, and to noting – as I've done before on several occasions – that. in general, central banks can buy time, but cannot solve structural problems.

Obviously, additional measures are required. Unfortunately, budgetary leeway is limited in most countries.

Public debt ratios remain high at 94% of GDP on average, and Europe needs to preserve the credibility of its fiscal rules.

So the most effective way by far to increase growth are structural reforms. Reforms would have a number of important benefits. First, they would increase the resilience and adaptability of EU member states, especially after crises.

The OECD estimates that moving towards best practices in Europa via reforms could raise GDP in member states by 4-7%.

Possible measures include product market reform, as well as liberalization of the service sector and of regulated professions.

Another priority should be to stimulate innovation, R&D and the application of ICT.

It would also be very helpful to increase the ease of doing business and to improve the investment climate.

It should for instance become easier to start a company in Europe, and easier for small firms to grow further.

Finally, the quality of institutions could be improved, leading for instance to higher efficiency of the judiciary system in protecting property rights.

One priority in this context is harmonization and modernization of insolvency laws.
This would allow Europe to free itself from the millstone of non-performing loans, thereby making room for economic growth.

7. How to implement reforms: Europe or member states?

Having explored what course of action we should take, we can now ask how these reforms should be implemented.

First and foremost, reforms are the responsibility of member states, because they reap most of their benefits and bear most of their political costs.

Still, difficult measures are often only taken once their urgency can no longer be ignored. This is why Europe should also stimulate reforms. Mechanisms like Europe 2020 and the Macroeconomic Imbalances Procedure aim to achieve this. Unfortunately, the implementation of policy recommendations remain incomplete so far.

Of the 158 recommendations within the framework of the MIP issued by the EC to Member States

in 2012-2014, substantial or full progress had been made for 5%, some progress had been made for 54% and no progress had been made for 41%.

Obviously, European coordination may need to become more binding in the future.

Strict compliance with the rules is necessary to reduce existing vulnerabilities more quickly, and to better prevent new ones.

That would also reduce the probability of future calls on public risk sharing schemes like the European Stability Mechanism.

The shared responsibility for risks should go hand in hand with better control of these risks.

8. Conclusion

Ladies and gentlemen, allow me to conclude.

I started my talk with a description of Amsterdam in the seventeenth century.

If you have time to explore the city, you will find that, four centuries later, Amsterdam is still as vibrant and attractive to work and live as it was in the old days. The surging house prices are only one reflection of its appeal to newcomers.

To retain its characteristics, the city not only puts much effort in preserving its splendour of the past, but also in continuously adapting and revitalizing itself. As an indication, two weeks ago, it was awarded the 2016 European Innovation Capital Award for its holistic vision on innovation in and for the city.

This may serve as an example for Europe. In my view, policymakers need to propagate:
- that a more integrated Europe is a better place to work and live;
- that together, European countries are better able to cope with financial crises,
with the effects of globalization, with climate change andwith international terrorism.
- And also that together, European countries can get the convergence process
going again, and thus increase living standards for their citizens.

That would provide a positive perspective on Europe, the perspective we had when we began this project decades ago.

Executive Summary

Growth prospects: how to reinforce investment and growth in the EU?

Governor Knot opened the Eurofi seminar with a keynote speech on growth prospects in Europe. Below is a summary of this speech, which is reproduced in full further down in this report.

1. European Union in a difficult phase

Today, the European Union is going through a difficult phase. Geopolitical tensions at the borders, large migration inflows and threats from terrorism touch upon issues like solidarity and security. And the United Kingdom is even questioning its EU-membership in an upcoming referendum. In the wake of the financial crisis, the contribution that the European Union can make to higher living standards is in doubt. Many EU countries are struggling to find sustainable growth after the crisis. Unemployment is estimated at 9% in the European Union as a whole this year, and even at 10.5% in the euro area. From this perspective the skepticism is understandable. Sustainable economic growth is therefore urgently needed.

2. The European convergence machine needs fixing

The majority of member states that joined the EU in 2005 and 2007 are doing quite well, even though they started at much lower income levels. Since 1999 their annual per capita GDP grew by 3.4% on average. In stark contrast, the 12 countries that originally joined the monetary union when it was formed in 1999 are now lagging behind. Annual GDP per capita grew by only 0.8% on average in these 12 countries. The hope also that the monetary union would contribute to convergence of living standards did not materialize in this group. Quite the contrary. The countries that entered EMU with a relatively low GDP per capita, such as Greece, Italy, Portugal and Spain, only fell further behind. Their relative GDP per capita decreased from 97% of the EU average in 1999 to 82% in 2015.

It is obvious that the situation needs to improve. European countries need better economic performance, while new member states should ensure that their performance can continue. In other words: the European convergence machine needs fixing.

3. Explanations for low growth in Europe

Part of the explanation is related to the imbalances that developed before the crisis, such as housing market bubbles, eroded price competitiveness, current account deficits and high public and private debt.

Second, some reasons for low growth may be related to the design flaws in the monetary union, which were exposed during the European sovereign debt crisis. Examples of this are the negligence of imbalances within EMU. It was erroneously thought, for instance, that current account imbalances would be irrelevant in a monetary union.

Another flaw is the lack of compliance with the stability and growth pact. During the period 1999-2014, Luxembourg was the only country of the current 19 euro area Member States that managed to keep its budget deficit below 3% of GDP. Seven countries have failed to achieve this in over half of these 16 years. And out of all 19 euro area countries, only one, Belgium, managed to lower its public debt between 1999 and 2014.

Third and finally, an important part of the growth problem is structural. Many EU countries simply have very low potential growth rates. The European Commission projects potential growth in the euro area at only 1.1% per year. Partly, this very moderate growth potential is the result of

structural headwinds, which many developed countries inside and outside the EU are facing. These include ageing populations and a gradual decrease in the growth of labour productivity. Also, some economists fear that new technological innovations will not yield the same productivity gains as past innovations. Yet another part of the explanation for low growth is more policy-related, as several countries have failed to adapt their economies to the changes in the economic environment in recent decades. While structural convergence was clearly what was needed, structural differences between euro area countries only widened.

4. The most effective way to raise economic growth are structural reforms

Central banks can buy time, but cannot solve structural problems. Obviously, additional measures are required. Unfortunately, budgetary leeway is limited in most EU countries. Public debt ratios remain high at 94% of GDP on average, and Europe needs to preserve the credibility of its fiscal rules. So the most effective way by far to increase growth are structural reforms. Reforms would have a number of important benefits. First, they would increase the resilience and adaptability of EU member states, especially after crises. The OECD estimates that moving towards best practices in Europe via reforms could raise GDP in member states by 4-7%. Possible measures include product market reform, as well as liberalization of the service sector and of regulated professions.

Another priority should be to stimulate innovation, R&D and the application of ICT (Information and Communication Technologies).

It would also be very helpful to increase the ease of doing business and to improve the investment climate. It should for instance become easier to start a company in Europe, and easier for small firms to grow further.

Finally, the quality of institutions could be improved, leading for instance to higher efficiency of the judiciary system in protecting property rights. One priority in this context is harmonization and modernization of insolvency laws. This would allow Europe to free itself from the millstone of non-performing loans, thereby making room for economic growth.

5. How to implement reforms: Europe or member states?

Having explored what course of action we should take, we can now ask how these reforms should be implemented. First and foremost, reforms are the responsibility of member states, because they reap most of their benefits and bear most of their political costs.

Still, difficult measures are often only taken once their urgency can no longer be ignored. This is why Europe should also stimulate reforms. Mechanisms like Europe 2020 and the Macroeconomic Imbalances Procedure (MIP) aim to achieve this. Unfortunately, the implementation of policy recommendations remains incomplete so far.

Of the 158 recommendations within the framework of the MIP issued by the European Commission to Member States in 2012-2014, substantial or full progress had only been made for 5%, some progress had been made for 54% and no progress had been made for 41%. Obviously, European coordination may need to become more binding in the future.

Strict compliance with the rules is necessary to reduce existing vulnerabilities more quickly, and to

better prevent new ones. That would also reduce the probability of future calls on public risk sharing schemes like the European Stability Mechanism. The shared responsibility for risks should go hand in hand with better control of these risks.