NBP Narodowy Bank Polski

NBP Biannual EU Presidency Lecture
Occasional Paper No. VII

Klaas Knot

Beyond the Horizon of the Dutch Presidency: A Central Banker's Perspective

The views expressed are those of the author and do not necessarily reflect those of Narodowy Bank Polski.

Enquiries should be addressed to:
Narodowy Bank Polski
International Department
International Conference Division
00-919 Warsaw, 11/21 Świętokrzyska Street
E-mail: conference@nbp.pl

Layout and print:
NBP Printshop

Published by:
Narodowy Bank Polski
Education and Publishing Department
00-919 Warszawa, 11/21 Świętokrzyska Street
phone: +48 22 653 23 35, fax +48 22 653 13 21

http://www.nbp.pl

Warsaw, February 2016

About the *NBP Biannual EU Presidency Lecture*

The initiative of the NBP Biannual EU Presidency Lecture cycle has been established to provide an opportunity to present the views of the central bank governor of the EU Member State currently holding the Presidency of the Council of the European Union on the Presidency priorities and key economic issues. The lectures are addressed to the participants from Polish financial and economic sector, among others representatives of the diplomatic representations, public administration, private sector, academia, independent research institutions.

The seventh lecture entitled Beyond the Horizon of the Dutch Presidency: A Central Banker's Perspective, was presented in Warsaw by Mr Klaas Knot, the President of De Netherlandsche Bank, on 3 February, 2016, during the Dutch Presidency.

Klaas Knot

President
of De Netherlandsche Bank

Prof. Klaas H. W. Knot has been President of De Netherlandsche Bank since 1 July 2011. In this capacity Mr Knot holds seats on the Governing Council, the General Council and the European Systemic Risk Board of the European Central Bank as well as on the Financial Stability Board, besides being a Governor of the International Monetary Fund and a member of the Board of Directors of the Bank for International Settlements.

Mr Knot holds several secondary positions. He is chairman of the Koning Willem I Foundation, the Nicolaas G. Pierson Foundation, the Supervisory Board of the Teylers Museum and the Supervisory Board of CliniClowns Foundation. Since 2005, Mr Knot has been Professor of Economics of Central Banking at the University of Groningen and, with effect from 2015, he is Professor of Monetary Stability at the Faculty of Economics and Business of the University of Amsterdam. Mr Knot has published a variety of articles in leading international journals in monetary and financial economics.

Before joining the Governing Board of DNB, Mr Knot was Deputy Treasurer-General and Director of Financial Markets at the Dutch Ministry of Finance (2009–11). From 1995 to 2009 he held several posts at DNB, varying from Senior Economist to Director of the Supervisory Policy division. At two intervals during this period, Mr Knot worked at the International Monetary Fund (1998-99) and the then Pensions and Insurance Supervisory Authority (2003-04).

In 1991, Mr Klaas Knot graduated with honours in Economics at the University of Groningen. In 1995 he obtained a doctorate in Economics. Mr Knot was born on 14 April 1967 in Onderdendam. Mr Knot is married and has two children.

Beyond the Horizon of the Dutch Presidency: A Central Banker's Perspective

Klaas Knot

President of De Netherlandsche Bank

Warsaw, February 3rd, 2016

Contents

RAISING GROWTH POTENTIAL IN THE EUROPEAN UNION IN A SUSTAINABLE WAY

Introduction

Ladies and Gentlemen, President Belka, dear Marek. It is also clearly my privilege to come here to Warsaw and to give this *Biannual EU Presidency Lecture*. A number of esteemed colleagues have already preceded me, and I hope that I can also add something of value to the ongoing debate about the future of the European Union. And Warsaw is actually the perfect backdrop for a lecture on Europe. Walk around the city, like I did this afternoon, and you feel how much it echoes European history. The buildings for example, they remind us of how much Warsaw suffered during the Second World War and also how much has been rebuilt in the past few decades. And the atmosphere of the Old Town makes me realize how much European countries have in common, for instance in terms of architecture. More generally, Poland has proven to be fertile ground for creative people. Creative people that have contributed to European culture over the centuries. Physicists – Copernicus and Fahrenheit – come to mind, as does, of course, the composer, Chopin. But also don't forget the footballer Robert Lewandowski who last September scored an incredible five goals in nine minutes.

European Union in difficult phase

In today's lecture, I would like to address an issue that I think is central to the present and to the future of Europe. Which is: how can we raise economic growth, how can we raise economic growth in the European Union in a sustainable way? Allow me to explore a number of considerations. Looking back, 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, peace and prosperity. Today, however, the European Union is going through a difficult phase. Geopolitical tensions at our borders, large migration inflows, and threats from terrorism touch upon issues like solidarity and security. Many countries are struggling with low growth and high unemployment and at the same time, support for further European integration is quite low. Member States hesitate to transfer more sovereignty to Brussels. And some countries even want to sort of return competences to the national capitals instead. The UK is even questioning its EU membership in an upcoming referendum.

As the case for further integration is becoming less convincing, policymakers will need to show that the European Union can actually deliver tangible results for its citizens. The current Dutch presidency is acutely aware of this. The Netherlands therefore wants to focus its presidency on four priority areas. First, migration and international security. Second, Europe as an innovator and job creator. Third, sound finances in a robust Eurozone. And fourth, forward-looking climate and energy policy.

Sustainable economic growth in Europe

And it will strike you that all of these four issues ultimately touch upon, or have a bearing on higher sustainable growth. Historically, European integration has contributed to growth and has brought about convergence in living standards. In the 1950s, for instance, trade integration contributed to the Continent's recovery after the Second World War. A trade agreement with Germany in 1949, for instance, allowed the Dutch port of Rotterdam to thrive and allowed the Netherlands to create a current account surplus. After the oil crisis of the 1970s, European leaders agreed to realize the internal market by 1992. And after the fall of the Berlin Wall, former communist countries in Central and Eastern Europe profited from EU accession. Poland, I think, is a prime example of this. According to the World Bank, the European economic model has been a very effective "convergence machine". This term was coined in a report called "Golden Growth 2012", and probably you, Marek, know the report very well because at that time you were chairing the development committee.

In the wake of the financial crisis, however, the contribution that the European Union can make to higher living standards is in doubt. Some believe that Europe is the cause of the problem, rather than the solution. Many EU countries struggle to find sustainable growth after the crisis. Unemployment is estimated at 9.5% in the European Union as a whole this year, and even over 10% in the euro area. From this perspective, the scepticism is understandable. We should not forget, however, that advanced economies outside the EU have also witnessed increasing fears of persistent low growth, also known as secular stagnation. This is not only due to the crisis, but also to structural headwinds which many developed economies inside and outside the EU face. These include aging populations and a gradual decrease in labour productivity. Some economists, like Robert Gordon, fear that new technological innovations will not yield the same productivity gains as past innovations did. They argue that for example, smartphones, while very nice gadgets, will not have the same impact as electricity, the combustion engine or the airplane had

in the past. Other economists, such as Joel Mokyr, are much more optimistic about the impact of promising innovations like nanotechnology, artificial intelligence, robotics and the like. Others fear something else altogether: that technology will destroy jobs.

Well, no matter which view is right, the following quote warns against too much pessimism about long-term growth perspectives. I quote, "Many of the great economic forecasting errors of the past half-century came from excessive extrapolation of performance in the recent past", end of quote. You may be surprised to learn that this quote actually comes from Larry Summers, who reintroduced the idea of secular stagnation in 2013. In this case, to be fair, Summers referred to China, not to the advanced world. But he is right that predictions in the past have often proved wrong. The recent unexpected decline in commodity prices, I think, is another strong reminder of this.

Indeed, an interesting fact that may perhaps lift the spirits of Eurosceptics is that the majority of Member States that joined the EU in 2004 and 2007 are actually doing quite well today, even though they started at much lower income levels. Since 1999, their annual per capita GDP grew by 3.5% on average. It's true that countries like the Baltic States and Cyprus were also severely hit by the crisis, partly because their rapid income convergence and their speedy EMU accession led to large financial imbalances. For example, all of these countries had foreign account deficits exceeding 10% of GDP before the crisis. Other new Member States, on the contrary, took a much more gradual approach and proved surprisingly resilient. And this, I think, is particularly true for Poland, which, few people will realize, was the only country in 2009 that witnessed positive GDP growth the year after the financial crisis struck. This was mainly thanks to the absence of severe macrofinancial imbalances and to a very disciplined macroeconomic policy framework that proved resilient. The relatively closed Polish economy was also shielded from the collapse in global trade that followed.

Overall, convergence in living standards continued unabated in the new Member States, despite the crisis. Income per head increased from around 49% of the EU average in 1999 to just over 70% in 2015. At this higher income level the challenge of course is now to continue the convergence process in the future.

It is becoming more difficult for new Member States to catch up on the basis of lower wages and the adoption of modern production techniques. Factors like innovativeness and institutional quality are becoming more important to sustain convergence, and this of course may require additional policy measures.

However, in stark contrast to these emerging countries, the twelve countries that originally joined the monetary union when it was formed in 1999 are now lagging behind. Not only compared to these new Member States, but also compared to other advanced economies. Annual GDP per capita grew by a meagre 0.8% on average in these twelve countries. The hope that also the monetary union would contribute to the convergence in living standards, clearly did not materialize within this original group. Quite the contrary. The countries that entered the economic and monetary union 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. And it's very clear that should this lacklustre performance continue, it could eventually erode public support for the Euro and perhaps even for European integration.

Possible measures to increase growth

It's obvious that this situation calls for improvement. Euro area countries need better economic performance, while the new Member States should ensure that their performance can continue at the same speed and at the same level. In other words, the European convergence machine is in for a restart. To determine the best course of action, we first need to make a proper diagnosis. Simply put, why is growth so low in the EU countries and why are the EMU countries even lagging further behind?

Well, firstly, part of the low growth is clearly cyclical and related to the economic imbalances that developed before the crisis. Not only in the original Eurozone's Member States, such as Greece, Spain, Ireland and Portugal, but to a varying degree also in other EU counties like the Baltics, the Nordics, the UK, Bulgaria, and Romania. These imbalances include housing market bubbles, eroded price competitiveness, current account deficits and high public and private debt.

Secondly, some of it may actually also be related to the original design flaws in the monetary union, which were exposed during the European sovereign debt crisis. One is the negligence of these imbalances within the EMU. It was wrongfully thought, for instance, that current accounting balances would be irrelevant in the monetary union. Well, we know better now. Another design flaw is the lack of compliance with the stability and growth pact, which was meant to not only correct fiscal imbalances but also to prevent fiscal imbalances. A final design flaw was the lack of crisis instruments, which contributed to financial fragmentation and capital flight during the European sovereign debt crisis.

But thirdly 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. Countries like Greece, Italy and Portugal have simply failed to sufficiently adapt their economies to the changes in the economic environment over the past decades. These changes include globalization, which strongly increased the size of capital flows and trade competition, also with low-wage countries like China. The effects of globalization coincided with the removal of the exchange rate as an adjustment mechanism, against the background of persistently diverging unit labour costs and continued downward price and wage rigidities. It was therefore already clear in 1999 that structural reforms and structural convergence were needed, as acknowledged in the so-called Lisbon Strategy. But instead, structural differences between euro area countries only increased, resulting in real divergence rather than the needed convergence.

Now, if policymakers want to increase growth in a sustainable fashion, what measures should they take? Our diagnosis points to various causes for the lacklustre growth performance, so policymakers clearly cannot rely on one instrument only. Instead, they will need a mix of instruments to tackle the underlying problems. One of them is monetary policy, which has been used quite extensively by many countries after the crisis. So far the European Central Bank has taken many measures, including low, very low policy rates, full allotment of liquidity to the banks, longer-term funding to the banks, and purchases of private and public assets. Polish monetary policy thus far did not need to be as accommodative. But Narodowy Bank Polski also has cut policy rates by no less than 325 basis points to 1.5% today since the summer of 2012, due to slowing growth and low inflation spilling over from the Eurozone.

In general, however, the contribution that monetary policy can make to economic growth is very limited. This is especially true when policy rates have been near or at the zero lower bound for a number of years. After all, what low policy rates do is they tend to stimulate demand because they bring future spending forward in time. But of course this process cannot go on forever, because it also increases debt and, therefore, future liabilities. And at some point, however, the future will catch up with you, “the future will become the present”, as the recent report by the Group of Thirty so eloquently underlines. Monetary policy accommodation is reaching its limits, and if maintained for an extended period of time, it comes with risks of negative side effects like financial imbalances, like misallocation of resources, etc. Research by De Netherlandsche Bank suggests that low rates may eventually even reduce potential growth, as they lead to evergreening of bad loans and misallocation of scarce resources. In short, central banks can buy time, but they cannot solve structural problems.

From this it follows that additional measures are needed in other policy areas. Unfortunately, budgetary leeway is also quite limited in most countries. Public debt ratios shall still remain fairly high in the EU at almost 90% of GDP on average. And against this backdrop, Europe now needs to preserve the credibility of its fiscal rules. So, by far the most effective way to increase growth are structural reforms, reforms that will have a number of important benefits. First, they would increase the resilience and the adaptability of EU Member States, especially after the crisis. Let me give an example: unemployment in relatively resilient Ireland decreased to 9.6% this year, while in the more rigid Spanish labour market, unemployment remains staggeringly high, at 22.4% today. Second, structural reforms also have a positive impact on the growth potential. The OECD estimates that moving towards best practices in Europe via reforms could increase GDP in Member States by no less than 4-7%.

Possible measures in this area include product market reforms as well as liberalisation of the services sector and of regulated professions. Research shows, for instance, that a further reduction in the differences in product market regulation would increase trade flows by no less than 10%. Another priority should be to stimulate innovation, research and development and the application of ICT. European countries lag behind in these areas, compared, for instance, to the US. From this perspective it is also very helpful to increase the ease of doing business and to improve the investment climate in many of the Member States. It should, for instance, become much easier to start a company in Europe and much easier for small firms to grow further. Finally, the quality of many institutions could be improved, leading, for instance, to increased efficiency of the judiciary system in protecting property rights; another essential fundamental for economic growth.

How to implement reforms: Europe or Member States?

Now, having explored what course of action we should take, we should now ask ourselves how these reforms should be implemented and what the role of the European Union should be in that regard. First and foremost, reforms are the primary responsibility of individual Member States, because they are the ones that reap most of their benefits, and they are the ones that will have to bear most of their political costs. I think that new EU Member States like Poland are fully aware that the benefits of European integration are clearly not "manna from heaven". Countries need to make serious efforts themselves to enjoy these benefits. Unlike many of the EMU countries, new Member States have actually implemented quite an impressive list of reforms in the past decades. In Poland, such reforms included a more stability-oriented macroeconomic policy framework

and the strengthening of market-oriented institutions. Yet, as President Belka acknowledged some time ago, additional reforms will be required if new Member States, as he put it, "aspire to the status of an advanced economy".

Still it remains often quite difficult to find sufficient support for reforms. In practice important measures are only taken when they have become urgently needed. And this has been true for my own country on more than one occasion as well. The Netherlands started a wave of reforms in the 1980s when the economy stagnated because it had become too densely regulated and the public sector had grown out of proportion. And, recently, we only started to reduce our generous tax deductibility of mortgage interest rate payments after the financial crisis and after the correction that took place in our housing market. Recent DNB research on the increase of the Dutch retirement age actually shows that public acceptance of reforms may grow via careful discussion. Governments, central banks and policymakers should therefore very carefully prepare the ground for such reforms. But, and this must be said, this takes time.

This is why, in my view, Europe can and should also play a leading role in stimulating reform in its Member States. In my view, there are two main ways of doing this. Firstly, Europe is of course in a position to take measures on its own. The internal market offers a large untapped potential, for instance in the services sector and with respect to digital services. In fact, a more complete implementation of the European Services Directive would increase European GDP by 1.5%. The large single market could also enhance the positive effect of reforms in individual Member States. Secondly, Europe can also take on a coordinating role. It can formulate priorities, it can make recommendations to Member States, it can monitor their performance and it can apply peer pressure. This is what the Lisbon Strategy actually envisaged, when in 2000 it set out to make Europe "the most competitive and the most dynamic knowledge-based economy in the world". Unfortunately, it largely failed. Instead, Europe now has other correction and coordination mechanisms, like the Europe 2020 strategy, like the macroeconomic imbalances procedure and like the country-specific recommendations of the so-called European Semester. Their success should be clear over time. So far, however, also with respect to these initiatives, the implementation of policy recommendation remains far from complete.

This begs the question whether European coordination with respect to reforms should actually become more binding in the future. My answer is, in principle, yes, because I believe it would contribute to better economic performance, and because I believe that it would contribute to faster income convergence in the European Union. After all, budgetary and macroeconomic imbalances in one country may have large spillover effects

in other EU Member States. The imbalances in the euro area that led to the sovereign debt crisis not only affected other EMU countries, but it also affected such countries like the UK, like Denmark and Poland. Stronger coordination is therefore needed to better reduce existing vulnerabilities in the EMU Member States, such as the high public debt ratios we're facing today. Stronger coordination is also necessary to better prevent new vulnerabilities from emerging in the future.

Moreover, stronger coordination is necessary because the euro area countries have decided to increase risk sharing after the financial crisis. Eurozone countries step in, when other countries get into trouble. Via mechanisms such as the European Stability Mechanism, and the Banking Union. If, however, compliance with European rules remains low, chances are that Member States will need to call again on other EMU countries to share the risks in the future. And this increases the risk of permanent transfers within the euro area for which there is little, if any, political support. Stronger implementation of rules is therefore necessary for a better balance between liability for risks on the one hand, and the control over these risks, the mitigation, the prevention of these risks, on the other hand. Liability and control need to move in tandem. And eventually, stronger implementation of rules is also necessary for a more robust monetary union.

Conclusion

So Ladies and Gentlemen, allow me to conclude. One of the key challenges for EU Member States is to increase the growth potential in a sustainable fashion. This primarily requires measures from the countries themselves. As in the past, European integration can also contribute to this goal, depending, however, on the type of integration. Integration has increased markedly due to the financial crisis, but the argument that "there is no alternative" is becoming less and less convincing. Policymakers need to show and to demonstrate that European integration will provide value added. For example, because together European countries are much better able to deal with financial crises, with the effects of globalization, and with the effects of climate change or international terrorism for that matter.

These are all public goods that can be provided much better and much more effectively at the EU level than at the level of individual Member States. And also because together European countries can get the convergence machine going again and increase living standards for their citizens. That would provide a positive perspective on Europe just when we began this project 65 years ago.

I thank you for your attention.

www.nbp.pl