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SPEAKING NOTES

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EPC Breakfast Policy Briefing: Economic recovery in the eurozone: how strong?

Reaction to presentation of IMF Director Michael Deppler

It is difficult to add substance after the comprehensive review presented by Michael Deppler. Let me nevertheless make few remarks, which mainly reinforce what has been said already.

Concerning the short-term outlook, UNICE has published two weeks ago its forecasts where growth is expected this year to reach 2.5% for the euro area and 2.9% for the EU as a whole.

The three main drivers are strong global demand, high profitability and improved labour market conditions. But growth is already expected to level off to potential next year (2% for the euro area, 2.3% for the EU). This illustrates the fragility of the current growth momentum.

Beyond the more anecdotal impact of the VAT hike in Germany in 2007, two important factors put a lid on outlook: weak productivity growth and unsustainable public finances.

Let me say few words on each of these subjects, starting with productivity.

Priority 1: the recovery will not be sustained without a productivity revival

Despite the cyclical upturn, UNICE estimates that hourly labour productivity growth in the euro area will remain below 1½% over the next two years.

With this weak productivity momentum, it is difficult not to worry about upcoming challenges, be it demographic ageing, global imbalances, but also the development of competitiveness imbalances within the euro area.

Where is this productivity problem coming from? As nicely put in a recent paper by Philippe Aghion from Harvard University, the trouble is that Europe, and the euro area in particular, continue to have the institutions and policies of a "catching-up" economy. In this growth model, structural rigidities are less of problem because technological cycles are longer and protecting incumbent firms and workers does not hamper growth excessively.

But Europe is in a different stage today, and its growth model relies more and more on innovation and adaptability. This is where Europe is not so good at, as reflected in the trend decline in TFP growth shown in one of the slides of Michael Deppler.

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Mr. Deppler demonstrates quite convincingly that competition and labour market flexibility is good for employment, and does not imply inequality in society. I would strongly emphasise that these two elements are of course essential for productivity as well.

First, competition is probably the most powerful, and cost effective, way to foster innovation and productivity, simply because it helps new companies with good investment projects to prosper and gain market shares. But we see that European markets continue to be largely fragmented and competition distorted by burdensome regulations. There is here a huge potential for productivity improvements, especially from deepening the integration of services and capital markets, as was explained earlier.

Second, and this partly follows the same reasoning, we need to make a link between the current debate on flexicurity and the productivity challenge in Europe. The big drawback of rigid labour markets is that they reduce the speed of adjustment to change. When there is a positive shock, like the ICT revolution in the late 1990s, this comes with slow technological diffusion and insufficient productivity growth.

I don't mean to say that labour market flexibility is the universal remedy, and it must be complemented in particular by good education systems and efficient labour market institutions. But flexibility must be one important pillar of the reform agenda looking forward, and we must ensure that it is equally distributed in the labour market rather than born by some segments only.

Now turning to fiscal policy …

Priority 2: there is still a long way towards sustainable public finances

Deficits are generally expected to decline over the next few years. This is good news but if we look closer we see that it is mostly a cyclical improvement on the one hand and the result of excessive deficit countries making extra efforts on the other.

Countries that have a deficit already below 3% are showing more limited interest in taking new measures in a stronger growth environment.

But why is this a problem for the recovery?

First, a lack of fiscal discipline reduces the central bank's capacity to keep interest rates at a low level.
Second, ageing cannot anymore be considered a long-term issue, and people will expect more painful adjustments in the future if measures are not taken now that the economy is strong.

But there is another, equally important, problem: in the euro area, with a single monetary policy, fiscal policies become the main instrument to absorb country specific shocks, and avoid that these end up in overheating and overcooling episodes at the national level.

Fiscal policies are not playing that stabilising role right now. What we see instead is that governments become less willing to upset vested interests when growth is strong and they are often encouraged by economists, who have a tendency to take cyclical improvements for structural ones.

An extreme example of this is Portugal. We know today that it had, back in 2000, a structural fiscal deficit of more than 4.5% of GDP. This mean of course that there was insufficient consolidation during the previous years of strong growth.

But in real time, that is back in 2000, the structural deficit was estimated, including by IMF, to be more than twice lower than known today. The awakening as been very painful for Portugal and was followed by years of weak growth, punitive fiscal consolidation and many reforms still to come to rebuild competitiveness.

This kind of experience needs to be avoided in the future, notably because it can be destabilising in monetary union if larger countries become stuck in these drawn-out adjustments.

We have said this to Jean-Claude Juncker yesterday at the EU Macroeconomic Dialogue, and we have asked in particular to:

- First, strengthen the preventive arm of the SGP, by exerting more pressure on countries in a recovery phase
- Second, set concrete deadlines to reach the agreed medium-term budgetary objectives
- Third, reinforce structural reform coordination to internalise policy spill-overs that exist between countries sharing the single currency

Allow me to finish with few more words on the ECB…

Priority 3: ECB need to take better account of exchange rate risks

The current monetary policy stance is appropriate, and we support in particular the ECB's emphasis on anchoring inflation expectations at a low level.

This is particularly important in the euro area, because prices and wages adjust very slowly, so letting inflation overshoot has more negative consequences for future growth than in a more competitive economy like the US for instance.

This said, we are less keen than the IMF on the need for further interest rate hikes at this stage. We consider in particular that the ECB is currently paying insufficient attention to exchange rate risks and perhaps some excessive attention to wage risks.

We see it today, downward pressures on the dollar are re-emerging, and the ECB should be careful that this does not translate into a significant real appreciation of the euro. We are already above 1.30$ per euro and this is very close to the pain level for the euro area economy.

Given the risk of further appreciation, the ECB should probably lean on the side of caution today, and take a pause after its announced hike in December. Anyway, a pause would be perfectly reasonable because interest rates are close to neutrality and inflation appears contained.

In fact, beyond the recent oil price decline, we find no reason to be excessively alarmed about wage developments, at least at the euro area aggregate level.

The reason is clear: global competition, raising labour participation and net migration are containing wage pressures and we trust that social partners will continue to act responsibly in the future, and privilege sustainable labour market improvements over short term gains.

To conclude:

Europe is experiencing a recovery, but as usual in such context, there is a risk in structural difficulties becoming less apparent and reforms being delayed. These have been typical mistakes of the past, which have led to a weak growth and growing imbalances within the euro area.

The current period running up to the EU Spring Summit will tell if we have collective learned from these mistakes and if we can build a consensus on the need for more reforms, rather than put them aside until the next downturn.

Thanks for your attention

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