# How to achieve stronger growth in the EU?

Opening remarks by Mr Gaston Reinesch, Governor of the Banque centrale du Luxembourg, at the occasion of The Eurofi Financial Forum 2015

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*(Check against delivery)*

Ladies and gentlemen,

Distinguished guests,

At the outset, I would like to thank Eurofi and its President Jacques de Larosière for inviting me to make the opening remarks to this afternoon's debates on "How to achieve stronger growth in the European Union", a highly topical subject, to say the least.

I will focus on the euro area and structure my remarks in two parts.

First, I will touch upon the economic outlook in the euro area. I will do so in light of the European Central Bank's (ECB) staff euro-area macroeconomic projections, which have been published last week, referred to hereafter as the "staff projections".

Second, I will proceed with a broad overview of the issues and challenges of longer term growth in the euro-area and put forward some avenues for reflection and discussion.

The information available from the staff projections indicate a continued though somewhat weaker economic recovery and a slower increase in inflation rates compared with previous expectations. As far as inflation is concerned, the staff projections foresee an annual Harmonized Index of Consumer Price Inflation (HICP) of 0.1% in 2015, 1.1% in 2016 and 1.7% in 2017.[1] In comparison with the June projections,[2] the outlook for inflation has been revised

[1] ECB Staff Macroeconomic Projections for the Euro Area, September 2015.

[2] Eurosystem Staff Macroeconomic Projections for the Euro Area, June 2015.

down, largely owing to lower oil prices and, to a much lesser extent, a slower closing of the negative output gap. Furthermore, taking account of the most recent developments in oil prices and recent exchange rates, there are downside risks to the September staff inflation projections.

Concerning the economic situation, recovery is expected to continue, albeit at a somewhat weaker pace than earlier expected, reflecting in particular the slowdown in emerging market economies, which is weighting on global growth and foreign demand for euro area exports. Domestic demand should be further supported by the monetary policy measures of the ECB and their favorable impact on financial conditions as well as by the progress made in fiscal consolidation. Moreover, the decline in oil prices should provide support for household real disposable income and corporate profitability and, thereby, enhance private consumption and investment.

Overall, this assessment is broadly reflected in the staff projections which foresee an annual real GDP growth of 1.4% in 2015, 1.7% in 2016 and 1.8% in 2017. Again compared with the projections in June, the outlook for real GDP growth has been revised downwards. This is due primarily to lower external demand owing to weaker growth in the emerging markets. The risks to this outlook are tilted to the downside, reflecting in particular the increased uncertainties related to the external environment. Notably, current developments in emerging market economies have the potential to further affect global growth adversely via trade and confidence effects.

Before addressing the second part of my remarks, let me revert to the evolution of the output gap, i.e. the difference between actual and potential output. The negative output gap is expected to narrow gradually over the projection horizon, which is encouraging news. However, it is also necessary to stress that while the output gap is narrowing, it is occurring against a background of weak potential output growth, which is estimated to be around 1% over the projection horizon.

This is below its pre-crisis level. In noting this, we should, moreover, not overlook the fact that since the late 1990s the euro area experienced a steady decline of potential output growth:

from about 2% in 2000, it declined continuously to about 1.5% before the crisis. There is indeed a problem in long-term growth dynamics. This problem is not new but has deepened over time.

With this in mind, let us consider very briefly fiscal and monetary policy before focusing later on structural reforms. Starting with fiscal policy, it should support the economic recovery, particularly through growth-enhancing public investment, material and immaterial, while remaining fully compliant with the Stability and Growth Pact. A full and consistent implementation of the Pact is crucial to maintain confidence in the euro area's framework. This, in turn, would have positive implications for future growth prospects, which should help ensure debt sustainability and be conductive to future fiscal space.

With regard to monetary policy, which has to be focused on the primary objective of maintaining price stability over the medium term, its highly accommodative stance has contributed and continues to contribute to support economic activity and investment, narrow the negative output gap and foster economic growth. Let us also bear in mind the important fact that price stability, as well as financial stability, is a conditio sine qua non for a stable and growing economy. The monetary policy stance currently provides a window of opportunity to implement reforms.

This brings me to the third crucial policy area, which can and should contribute decisively to future growth, namely structural reforms. There exists a large consensus that structural reforms are needed to boost potential output and productivity growth in the euro area and to reduce unemployment which is much too high, especially, but not only, among the youth.

Incidentally, let me say that I prefer speaking more generally of increased productivity rather than increased competitiveness, the latter being a more elusive and relative concept. The world as a whole can become more productive, but it cannot gain in competitiveness. Structural reforms, notably in product and labour markets, but also through actions improving the business environment, can have two key effects and here I refer to ECB President Draghi's

speech this year at the ECB Forum on Central Banking, which took place in Sintra earlier this year.[3]

First, they lift the path of potential output, either by raising the inputs to production – the supply and quality of labor and the amount of capital per worker – and by ensuring that those inputs are used more efficiently, that is to say by raising total factor productivity. Second, they make economies more resilient to economic shocks by facilitating price and wage adjustments as well as a swift reallocation of resources within and across sectors. These two effects are complementary. An economy that rebounds faster after a negative shock is an economy that grows more over time and it suffers lower hysteresis effects. And the same structural reforms will often increase both short-term flexibility and long-term growth. A comprehensive and credible package of structural reforms will therefore help increase resilience and growth and reduce unemployment.

Structural reforms are often considered with a critical eye, if not fiercely opposed. Three considerations are mainly mentioned in this context: the "ugly" argument, which has to be resisted; the "bad" argument, which calls for careful refutation; and the "well meant" argument, which raises an issue that needs to be addressed.

The ugly argument can be considered as a problem of collective action and rent-seeking. Structural reforms touch vested interests.

The benefits of such reforms are large, but spread among the whole economy and are partly backloaded. Disadvantages, albeit globally low, are concentrated in relatively small groups, who are highly motivated to oppose them. This kind of opposition should be resisted and these arguments discarded.

The bad argument has some intellectual merits. It states that in a situation of significant economic shock, structural reforms may have a negative effect on short-term demand. Such a conclusion, implying that structural reforms should be postponed – and here again I refer to

[3] "Structural reforms, inflation and monetary policy", Introductory speech by Mario Draghi, President of the ECB, ECB Forum on Central Banking Sintra, 22 May 2015.

President Draghi's speech[4] – has nevertheless to be rejected. The reason for such a rejection is that the short-term impact of structural reforms does not simply depend on when they are implemented but how, the credibility of reforms and their interactions with other policy measures. And if structural reforms are well designed along such parameters, they can in fact have a largely neutral, if not positive, impact on short-term demand even in adverse cyclical conditions.[5]

Then, there is a line of argumentation stemming from the more general concern of increasing inequality in our economies. In the context of structural reforms, this issue has to be taken seriously. European citizens are sensitive to the problem of increased inequality. Or, successful reforms require the acceptance of citizens and their conviction that such reforms will eventually increase per capita income without adverse inequality effects.

Structural reforms have therefore to be designed in such a way as to avoid increased inequality and, if needed, accompanied by budgetary redistributive measures. For example, and this is also relevant in the more general context of growth, it seems that there is scope in a lot of countries for tax reforms, which could be both efficiency and equality enhancing, whilst being revenue neutral.

All this being said, structural reforms in the euro area are necessary and should be seen beyond the confines of national economies. This is important in order to enhance all possible mutually reinforcing effects and positive spillovers. Further, it would also be helpful to strengthen coordination, minimize national discretion and think of the euro area as being one economy and not the simple addition of 19 economies. The implementation of measures should be enforced and national parliaments should be involved to ensure democratic accountability and local ownership.

So far, I used the term "structural reforms". However, the term "structural policies" might be a more appropriate and all-encompassing terminology. In that sense, let me very broadly mention how other policy areas or initiatives can through different channels contribute to enhance medium and long-term growth: first, innovation; second, the transition to a low

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[4] Ibid.

[5] Let us note that the current accommodative monetary policy and its effectiveness should not be used as an excuse to delay necessary structural reforms.

carbon economy; third, the completion of the Financial Union; and fourth, institutional reforms in the governance of the economic pillar of the Economic and Monetary Union.

Technological progress, product and process innovations are key drivers to long-term growth as recalled by Professor Christopher Pissarides in his presentation at the Sintra ECB Forum on Central Banking,[6] who stated that Europe as a whole was not doing very well in this field, although there were exceptions.

This points to the need to improve the ecosystem of innovation throughout the different stages, from basic research to successful market applications. There is still a too broad and deep Death Valley along this process.

Second, the transition to a low carbon and more resilient economy represents another key challenge in this respect. This is a global problem. Europe is, however, a key player in this field, as the forthcoming United Nations climate change conference in Paris demonstrates. Climate preservation is not only a necessity but also, as continuously stressed for example by Nicholas Stern,[7] an opportunity for the enhancement of the co-evolution of growth and structural change.

Third, the Financial Union has also a strong potential to support future growth. The Banking Union has to be completed and the Capital Markets Union has to be launched successfully. You will discuss that in detail over the next days.

Allow me only to touch on one specific element, which by the way was considered important enough by "The Economist" for a cover story some months ago, with the title "The Great Distortion - A Dangerous Flaw at the Heart of the World Economy",[8] namely the difference in taxation between debt and equity. This point has also briefly been touched upon in the

[6] "Structural Perspectives on European Employment: The Role of Innovation and Growth", Sir Christopher Pissarides, Professor, London School of Economics and University of Cyprus, Paper presented at the ECB Forum on Central Banking, Sintra, 22 May 2015.

[7] See for instance: "Economic development, climate and values: making policy", paper by Nicholas Stern, Chair of the Grantham Research Institute on Climate Change and the Environment, July 2015.

[8] "The Great Distortion - A Dangerous Flaw at the Heart of the World Economy", The Economist, 16 May 2016.

comprehensive Eurosystem contribution to the Commission's Green Paper on Building a Capital Markets Union.

Let me quote part of the relevant paragraph:

"Initiatives in taxation should aim to reduce the preferential treatment of debt financing as opposed to equity financing…

This can facilitate a greater reliance by firms on equity and have a positive impact on their access to other forms of finance. It could also be important to rebalance the financial structure of firms, especially in those countries where the level of indebtedness in the non-financial corporation sector is still significant."[9]

Fourth, and last but not least, there is also a case to contemplate institutional innovation and governance change in the Economic pillar of the Economic and Monetary Union.

Let me on this point quote Mario Draghi's response during last week's monetary policy press conference to a question by a journalist.

"If I look at the ECB – now, of course I am a biased observer here – you would judge that the integration of monetary policy has been pretty successful. Why that? Because we moved from a rules-based system that we had in the 1980s and 1990s to an institution-based system where you have co-decision.

Co-decision in our sense, not co-decision in the way it's been used in Brussels between Parliament and different institutions. So it's a sharing of responsibility and a sharing of sovereignty, within the same institution. And what I have been arguing is that the same path ought to be adopted in other areas, one of which is the budgetary area, where we now coordinate our actions based on a set of rules, one of which is the Stability and Growth Pact. Another one is the six-pack and so on. Now, we think, and I certainly think, that this system is not completely satisfactory, for a variety of reasons that you've seen in the last few years, and

[9] Eurosystem contribution to the European Commission's Green Paper on Building a Capital Markets Union, 2015.

so it would be a good thing if we were to move to a common institution also in the budgetary area. And this is a point that's been made in the Five Presidents' report so it's not only my own view.” [10]

Ladies and Gentlemen,

I hope that some of these inevitably piecemeal and largely incomplete remarks offer some food for discussion for the upcoming debates.

Thank you very much for your attention.

[10] “Introductory statement to the press conference (with Q&A)”, 3 September 2015.