Reviving Growth in Europe

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It is a pleasure for me to be here today, and I want to thank the organizers for inviting the IMF to give its perspective on how to revive growth in the European Union.

There is no denying that Europe today is in an extremely difficult situation. The pressure has been relentless for many months now, and it will unfortunately take further efforts to restore confidence in the European Union's economic future. The topic of today's conference —finding new sources of growth—will ultimately determine whether we are successful in that endeavor.

As I was preparing for this speech, I was reminded of Robert Schuman, one of the founders of the European Coal and Steel Community. This month, 62 years ago, he and his fellow politicians issued their call for an integrated Europe, starting the process that paved the way for the European Union we know today.

Schuman's dream was simple: He wanted an economic union, a sharing of strategic resources in Europe that would "make war not only unthinkable but materially impossible." At the heart of his vision was the idea that economic growth and shared prosperity would finally bring peace to Europe.

By that measure the project has been a resounding success. The EU has expanded to 27 member states and the economic union has grown ever deeper, including a common market and, for 17 countries, a shared currency.

And yet, today, the crisis afflicting some members of the euro area is threatening to undo those historic achievements. So where do we stand, and what needs to be done? In the next 15-20 minutes, I will look at what we think could be done to support growth in the short term, before turning to reforms that are needed to boost long-term growth and complete the process of European integration.

The big picture

Let's start with the big picture. The threat of a sharp global slowdown has in fact eased since last year, thanks to improved economic data coming out of the United States and better policies in the euro area. But the recovery remains fragile.

The challenges are daunting and concern every country in the world, not just in Europe. We at the IMF have been encouraging all our member states to enact policy measures that collectively can help pull the world economy out of its current weak state.

But there is no denying that Europe remains at the epicenter of the current crisis. It is essential to build on the considerable progress that has already been made to overcome the deep challenges facing the region.

Where Europe stands now

From the IMF's perspective, what more needs to be done? First, let's not forget how much has already been done to address the crisis.

The hardest hit countries—Greece, Portugal, and Ireland—have all undertaken unprecedented fiscal consolidation and are carrying out ambitious structural reforms, with financial assistance from the EU and the IMF to help ease the adjustment.

Efforts on the ground in individual countries have been supported by actions at the European level. EU leaders have improved fiscal governance and strengthened the firewall, and the European Central Bank has provided liquidity support on an unprecedented scale.

But despite all these efforts, financial and sovereign stresses remain elevated in many countries. Markets are worried about the ability and commitment of some European governments to rein in fiscal deficits, contain the crisis, and revive growth. Possible contagion from so-called tail risks have come to be seen as more likely. And the negative feedback loops between sovereigns and banks are still in place.

Those are the economic costs. But let's not forget what this crisis really is about: human lives. High levels of youth and long-term unemployment in Southern Europe risk creating a "lost generation," with lasting consequences for growth.

In Greece, for instance, the overall unemployment rate stands at more than 20 percent. For young people, the rate is above 50 percent, and the same is the case in Spain. In Portugal, more than 35 percent of young people cannot find a job.

Increased social and political tensions are threatening to undermine public support for the very reforms that are meant to put the economies back on track. The biggest problem is the lack of growth. If we are not successful in finding new sources of growth, it is very hard to see how tax revenues can recover, debt ratios decline, and weak banks restore their health and start lending again. Public support for reforms, so vital for success, will almost inevitably suffer as a result.

Finding new sources of growth

Reviving growth is no easy task. Growth and productivity trends in Europe have fallen behind peers over the past decade, reflecting slower productivity growth. Within the euro area itself, there is divergent economic performance. Portugal's economy, for instance,

contracted by 2.2 percent in the first quarter of 2012, whereas Germany grew by 1.2 percent. The differing growth trends are exacerbated by a growing gap in terms of competitiveness, leading to the severe imbalances within the monetary union that we see today.

Unfortunately, there is no magic bullet to spur growth and job creation. Crisis-hit countries in Europe will only be able to revitalize their economies by selling more goods abroad and creating new jobs in the private sector.

This challenge is complicated by the constraints imposed by the eurozone**.** In a context where the exchange rate cannot be devalued and productivity increases only take hold over time, improving competitiveness unfortunately requires a reduction in costs, including labor costs. As we have seen, that is an extremely painful process for the crisis-hit periphery of the euro area. People who lose their jobs and see their pensions cut rightly ask why they have to bear the burden.

These questions should be asked—and answered. But when we look at the crisis-hit economies in the euro area, we should not forget the wider context. What many countries in Europe are going through right now is a correction of the very large increases in wages that took place in the period up to the global economic crisis.

In Greece, for instance, wages have increased faster than productivity growth for years. Unit labor costs in manufacturing—which is a key measure of competitiveness – increased by about 30 percent from 2000 to 2008, while they declined by 8 percent in Germany.

The process of adjustment is underway, in Greece and elsewhere. It is so far happening largely via lower imports, but relative prices are beginning to adjust too: core inflation has lately slowed faster in the euro periphery than in the core.

Regaining competitiveness is a bit like running a marathon. Many reforms, especially of the structural kind, take time to show results, and it is easy to hit a wall when vested interests resist change. To make it to the finish line, it is crucial that European policymakers keep up momentum.

In this context, I want to emphasize two policy fronts we at the IMF think are particularly important: macroeconomic policies to support demand in the near term, and further progress in structural reforms to raise long-term growth and complete the process of European integration.

Supporting demand in the short run

We all know that fiscal consolidation—reducing deficits by cutting spending or raising revenues—can stifle growth. When a number of countries need to engage in fiscal consolidation simultaneously, the negative impact on growth is reinforced. Getting the pace of fiscal consolidation right is therefore of paramount importance, especially given the current context of weak growth and employment.

In Europe, there is no doubt that fiscal consolidation through credible medium-term plans must happen. Front-loaded fiscal consolidation measures are absolutely necessary for the most heavily indebted states.

Overall, fiscal adjustment plans for this year are broadly appropriate in Europe. In a few euro area countries, however, the nominal fiscal targets for 2013 agreed before the current slowdown in growth may prove too pro-cyclical and may need to be adjusted or at least expressed in structural terms.

The Stability and Growth Pact's excessive deficit procedure does allow for some flexibility in deciding how fast to bring deficits below 3 percent of GDP. Should economic conditions worsen, this flexibility should be used to revise deadlines for meeting the targets. Consideration could also be given to specify the targets in cyclically-adjusted rather than nominal terms, so that the automatic stabilizers can be allowed to work.

Monetary policy also plays a crucial role in terms of supporting growth in the short term. With price pressures expected to decline, this means the European Central Bank could consider further expansionary measures to prevent aggregate inflation slipping far below the target of keeping inflation at or below 2 percent.

Restoring the health of the financial sector

Well-functioning credit markets are another important element in terms of relaunching growth, both in the near and medium term. For structural reforms to pay off, sectors with growth potential must have access to financing. This is particularly important for small and medium-sized companies, which are more dependent on banks than larger firms for credit. A healthy and well regulated financial system is also critical for restoring investor confidence and preventing future boom and bust cycles.

Even though the reform agenda remains unfinished, much progress has been made since the global economic crisis first hit in terms of improving financial supervision and regulation, both at the national and EU levels.

One example of a country that suffered greatly from the lack of oversight and proper regulation of banks prior to the crisis, but has since made impressive progress in terms of overhauling its financial system is Ireland. The banking system has been restructured and the domestic banks recapitalized on the basis of stringent stress tests and independent loan loss forecasts. The priority now is to restore the long-term viability of banks and restart lending.

Spain is another example of a country that suffered from overlending into the real estate sector during the boom years. It, too, is carrying out a much needed restructuring of its financial system. The set of measures that have been recently announced by the Spanish authorities to address financial sector weaknesses demonstrates their resolve to ensure the stability of the banking system. Decisive follow-through is needed to help boost confidence and support growth.

Reforms to boost long-term growth

Let me now detail the second policy front that will have an impact in the medium- and long term. There, I see two challenges. First, countries will need to implement comprehensive structural reforms to raise their growth potential and facilitate the rebalancing of their economies. Second, at the regional level, EU leaders should aim to complete the architecture of monetary union.

Potential benefits from structural reforms are likely to be substantial over the medium term, though their benefits may not be obvious in the short run. Simulations by the IMF for the 17 euro area countries suggest that eliminating 50 percent of euro area countries' gap with OECD best practices in labor and product market policies could boost GDP growth by up to 4½ percent over five years.

The study also shows that there are significant gains to be made when structural reforms are implemented simultaneously. About a quarter of additional growth is expected from positive cross-country and cross-reform spillover effects.

The past experience of the Netherlands and Sweden attest to the substantial benefits that can be derived from comprehensive structural reforms. In the Netherlands, the employment rate increased from 53 percent in the 1980s to close to 67 percent in 2011. In Sweden, annual labor productivity growth increased from 1 percent in 1977-92 to 2.5 percent in 1992-2007.

Politicians have a tendency to overestimate what they can achieve in the short run and underestimate the impact they can have in the long run. But well-targeted structural reforms really do pay off if governments manage to stay the course and see implementation through.

The key is to design reforms that are closely tailored to each country's unique challenges. The problems relating to competitiveness vary even among the crisis-hit countries in Southern Europe. A lack of competitiveness was more acute in Greece and Portugal than in Spain, for instance, which enjoyed strong export growth in the years preceding the global economic crisis. And Italy remains pretty competitive even though it also needs to reform. But common for all countries is the need to improve competitiveness and invest more in human and physical capital.

In Southern Europe, the most critical issue is to improve the efficiency of the tradable goods sector. A fall in relative prices in the south vis-à-vis the north can facilitate this process. Take the example of tourism. A hotel room in Spain costs 50 percent more than in 2000 and vacation packages cost 22 percent more. In Germany, hotels are only 15 percent more expensive today, and the cost of vacation packages has barely changed in 12 years.

Several policies can help countries regain competitiveness:

- **Reforming labor markets**. Labor market reforms should be designed to make labor markets more inclusive and help achieve the needed price realignments. Policies to reduce the duality of the labor market, reform the wage bargaining system, and promote

higher labor mobility are all helpful in that regard. Active labor market programs, possibly financed by EU funds, can also bolster employment in the short term.

- **Lowering regulatory barriers.** Making it easier for firms to start up or close down, simplifying tax systems, and providing support for small- and medium-sized companies that are trying to gain a foothold in international markets will also improve competitiveness in most southern European countries.

- **Increasing investment.** Another key ingredient for growth is investment. Growth-enhancing public investment could be facilitated by increasing common resources available for new projects through the EU budget and the European Investment Bank. Project bonds for infrastructure investment and redirecting EU funds toward projects that can have a big impact on growth in a number of countries should be given priority.

Fiscal devaluation and nominal wage and price restraints can foster the process of internal devaluation in the short run, while minimizing the loss of purchasing power of households.

Finally, reversing the competitiveness gap within a currency union requires that domestic demand must outpace output somewhat in Northern European countries with current account surpluses. In contrast, Southern European countries with current account deficits must aim for higher net exports. These developments will be accompanied by higher inflation in the north than in the south.

Further integration at the European level

To complement reforms at the national level, EU governments will have to take further steps to integrate their economies. Though Europe has a single market for products, the single market for financial services is lagging. This is in stark contrast to other currency areas. Decisive steps toward more complete financial integration would complement the growth agenda and weaken the adverse bank and sovereign feedback loop.

Such steps would involve providing banking support from a common resource pool independent from national sources, sooner rather than later. To ensure that banks which receive pan-European support are properly restructured and supervised, these banks could over time be made subject to centralized regulation and supervision, through a joint bank resolution authority with a common backstop and a single deposit insurance fund.

The introduction of a common backstop for a pan-European financial system would entail some fiscal risk-sharing, but restoring stability and confidence will require additional pooling of sovereignty. Greater fiscal integration would contribute to lowering sovereign yields and would likely improve the ability of countries to access markets to finance their debt. Deepening the single financial market and developing a pan-European financial stability framework would decouple banks from sovereigns and reduce deleveraging pressures, thereby facilitating the availability of credit and investment.

Conclusion

I have outlined a number of reforms, which we at the IMF think are needed at both the national level and the EU level to strengthen growth in the short and medium term.

Let me make one final point. In many countries, reform fatigue is setting in. Adjustment of the kind Europe is going through right now is extremely difficult. The IMF has learned the hard way how important it is to protect social cohesion in crisis-hit economies—and how hard it is to achieve at a time of tight fiscal constraints. In our recent programs in Europe, we have worked closely with governments to protect social spending and jobs where possible, even when overall spending has to be cut.

For governments, explaining the rationale of reforms to the public is now more important than ever. Losing public support now, at this critical juncture, risks negating the efforts of the past two years, and will set Europe back.

Let me end here with a quote from another of Europe's great statesmen, Jean Monnet. "People only accept change when they are faced with necessity, and only recognize necessity when a crisis is upon them," he said. It is time to accept necessity, and to step boldly forward to complete the reform agenda that will restore Europe's growth and enable its future.