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“A CONSISTENT STRATEGY FOR JOBS AND GROWTH IN EUROPE”

**Speech at the conference "The missing link in the EMU:
economic coordination and structural reform"**

It is a pleasure to be back in Portugal once again, and to be able to address you this morning. I welcome this conference and the opportunity to discuss the important issue of economic coordination and structural reforms. In an economic and monetary union, these two topics are interlinked – and can determine success. But before I share my views on these points, I would like to take a step back and offer a broader view on the main economic challenges that Europe is facing today.

It has become almost commonplace to say that the euro area has undergone a crisis of unprecedented severity. Like the Great Depression of the 1930s, it will offer ample material for study for years to come. Its causes and effects will be dissected, analysed and debated by many. I have offered my own views in a book called "*Europe in the Storm*", published in Portuguese as "*A Europa na tempestade*".

Today, I will not bother you with a detailed discussion on these issues. I want to look forward and I will only look back to the extent it will be relevant to what I want to say about the future.

The most acute phase of the debt crisis now may be behind us, thanks to the concerted actions by Member States – including Portugal – and EU institutions, but we cannot rest until sustainable growth is restored and unemployment is reduced from its current unacceptably high level.

These are times of change. The global economy is changing fast, bringing about a series of hefty challenges. Addressing these challenges requires adjusted policies and ways of governing. Much of the work has to be done at national level – think of pension reform, labour markets or education. But Europe, and particularly our economic and monetary union, has responsibilities too.

In June, the European Council agreed the Union's five priority areas for the next five years:

1. jobs, growth and competitiveness;
2. protecting and empowering all citizens;
3. an energy union and a forward-looking climate policy;
4. freedom, security and justice;
5. and finally, the Union as a strong global actor.

I invite all of you to take a look at this strategic agenda. The next European Council President, Donald Tusk, my successor, promised upon his election ten days ago to make it his own.

Today, I will focus primarily on growth, jobs and competitiveness.

My main message is this: our economic models need to change. It is the only way to save our welfare systems, reduce inequality and guarantee more jobs and a brighter future to the younger generations. Europe should shape the 21st century instead of being shaped by it. On the economic front, Europe should evolve towards a new model where growth is driven by innovation. A growth model that is truly inclusive, taking the interest of the next generations into account and addressing inequality at its source.¹

The economic model that worked so well after the Second World War – what the French call *les "Trente Glorieuses"* and what in Germany was the *Wirtschaftswunder* – is no longer fit for today's challenges.

After 1945, economic growth in Europe was driven mainly by four forces: 1) the so-called "catching-up", meaning productivity gains from industrialisation; 2) post-war rebuilding of capital stocks; 3) cheap and abundant energy; and 4) technological imitation.

Since the 1980s this model has stopped working. Growth in advanced economies is no longer driven by imitation but by innovation. It is now the turn of the emerging economies to take advantage from catching-up. Globalisation puts us in direct competition with countries like India, China or Brazil – they can copy the same technologies and tap the same foreign direct investment sources, but benefit from a cheaper labour force. So today, the only way for Europe to succeed is to be at the "technological frontier" – to develop the technologies and products of tomorrow.

This is no news, but it has profound implications for public policies and the role of the state in the economy. In the first half of my talk, I should like to spell out what it means for fiscal policies; for efforts to increase productivity; and also for the fight against unemployment and against inequality. Let me address each of these four points.

First, on fiscal policy. In a globalised, innovation-driven economy, fiscal tools become less effective. In such a world, raising expenditure to stimulate domestic **demand** works only when companies are competitive. If they aren't, more public spending simply leads to higher public debt and higher trade deficits, because the extra money will largely be spent abroad...! That is why, at the same time, national enterprises must be made more productive, which implies reforms on the supply side.

That is not all. The old approach – of stimulating demand through higher consumption financed by more taxes and public debt – leads to serious imbalances, real and financial. Real, because of the competitiveness loss due to a higher tax burden on businesses. And financial, because in an integrated economic and monetary union, where capital can freely enter and leave a country, a loss of credibility can lead to financial instability and, in extreme cases, a loss of market access. The Portuguese people know what I am referring to. You have gone through this painful experience and we must prevent it from ever happening again.

¹ See for instance : *Changer de modèle*, Philippe Aghion, Gilbert Cette and Elie Cohen, Paris 2014.

This does not mean that fiscal policy has no role to play in stabilising the economy. Sound budgets and sustainable debt are necessary conditions, and efforts here need to continue, but the quality and the pace of the adjustment are key for growth.

Let me start with pace. Regardless of all the differences between countries, there is a common lesson: when default looms, there is no option but to 'frontload' the adjustment. This is what happened during the acute phase of the crisis when several of our member states, including Portugal, lost market access. In the short run, these decisions are very painful and have a cost in terms of growth. But in the medium run, they are essential to go back to healthy economic fundamentals – to ensure the country can continue to shape its own future and withstand any new crisis. I know the sacrifices have been high. But I am fully confident Portugal is emerging stronger and more resilient from this crisis.

The quality of the budget planning, both on the expenditure and on the revenue sides, also matters. Again, each country is different, but cuts to the public wage bill and to pension liabilities are often unavoidable. Nevertheless those at the bottom of the wage and pension scales and vulnerable people – poor families, the elderly, or disabled people – must be protected. Likewise, education and health must receive particular attention; budgetary savings, when unavoidable, should come with reforms that make them better and more accessible. By and large, this is the strategy being followed in Portugal.

Reducing deficits by increasing taxes instead of cutting spending is generally self-defeating. It may be justified in the short run to regain credibility, but it must be accompanied with a credible commitment to reduce spending over time – otherwise it can worsen a recession. In the early 1990s, Sweden showed how a country can successfully enact a tax reform that allows tax cuts and spurs growth, while at the same time improving public services and public administration.

After fiscal policies, let me turn now to productivity. In today's global economy, sustainable growth can only come through higher productivity. And employment can only be sustained by firms that are competitive, innovative and able to invest. The recipes to make product markets and services markets more efficient are familiar. Certain sheltered sectors must be opened. In telecoms, energy and transportation, we need more competition. The business environment can be improved by cutting unnecessary red tape – a priority of the new Commission.

It strikes me that the boldest reforms in that respect have taken place largely in countries, like Portugal, which have gone through an adjustment programme. But most other member states need to do more, including Germany by opening its services market, as well as France and Italy on the business environment.

As European Union, we clearly need to give a big boost to completing the internal market in products and services, as well as finalising in 2015 the digital single market – areas I have put a number of times on the agenda of leaders but where we must continue to push.

This brings me to unemployment and the labour markets. Jobs remain the highest priority. Despite efforts by most member states and signs of improvement, including in Portugal, unemployment remains unacceptably high. And we all know that it affects disproportionately the young. Hence the specific employment policies for young Europeans decided these last years, like the €8 bn Youth Guarantee Scheme, aiming to ensure quality offers of employment, continued education, apprenticeship or a traineeship for all.

Of course cyclical factors have clearly contributed to the rise of unemployment, and we must draw consequences from that situation, as President Draghi also recently set out. However, in several member states unemployment is to a significant extent structural.

Three remarks about labour markets in this respect. First: shifting taxes away from labour. This is potentially the single most important boost for jobs right now. Which is why the European Council and the Commission insist so repeatedly on it. On average, the so-called "tax wedge on labour" is 11 points higher among eurozone countries than among non-euro EU countries, and much higher than in the US and Japan. If you want to explain why expanding companies do not hire more or faster, no need to search any further!

My second point is about the rules governing labour markets. The economies with more flexibility in their labour market are those that have weathered the crisis best in terms of employment. The key point is that flexibility doesn't mean simply cutting wages or jobs. In Germany, the Hartz labour market reforms (launched last decade) meant firms had the tools to adapt working time to demand at a reasonable cost. When the crisis hit, firms could adjust, for instance by reducing overtime hours or using short-time work schemes, rather than by letting go of workers.

A third remark: we must overcome the growing divide on the labour market between "insiders" and "outsiders". Between those that are protected, and those with the temporary, unprotected jobs – mainly women, young people and unskilled migrant workers.

This duality in labour markets can explain the steep rise in unemployment during *this* Great Recession, for instance in Spain. When the crisis hit, the burden fell primarily on unprotected workers. Since then, Spain has introduced fundamental labour market reforms aiming at solving this problem. Such reforms are the only way to overcome this divide, which is not just an economic issue, but a social and political issue too.

Which brings me to the fight against inequality – one of the defining themes nowadays. It is an issue close to my heart and I am glad it is finally again in the headlines. The rise in inequality, and the feeling that the gains before the crisis and the pain after the crisis have been unfairly distributed, are at the core of people's disenchantment with politics – both national and European politics. The May European Parliament elections were another indication.

Ultimately, rising inequality could threaten not only social cohesion and the stability of democratic institutions, but also put a break on growth and prosperity. The key element here is to look at education and jobs. All experts agree that inequality feeds on inadequate skills and long-term unemployment, because they reduce opportunities and undermine social mobility.

That is why it is at the root that we must tackle inequality. Tax policy and social transfers have a role to play in correcting inequality *ex-post*, but they are not enough. Indeed, we can see with a country like France how you can have very high taxes and social transfers, yet still have high inequality. Tackling inequality at the root means better education. That does not necessarily mean more spending; it means better spending.

For example, Finland spends on education roughly the same share of its GDP as my own country Belgium, but with much better education outcomes (as measured by the so-called Pisa tests). Of course you can never simply copy a model, but there is clearly scope to draw from best practices.

After this overview of policies and recommended reforms, let me now turn to the immediate economic situation and how to boost the recovery.

Despite the significant improvement in financial market conditions, the economic and employment situation in Europe raises significant concerns, which the European Council expressed when we last met on 30 August. In recent weeks, the economic data confirmed that the recovery, particularly in euro countries, is uniformly weak. Poor growth now affects all major economies. Inflation has continued to fall and has now reached the lowest level since the Great Recession in 2009. More importantly, inflation expectations are showing signs of decline. As a result, nominal GDP is hardly growing. Unemployment remains unacceptably high.

The combination of low growth and low inflation is a problem, and not just for those countries with high public debt levels. It is a collective issue as most member states suffer from very high total (public plus private) debt. Even if the euro area is not in deflation, persistently low inflation in a context of high total debt levels puts a break on growth for various reasons. It brings up real interest rates and increases the debt burden (since the real value of debt goes up). It also makes it even more difficult to regain price competitiveness in the countries that would most need to.

So what should be done? As will be clear from everything I already said, I share the views of President Draghi that we need to act on both sides of the economy: stimulating supply and stimulating demand.

I've already talked about the supply-side of the economy – with issues like innovation and much-needed labour market reforms. Today, demand-side policies are also justified – to help give growth a push, and to act against the cyclical part of unemployment. But I have underlined earlier how demand-side policies, in today's open economies, work best in a competitive business environment. Hence the need for action on both fronts. And this has implications for our fiscal and monetary policies.

Fiscally, it is key to respect our commonly agreed rules. The Stability and Growth Pact and the Fiscal Compact act as an anchor for confidence. We should not put our fiscal credibility at risk, especially when in some cases it was so painstakingly regained. Nevertheless, we need to use the flexibility that is built into the rules in the best possible way. This is precisely what leaders agreed at the European Council of 27 June. I think there is scope for doing this. Actually, the Commission already did this last year when it extended the deadline for reaching the 3% deficit ceiling for some member states. The Commission's assessment this fall of the draft national budgets for 2015 will be crucial in this context.

Let me make two additional points. First, when assessing these draft national budgets, I think it would be useful to have a serious discussion on the overall fiscal stance of the euro area to achieve a coherent and growth-friendly aggregate result. The eurozone is more than the simple sum of its members. There is a collective dimension that needs to be better taken into account.

Second, let me say a word on investment. Investment fell strongly in the euro area in the initial phase of the crisis and has not yet recovered to its long-term average.

In most member states, the scope for increasing public investment is relatively small, given the need for sustained fiscal consolidation. But shouldn't those member states with more fiscal space and which suffer from an investment gap take advantage of the current close-to-zero borrowing costs to upgrade public infrastructure and take measures to boost private investment?

And as a Union, we should also look more closely at projects with EU-wide relevance, notably in transport, energy and digital networks. The 300 billion euro of new private and public investment over three years, as proposed by incoming Commission President Juncker, is a good line of action. This plan should be given top priority.

Let me say a word now about monetary policy: it needs to continue playing a central role in supporting the economic recovery throughout the whole eurozone, for as long as needed. I very much welcome the important package of measures announced both last June and last week by the European Central Bank. And I am confident that, within its mandate, the Bank will use all the available instruments to ensure price stability over the medium term.

Having said all this, clearly no amount of fiscal flexibility and monetary accommodation can make up for the necessary structural reforms; no demand policy can work effectively without competitive supply. I can't stress this enough.

Supporting the recovery requires that we also finish cleaning up bank balance sheets and, where needed, the recapitalising of banks. Member governments must put in place credible backstops to deal with the outcome of the stress tests that are being conducted right now.

The long journey of my speech – running from fiscal to labour market policies, and even to monetary policy – now brings me to the institutional architecture of our Economic and Monetary Union: the immediate topic of your conference and the shared framework for all eurozone countries for these policies.

Monetary union is a key achievement for Europe. Yet we know after the financial crisis that it entails more than just sharing banknotes and coins. It brought us closer to each other. Our fates are so intertwined that we can no longer operate as if each country's policies had no impact beyond its borders. Almost all the collective work done since 2010 has been about how to better manage this interdependence.

Back in December 2012, I published a Report called *Towards a genuine Economic and Monetary Union*, together with the other three Presidents (Barroso, Draghi and Juncker – at the time as head of the eurogroup). It set out a roadmap to complete the architecture of our monetary union – an ambitious, yet realistic roadmap. The banking union sketched out in that report will have its first leg fully operational next month, when the Single Supervisory Mechanism will take over banking supervision of euro area banks. Its second leg, the Single Resolution Board, will start next year, and the Single Resolution Fund will become operational in 2016.

The banking union is key to the smooth functioning of the monetary union. It addresses the most urgent gap in the EMU's architecture. Keeping bank supervision and resolution at national level, while integrating financial markets was one of the most serious faults in the eurozone's initial architecture. In the run-up to the crisis, national bank supervisors, both in debtor and creditor countries, were unable or sometimes unwilling to address the risks entailed by very high cross-exposures between their banks. No one felt really responsible for systemic risks. And we all know the consequences.

Now the priority is to make the Banking Union fully operational. The Single Resolution Fund should be fully credible: in other words it should always be able to draw at short notice on resources that are sufficient to deal with any serious crisis. To ensure this, Europe will develop adequate backstops, both for the transition phase and for the steady state. Together with other pieces of legislation, we'll have a system in place that ensures financial stability and protects taxpayers from having to bear the costs of bank failures.

Establishing the Banking Union is probably the single most important reform since the launch of the euro. When fully operational and with the backstops I referred to, I think that the minimum requirements for a stable Economic and Monetary Union will be in place. That is how we laid “the Storm”, the financial *tempestade*, to rest.

We have successfully overcome the monetary union's existential crisis, with new rescue mechanisms, stronger governance, and the banking union. The question now is: can we afford to stop here? Surely not. I for one believe that it is already time to prepare the ground for the next steps needed to complete the EMU's architecture. Rome was not built in a day.

In particular, and this is the focus of your conference, the eurozone needs closer coordination of structural economic policies. An alternative needs to be found to the idea of "contractual arrangements" that I put forward in my 2012 report – one can ignore a solution, one cannot ignore a problem. This will be work for my successors. But there is no need to start from scratch.

One alternative could be to build a consensus on a number of fundamental principles that should guide structural policies – but only in those areas crucial for the smooth functioning of the EMU. Labour markets is one of these areas. The idea would be to set out a gradual and monitored process of structural convergence, ensuring all countries are well equipped to reap the full economic gain from their participation in the EMU – all in all, a bit like the fiscal converging process that preceded the establishment of the euro. Looking a little further into the future, those eurozone countries that successfully meet these criteria could more easily develop and join risk-sharing mechanisms, which would help further strengthen their resilience to macroeconomic fluctuations. Such mechanisms could take several forms, but they should be designed in a way that offers a real incentive for convergence while at the same time avoiding moral hazard.

Europe has overcome a major crisis, and so has Portugal within it, but we are facing new challenges. Our capacity to face these will not only require the best policies and a vision for the future (and I have used my speech to share my views on this). No, it will also require political leadership as well as political trust – trust among countries, between member states and institutions, and among leaders, between people.

But from my experience five years in office, we can have this confidence in ourselves, in our countries, in the future of Europe. There is much work ahead. And I am confident that it can and will be taken forward – by you, by all of us together. Thank you. Obrigado.
