

**Real and nominal convergence to EMU:
Reforms, harmonization and
Trans-European initiatives**

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Prague, November 11th, 2004

The current economic situation

For European economies, the last two years proved to be difficult, since the long-expected acceleration of the economic recovery did not occur. The perspectives for 2004 and 2005 are less ominous, but given the oil price spiral the average growth rate of the EU is not likely to improve in a significant way.

The continuing tension in the Middle East and Iraq, the uncertainty concerning domestic demand and the deceleration in the pace of structural reforms, suggest a lack of confidence in investors and consumers and leave little room for greater optimism. In this context, there was recently an intense debate on whether the Stability and Growth Pact continues to constitute or not the right framework for fiscal policy.

Over the previous years, many called for the use of a more expansionist macroeconomic policy in order to reinforce economic activity. Frequently, such discussions and doubts raised about the Stability and Growth Pact have sent false signals to the international markets, but also towards European citizens, as far as the framework for the exercise of fiscal policy is concerned.

It is apparent that the European economy cannot continue to have a **common** monetary policy and 25 **independent** fiscal policies. Hence we need a better coordination between our policies. The best way to achieve it remains a big challenge, as is the way to improve the quality and gain better control of public expenses.

The Stability and Growth Pact is a framework that is simple, comprehensible and not as rigid as many think. With the experience we have acquired, we were able to see its weaknesses, and efforts to improve it are already underway: based on proposals of the European Commission, they

intend to make it more flexible and realistic. In any case, nobody seriously believes that the current low performance of the European economy is due to the restrictive character of the Pact.

The framework must be flexible, in order to face the cyclical fluctuations and imbalances in the short term. Nevertheless, it should not be undefined. It should set explicit fiscal rules that will secure stability, shield the EU against economic shocks, and reinforce the credibility of economic policy. Several countries that in the past have witnessed the vicious circle of high deficits and low growth, know this all too well.

The excessive attention however that is recently paid to the scope, limits, and meaning of the Stability and Growth Pact is shortsighted and falls short of responding to the challenges that the new EU is currently facing.

Apart from the governance of economic policy in the short term, what should also concern us is finding and unleashing the new sources of growth in order to boost the growth potential of European economies in the medium and long term.

On reforms

Four years ago, the leaders of the EU set in Lisbon a particularly ambitious agenda, through which they wanted to transform the European Union into a dynamic, competitive economy based on knowledge, capable of creating 10 million jobs until 2010, promoting social cohesion, and capable of giving a promising response to the expectations of European citizens.

This simple but fascinating idea has been translated into several strategies, multiple action plans, and dozens of monitoring indicators. It has constituted an exceptionally useful tool to mobilize or support the European efforts for

economic and social reform. Four years after its adoption and half the way towards the 2010 target, the EU has achieved notable successes in some areas, but shows dramatic delay in several others.

For example, despite the deceleration of the European economy in a particularly harsh year 2002, 500,000 new jobs had been created. Meanwhile progress in implementing economic reforms has been advanced, as for example can be seen from the decisions for the liberalization of the electricity sector.

It is clear to all of us, however, and to the European public opinion, that there is a sizeable **delivery gap**.

We need to convince today that Europe, two years after the physical introduction of the Euro, has both the capacity and the will to proceed with the necessary structural reforms, so as to gradually transform itself into one of the greatest economic forces in the world.

It is time the European Union starts to regain self-confidence as a leading and pioneering economic force on the international level. Otherwise, we may be borrowing excuses from unfavourable developments elsewhere, but we will not be able to establish a European growth potential.

Where will this growth potential come from in Europe during the next years? Which will be the new sources of growth that will provide a new boost? Let me touch some of them:

1. Completing the single market and ensuring connectivity in Europe

The process of economic integration is in itself a source of growth. The European Union cannot remain merely the sum of 12, 15 or, today, 25

different economic systems. It has to decisively move towards creating integrated economic activities, in sectors such as the financial services market, and services in general, and in the goods market.

The integration of the European market naturally will lead to the creation of trans-European enterprises in fields where size and critical mass constitute a major component for competitiveness in global markets.

More integration of **financial services** will bring measurable benefits. For example, making it easier for companies to issue shares and bonds as an alternative to borrowing could save **0.3%** of GDP. The creation of a truly single market in stocks and shares would, overall, add at least **1.1%** to GDP and increase employment by half a percentage point. If banking markets were truly integrated, that could save **1.5%** of GDP. Much has already been achieved in this field and the remainder is due for completion by 2005.

But there is another important factor in the direction of more market integration. Beyond the removal of institutional barriers is the physical completion of infrastructure – in energy, transports, telecommunication – in the new enlarged Europe. The fact that there are now 10 more economies in the European Union makes this objective even more imperative.

The **Trans-European networks** should not be forgotten. Several years after the Delors proposals, the issue of expanding and completing the European network infrastructures is once again in the spotlight – especially in the framework of the current geopolitical uncertainties.

In order for all this to happen, more investments are needed. And this is why we need to find the necessary resources – public resources but with an emphasis on innovative ways of private funding – as well as the necessary partnerships at an international level which will make use of all the funding

tools and organizations. The previous Commission has prepared the framework of financing connectivity infrastructure, and I hope that soon we shall move in the implementation phase.

2. The knowledge economy

The second source of growth lies at the heart of the “Lisbon process” and the effort to transform the EU into a dynamic knowledge economy. Several years ago, Bob Solow wondered how it was possible that we saw computers everywhere, except in the productivity statistics. He posed, in other words, the issue of the economic exploitation of new technologies. Today, we have almost reached the point where we can explain “**Solow’s paradox**”.

Economic theories as well as the reality of the markets have shown that research, innovation, investments in new technologies constitute a necessary condition for growth and determine the direction and pace of contemporary society evolution.

They are a key factor for the increase of potential product of an economy, because they are at the heart of the pursuit of employment, competitiveness and sustainability.

We see, however that as far as the aggregate productivity of European economies is concerned, the picture is not very encouraging. The gap between the US and the EU is growing instead of diminishing.

The investments for **research and technology** doubtlessly determine in a significant way the ability of an economy to direct its resources towards the knowledge that will make it more competitive and efficient. It ought to invest, in other words, not only for the extension of productive capital, but

also for its continuous upgrading. These expenditures in the EU, apart from few exceptions, fall short of those in the US.

It is crucial to close the technology gap with the United States and Japan. The EU spends less than 2% of GDP on research and technological development; the US spends nearly 3% and Japan is not far behind the US. In the EU, high technology accounts for 10% of value added in manufacturing, as against 14% in Japan and 26% in the US. Expenditure on information and communications technology is 7% of GDP in the EU, against 8% in the US and 9% in Japan.

Apart from research expenditures, more actions are needed for the acceleration of the convergence with the US: entrepreneurial use of knowledge, diffusion mechanisms and improved awareness of new technologies by the European public.

Europe is also lagging behind in many frontier technologies. In sectors like **biotechnology** we see a major brain-drain from the EU to the US, where significant pharmaceutical and biotechnological enterprise investments are made, in order to take advantage of the knowledge that is produced in a critical sector, which is going to create advantages in many fields later on.

At an institutional level, we need to take steps for the modernization of the education system and the reinforcement of ties between industry and universities and research centers, the undertaking of entrepreneurial action from the universities themselves.

But the impact on economy wide productivity and growth mainly derives from the diffusion and use of such technologies throughout the productive fabric – from the agricultural economy, to light and heavy manufacturing

industries, to the environmental industries, and especially in services, from tourism to financial markets and social services.

Unleashing Europe's **digital potential** is equally vital to continuing growth. EU governments have already agreed to ensure that access to the Internet is cheap, fast and secure and to invest heavily in providing people with Internet skills. The EU is also working to stimulate a whole range of online activities such as e-commerce, online government services, online health services, European web content and the use of intelligent technologies to tackle transport bottlenecks.

And of course, positive results are usually noted when investing on machines is accompanied by intangible investments in knowledge, new processes, new ways of organization, efficient governance and ways of working.

3. Entrepreneurship

Entrepreneurship is key for the mobilization of the dynamic of new technologies and its transformation into products and jobs. So a third source of growth lies in actions that reinforce entrepreneurial potential in Europe.

Europe has an **entrepreneurial deficit**, especially in knowledge intensive fields. New entrepreneurs and small businesses do not contribute as much as they could to employment, growth and regional cohesion.

To alleviate this problem, obstacles to the market entry for new firms must be reduced and procedures simplified. We need to reassess market-exit mechanisms such as bankruptcy laws, and also to provide better access to

entrepreneurial capital and know-how. Once more, I note that we need to encourage entrepreneurship through the education system.

For a long time, entrepreneurship was an ambiguous notion in many European countries. It is time we give new entrepreneurs, men and women who undertake risks, invest and offer growth, jobs and prosperity, the place they deserve in our policy agenda.

It is important to change mindsets and remove the barriers to creating and developing new businesses. Europeans lag behind Americans in this area: Europeans appear to be more comfortable in employment than being self-employed. Yet job satisfaction is higher among those who run their own businesses. When Europeans do start new ventures, these tend to grow more slowly than their American counterparts. Barriers to innovation are a major reason.

These include bureaucracy, difficulties in borrowing money to start new businesses and the high costs of obtaining patents. The European Commission is promoting action to tackle all these problems – to cut red tape, provide easier access to start-up capital and introduce a cheaper and more efficient **patent system**. Last year there has been a breakthrough in promoting a European patent system and this will lead to better transforming knowledge into market products.

This is the logic of a new horizontal policy for industry in Europe, that contributes to unleashing new entrepreneurial initiatives and thrives in knowledge-based fields. A policy that is based on innovative businesses and helps them by facilitating the access to know-how and capital, notably entrepreneurial risk capital.

4. Globalization

A fourth source of growth is the ongoing integration of the global economy. It is globalization itself, which is often demonized, but can provide great advantages, especially when its excesses are checked.

Europe has, for a long time, been somehow withdrawn and detached from major world activities. It has let the US and Japan rule over global economies and international investments flows. It has been suspicious regarding new international economic conditions and the role that international trade and investment can play.

Today, Europe's reserve has receded to a great extent as far as the movement of goods and capital is concerned, but still remains regarding the movement of people. We need to overcome this, in order to bring Europe back to the forefront of the world economy. New enterprises and entrepreneurs, nurtured in an open environment beyond their country's borders, seek globalization by remaining open to international markets and hiring human resources from abroad.

The EU should to reinforce such efforts, especially between its Member States as these constitute the spirit and essence of the European integration.

When it comes to elevating the role of the United Europe in world markets, it is particularly positive that the EU is now negotiating at WTO with a single voice, so that we can give a boost to international trade and develop a framework of participation in international prosperity for poor countries as well.

5. Employment and cohesion

The exploitation of these sources of growth can provide the European economy with the boost that it needs for the next years. It is also the only way for the European economy to create the new jobs that are needed.

In labor markets the challenge lies in maintaining the social character that characterizes Europe as compared to US, while also pushing towards greater flexibility and adaptability to change.

We need to move towards both these directions at the same time: to spread a more efficient safety net, as well as provide the markets with the right incentives.

Confidence, solidarity, social cohesion, smooth functioning of institutions constitutes an inextricable part of the European social contract and of what has been named “**social capital**”. Its role is significant as a factor of growth and increased productivity, as much as it is for a fairer income distribution.

The preservation of the European model for social cohesion is a basic characteristic of policies, because the European Union will lose its value towards its citizens if it does not safeguard and enrich the founding basic principles.

At the same time, social policy has to prove its effectiveness. For the European social model to survive it has to transform itself, to become more efficient and, in the process, more socially just.

6. Regional convergence

Growth yes, but for how many and for whom? Regional inequalities remain very important and social cohesion is developing sluggishly in a climate of economic recession. The Union has the necessary depth only if it is considered as a whole, and not as separate economies. And this should be the message: **a common course**.

The recent enlargement of the EU has set an additional challenge, as it is expected to lead in the first instance to greater economic inequalities, to their geographical movement towards the east and to a deterioration of the level of employment.

The new Member States aspire to benefit from the accession, just as other countries of the European South aspired to this process, and are waiting for the Union itself to signal the process of convergence.

Certainly, there are tangible economic benefits to the EU. The economy of the 'old' member states benefits since, as previous enlargements have shown, competition and increased personal mobility are good for growth. By the end of the decade, the combined economies of the 'old' member states could be **1%** larger than they would otherwise have been. The newcomers, meanwhile, can expect up to **1%** more growth each year from membership. This will come largely from higher investment and from reforming their economies so that they run more efficiently. Standards of living and quality of life will improve. It could also mean the creation of hundreds of thousands of new jobs in these countries by 2010.

New Member States that meet all the convergence criteria and have achieved a high degree of economic convergence with the euro zone could

join the new exchange-rate mechanism and then, after the two-year test phase, introduce the euro in later years.

However, there are two points of consideration in the convergence process of the new countries. The first is the risk of indifference for undertaking the right structural policies, with the simple but mistaken belief that accession itself will, in a magic way, accelerate the process of economic growth. The second risk is hastiness, which is already expressed in certain political choices, like the desire to integrate immediately in the monetary system of the Euro.

Convergence requires a specific transition plan, which is realistic, credible and with time-specific goals. This is exactly what reinforces the need for both old and new members of the European Union to promote the Lisbon structural reform strategy, and to follow a coherent policy for the coordination and credibility of economic policies.