

## Brussels Economic Forum

### Session 1 "The Economic Outlook : Weighing the Risks"

In his opening remarks, **Commissioner Almunia** emphasised the need for Europe to address the challenges posed by globalisation and the ageing of populations. He expressed his confidence that – despite downside risks from high and volatile oil prices and recent exchange rate movements - global growth will continue to be strong at this juncture and the recovery in Europe will stay on track. But he also stressed that the renewal needed in Europe is not just about an upturn in the numbers; it is also about our willingness to evolve and adapt to a fast-changing and interdependent world. Europe must find new and better ways to create new activities and jobs on the one hand, while supporting the inevitable adjustment process on the other. This is of course what the Lisbon strategy sets out to do. Indeed, innovative and competitive economies are necessary to face global competition, and social models need to be modernised in order to foster growth and provide the so-called "flexicurity", in other words helping and protecting *people* rather than specific *jobs*. As regards enlargement of the EU, Commissioner Almunia – while referring to the clear economic success of consecutive waves of enlargement, including the most recent one – stressed the need of thorough and careful preparation of any further enlargements as a key condition to obtain similarly good results. He concluded that Europe can look forward with hope and a clear sense of what needs to be done: (i) strengthen Economic and Monetary Union by fostering an open and dynamic single market (ii) step up the implementation of a comprehensive set of structural reforms in product, services, labour and capital markets, (iii) invest more in human, physical and knowledge capital, and reorganise our economy to fully benefit of our resources.; and (iv) last but not least it is important to remind ourselves that Europe is above all a political project built on sound economics. Thus, following the one year reflection period post French and Dutch referenda, the debate on the Future of Europe is now back on the agenda.

**FAN Gang** addressed the issue of global current account imbalances and of what he labelled "currency asymmetries" from a Chinese perspective. He pointed out that China's net exports have actually been relatively small in the past couple of years, averaging some 2% of GDP. Fast rising exports have been matched by imports growing almost in parallel, albeit not from the US but mainly from other Asian countries. The increase of foreign currency reserves was much higher than the current account surplus due to capital inflows (for example, in 2004 accumulation of 200 bn US \$ in foreign reserves, while the current account surplus was only 30 bn US \$.). He acknowledged the high domestic savings rate in China, but pointed out that China also spends a lot on investment and the import of commodities. In consequence, according to his view, it is not China's national savings that should be blamed for the high US current account deficit and a sharp revaluation of the Renminbi cannot be the solution to the underlying problem. He suggested that the current exchange rate policy in China of a "managed float" is the correct approach and should allow for a gradual appreciation in line with wage and productivity developments. He concluded with some reflections on the role of the US \$ as international currency and the implications of a US \$ devaluation.

In his intervention, **Malcolm Knight** addressed three key questions: Are the current global imbalances sustainable? If not – as he would strongly argue -, why have they persisted for so long? And finally, if adjustment is inevitable, what can policy do to help engineer a relatively

smooth adjustment process. He pointed to the huge cumulated effect of current account imbalances over the past couple of years leading to very large stocks of external assets and liabilities relative to GDP and stressed some of the highly unusual patterns, in particular the fact that emerging countries are financing a capital-rich country such as the US; moreover, looking at US net savings per sector it is astonishing to see that net corporate saving is positive, while both government and private household net savings are significantly negative. Mr. Knight suggested three main reasons why such an imbalanced situation could persist for so long: (i) Savings have been high in China and elsewhere in Asia, but with the exception of China, investment has remained subdued in Asia after the crisis in the end 1990s (ii) a reluctance to let Asian currency appreciate has allowed to finance growing US current account deficits, and (iii) low interest rates have supported US consumption and residential investment. As a market-driven correction alone could impose very large adjustment costs, the resulting "homework assignments" according to Mr. Knight are action to address the US fiscal imbalance and to raise the level of household savings, to strengthen euro area growth, and to liberalise domestic interest rates in China to allow for more efficient investment.

The theme of the intervention of Prof. **Mario Monti** was expansion of the euro area, which he interpreted in a two-fold way: the geographic expansion of the area by including new members and the economic expansion of the area by stimulating potential growth. With respect to euro area enlargement, he stressed that the undeniable benefits of the euro also carry a cost and that the associated "discipline" requirements have been sometimes neglected and/or underestimated. As a result, persistent divergences in growth and inflation do cause problems for the functioning of EMU. He argued that in this context potential benefits of joining the euro area are higher for new entrants, but also the potential costs of adopting the euro. The Maastricht criteria may not be fully appropriate to deal with the problem, as they are neither necessary in some areas (such as the fiscal deficit criterion), nor sufficient in others (such as inflation control), and he stressed the treaty requirement of a high degree of sustainable convergence. Turning to the growth performance of the euro area, Monti noted the wide cross-country variation in growth which suggests that neither tax pressures nor euro area membership per se could explain the differing growth performances. In his view, modernising the European social market model is crucial, comprising of better delivering social models and an effective embracement of the market economy. Monti noted with serious concern that the euro area has less single market in some aspects and appears to want less single market than in previous times and urged European societies to re-acquire ownership of the social market economy model.

**Angel Gurría** emphasised that the relatively good short-term outlook should support the efforts to tackle the medium and long-term challenges for Europe. He argued that the income gap to the US of about 30% in GDP per capita terms is large enough to be of concern, even more so as the gap is widening due to diverging productivity developments. He stressed the importance of competition as a key driver for innovation and growth and the need for thriving tertiary education, with the latter requiring more funding but also higher rewards to excellence. He called for a reduction in red tape and better regulation to facilitate the entry and exit of firm and more flexible labour market regulation including tax-benefit reform, less restrictive hiring and firing regulations and the reduction of obstacles to labour mobility. Among policies that do not work, he mentioned various forms of "work-sharing", including early retirement schemes, obstacles to cross-border FDI, unfair state-aid or other forms of open or disguised protectionism. He pointed out that "reform packages" have tended to perform better than piecemeal reform and argued that product market reforms could pave the way for labour market reform.

**Daniel Cohen** started from the observation that US potential growth at a rate of 3.5% is 1.5 percentage points higher than EU potential growth which runs at 2%. According to his view one third of the growth difference can be attributed to "demographics", one third is related to a lower degree of ICT production and diffusion, and the final third is attributable to lower productivity growth in non-ICT sectors, in particular in non-tradeables. The "demographic component" points to the importance of labour market institutions, such as early retirement schemes, which are essentially country-specific and should be dealt with at the individual country level. The "ICT component" shows the need for Europe to address research, innovation and tertiary education, both at the individual country and the Community level. As regards productivity increases in the non-tradeables sectors, Cohen offered some reflections on the role of the single market, exemplified by the debate about the services directive. In the final part of his intervention, Cohen expressed some concerns about a new volatility in the euro area and the adequacy of the existing fiscal framework against a background of global imbalances which could imply a very weak US \$ for the next decade.