

RODRIGO DE RATO Y FIGAREDO
MANAGING DIRECTOR
INTERNATIONAL MONETARY FUND



A Rising Tide Lifts All Boats: How Europe, by Promoting Growth, Can Help Itself and Help the World

Thank you very much. It is a pleasure to be with you today, and to spend some time in this beautiful city, and in the country of Mozart. The Irish playwright, George Bernard Shaw said that he learned from Mozart to say important things in a conversational way. I do want to talk about some important things today: the challenges facing the global economy, and those facing Europe. But I will try to do so in a conversational way: I think that people, including me, learn more from conversations than from lectures.

Let me start with the issue of globalization. Globalization has already caused enormous changes in the global economy, and has produced great benefits. You have already seen some of these benefits in Austria, which has been doing well in recent years, with higher growth and lower unemployment than euro area averages – because of its rapidly developing trade and financial ties with Central and Eastern Europe. More broadly, the world has seen huge changes in real sector conditions – the global transfer of goods, services, technology and jobs, and in recent decades we have been experiencing financial globalization, with the beginning of the emergence of a global savings pool. This is allowing the allocation of world savings to more productive and diversified investments. But globalization has also increased risks, and we need to recognize these if we are to make globalization work for us.

There are a number of risks to the global economy at present, notably, the risk that high and volatile oil prices begin to adversely affect global growth and inflation and the risks of an avian flu pandemic. On the latter, I would stress the need for countries in both Europe as well as other parts of the world to prepare business continuity plans, especially for the financial sector, that would ensure the



continuing functioning of the system. I am concerned that some countries, especially in Eastern Europe, may not be sufficiently prepared.

One risk that has emerged, in large part because of financial globalization, is the growing global economic imbalances that threaten the world's prosperity. We see a large deficit in the current account of the balance of payments of the United States – almost 6½ percent of GDP in 2005, and expected to be as high again this year. And we see large surpluses in the external accounts of other countries, including oil exporters such as Russia and Saudi Arabia, Japan and the emerging market countries of Asia, especially China. Global current account imbalances of this

magnitude would not have been possible without financial globalization.

You may ask, why should Europe worry about these imbalances? The European Union's external accounts are more or less in balance and the euro is generally considered to be close to its equilibrium value. And Europe does not have America's problems with low household savings, which, together with budget deficits, lies at the root of its deficit. Under these circumstances, it is tempting for prosperous citizens of Europe to sit in their comfortable houses and



look out of their windows with a sense of calm, perhaps sipping a glass of wine, untroubled by the turbulent skies outside. I believe that the comfort Europeans currently enjoy is precarious, and the sense of calm is in reality a dangerous complacency. Let me explain why I think this.

Global imbalances must eventually unwind. The risk is that they will be unwound in an abrupt and disorderly way. For example, there could be an abrupt fall in the rate of consumption growth in the United States, perhaps triggered by developments in the housing market. Or a disorderly adjustment might be triggered by developments in financial markets. Recent changes in exchange rates are in the right direction to help aid the adjustment process and, so

far, have been orderly. But if investors become suddenly unwilling to hold U.S. financial assets at prevailing exchange rates and interest rates, this could lead to an abrupt depreciation of the U.S. dollar and increases in U.S. interest rates. The global financial market disruptions and downturn that could ensue would have serious consequences for European countries as well as for others. The fact that the euro area's current account has been stable while imbalances have grown elsewhere is no assurance that it can escape the fallout from a disorderly adjustment – especially given the major international role of the euro. And Europe stands to lose a great deal from a global recession, still more if it was accompanied by a resurgence of protectionism. In these circumstances, no house would be a safe refuge against the storm.

Second, Europe has problems of its own. The first of these is low growth. Growth in the euro area was only about 1¼ percent in 2005, and the IMF projects that it will remain at about 2 percent in 2006. Europe's key economic challenge is to raise its growth and employment performance while preserving social cohesion. Social cohesion is already under pressure. Symptoms include growing hostility toward further European integration and globalization. A falling working age population and rising aging-related spending will cause further problems. At present, there are less than four people in the age range 15–65 for every one over 65. By 2050, that ratio could be closer to two to one. The fiscal consequences of this could be profound. If fiscal measures are not taken, deficits and debt could spiral out of control; if taxes are

increased, economic growth could grind to a halt. The combination of these things – low growth, social conflict, an aging population, the potential for a serious worsening of fiscal positions – suggest that Europe’s house is less secure, and its position much less comfortable, than is supposed. If you look more closely at the European standing in the window, you notice the graying hair, the carpet that has not been replaced in years, the absent or rebellious children.

I believe that Europe can surmount its problems. The key to doing so is the pursuit of policies that will raise growth. Growth is the tide that lifts all boats. Increasing potential and actual growth will reduce the fiscal crunch and ease the problems associated with an aging population. It will take the sting out of social discontent. And by helping to rebalance global demand it can also make a significant contribution to solving the problem of global economic imbalances. With the right steps, Europe can both assure its own future, and reduce the risks to the world.

The task then is to identify and follow through on policies that will raise growth. The IMF has been arguing for structural reforms, including product market reform, financial sector reform and labor market reform, and also for fiscal consolidation. I would like to make the case for these today, and to demonstrate the linkages between them.

Europe’s recent experience with structural reform, and especially with labor market reform, has not been happy. I believe that it is important not to be overly discouraged by recent events, and I will return to this issue in a few minutes. However, there are

other reforms that can be pursued without serious risk of social disruption, and some of these, including trade, product market and financial sector reform can actually make the more controversial reforms easier.

For example, there is powerful evidence that reforms in product markets are complementary to labor market reform. Extensive research by the IMF and OECD has shown that excessive product market regulation suppresses the beneficial effects of labor market liberalization because firms, protected from new competition, just appropriate the gains as profits. The corollary to this is that if labor market reform is preceded or accompanied by product market reform, the payoff in terms of employment gains is much greater. This seems also to be borne out by country experience. Some of the countries that have been most ambitious in their liberalization of labor markets – notably Denmark, the Netherlands and the United Kingdom – also undertook major liberalization of product markets over the same period. For example, Denmark and the Netherlands began liberalizing utilities in the early 1990s, and the Netherlands loosened competition regulation and lengthened shop opening hours in 1996. Over the course of two decades, from 1979 to 1997, the United Kingdom engaged heavily in privatization, reducing the share of GDP produced by public companies from 12 percent to 2 percent.

Of course, product market reform is also valuable for its own sake. A recent European Commission economic paper defines product market reforms as reduction in tariff and legal barriers, opening up of markets

to competition, measures to create a more business-friendly environment, and measures that seek to reduce the state's involvement in the economy, in so far as this distorts or interferes with market competition. Based on this definition, it is clear that product market reforms lie at the heart of the European vision. The European Union began with the reduction in trade barriers. The Single Market Program was a comprehensive exercise in product market reforms. The Lisbon strategy aims to boost both labor utilization and productivity.

Why is product market reform so important? Obviously, product market reforms can directly increase productivity and raise growth by reducing companies costs – for example, through a reduced administrative burden or lower barriers to trade. But there are also powerful indirect effects. The increased competition that results from a level playing field between businesses creates incentives for companies to use their resources more efficiently. The possibility of new entrants to product markets also forces businesses to innovate to stay ahead of their competitors. And of course, the possibility of bankruptcy or takeover concentrates minds wonderfully.

Turning now to financial sector reform, I'm sure that you are well aware of the financial sector's importance for the health of the overall economy. But you might be surprised at the extent to which less efficient financial services have contributed to the productivity growth gap between the United States and Europe in the period since 1996. Productivity has grown by about 1 percent a year more in the U.S. than in Europe. And al-

most half of this difference is accounted for by differences in productivity in financial services. Most of the remainder, incidentally, is accounted for by retail trade – which reinforces the arguments for product market reform I have already made.

Why have productivity increases in European financial institutions been so much lower than in their American counterparts? I invite your views on this, but I would suggest that one reason is that European banks are less exposed to competition, in part because of limited progress in integration of the financial sector. For example, payments and clearing and settlements systems remain fragmented, making cross-border business and trading expensive. Concerns over maintaining national ownership and differences in regulatory and supervisory frameworks have also held up cross-border mergers. The problems also appear to be worst at the level of retail banking. Certainly, cross-border activity has been limited in this area. This suggests that a major push for reform in this area is necessary.

Part of this push for reform could be in the area of greater integration, and I very much support Jean-Claude Trichet's recent call for a stronger push on this. More financial integration should enhance competition, improve efficiency, lower the cost of capital, and improve monetary transmission. Some progress has been made, and much has been done at the EU level to advance the integration of national markets since European Monetary Union. But effective implementation is still needed and work has barely begun on differences in taxation and legal systems – espe-

cially commercial and consumer protection law – that have impeded financial integration. Making progress will require establishing a level playing field for financial institutions to compete and innovate, to the benefit of consumers and investors.

I mentioned regulatory and supervisory differences. I am not suggesting that Europe should have one super regulator or supervisor. But I am pleased that the program of the Austrian Presidency underscores that „attention will be paid to further improving supervision of cross-border institutions, improving stability and crisis management arrangements.“ Indeed, some further centralization of supervisory powers – supported by legal and regulatory changes at the national level – will be necessary not only to improve crisis management but also to create a level playing field for competition and reduce the reporting burden on financial institutions. Baron Lamfalussy characterized Europe’s institutional setup to manage financial stability as a „mind-boggling patchwork.“ There is a clear need for a more systematic approach to collaboration on supervision, including a centralized repository for up-to-date information on systemically important financial institutions.

Let me now return briefly to labor market reform. The words may make some in Europe wince. Metternich once said that „When Paris sneezes, Europe catches cold.“ Well 2006 is not 1789 or 1830. So I hope that the events of this spring do not have a chilling effect on employment reform across the continent. They should not, because notwithstanding the recent French experience, many European countries have had great

success with labor market reform, and have managed to tackle structural problems in employment, without undermining social solidarity. In particular, the liberalization of part-time and temporary employment, and the phase-out of early retirement schemes in some European countries have improved labor utilization. But more needs to be done if Europe is to enjoy sustained strong growth.

The IMF has been recommending for some time a number of steps which will improve labor utilization. With regard to pensions, we would



recommend raising statutory retirement ages and adjusting actuarial regimes to promote intergenerational equity and help the sustainability of pension plans. Improving the targeting of social benefits for the unemployed can also increase labor utilization. For example, unemployment benefits could be set at generous levels but limited in duration, and long-term unemployment benefits can be linked to active search and the performance of socially useful work. Using income tax credits rather than high minimum wages can also promote higher employment.

Employment protection legislation is obviously the most contentious area at the moment. I have some sympathy with those who would lose out from reform, and would urge govern-

ments to find ways of ameliorating the social costs of reform on them. But we should also remember that almost one in ten of the labor force in Europe cannot find a job. Among the young the ratio is twice as high. These figures would be significantly lower if restrictions on hiring and firing were reduced. For example, recent IMF research suggests that merging permanent and fixed-term employment contracts into a single contract, with severance pay based on the duration of employment, would lower the structural unemployment rate in



France by two percentage points. Both justice and logic require that we continue to look for creative solutions to the problem of unemployment in Europe.

I said earlier that growth would help to ease the fiscal crunch that many European governments face. Let me talk a bit more about fiscal policy. With some important exceptions, the budgets of most countries are not in bad shape. But demographic changes are going to impose significant challenges for most of them. The European Policy Committee's Working Group on Aging Populations estimates that Europe's population will begin to fall around 2010, and that the effects of this over time will be additional public expenditure of about 4 percent of GDP. We in the IMF put

the costs somewhat higher, in part because we add an assumption for costs of long-term health care, and in part because of different growth assumptions: we think it is important not to assume higher employment and productivity growth unless measures are in place to secure it – the kind of measures that I have already talked about.

With regard to what fiscal policy should be pursued, there is general agreement that it will also be important to place Europe's public finances on a sustainable footing, that governments should be reducing rather than raising debt now, and that the target should be broadly balanced fiscal positions by 2010. There is also agreement that steady consolidation of about ½ percent of GDP per annum is necessary to achieve this objective. The problem is that while agreeing to the objectives, most governments have not proposed the measures necessary to achieve them. It's a bit like agreeing that you need to lose weight, but then buying the same groceries as you did the week before. Obviously this is something we are talking to European governments about.

Governments should also become more transparent about their fiscal policies. In particular, we think it is important that governments deepen public understanding of the longer-term issues facing countries and the policies needed to address them. Some of the things we would recommend are debating stability plans in parliaments alongside budgets and strengthening auditing agencies.

This is a long agenda, but there is high payoff from structural and fiscal reform. Most of the benefits will accrue directly to European citizens.

There is a clear payoff from higher growth, higher productivity, higher employment and sustainable budget positions. I think there will also be a payoff in terms of social peace. It may sound paradoxical to urge greater reform to lessen public discontent, but you have to ask what is the counterfactual? Does anyone really think that slow growth and a gradual relative decline would not have social costs? And I would also note that the temporary pain of many of the measures that I have set out – especially in the areas of product market reforms and financial sector reforms – will be felt most acutely in boardrooms, and company directors are not particularly likely to rush to the barricades.

There is also an international dimension. While Europe has not been at the center of the problem in terms of widening external imbalances, it should be part of the solution. At our recent Spring Meetings in Washington, the IMF's governors gave me a mandate to pursue multilateral consultations in which issues will be taken up comprehensively and collectively with several members of the IMF at once and, where relevant, with entities formed by groups of members. These multilateral consultations will be something new for the IMF and for our members, and they will be an important vehicle for anal-

ysis and consensus-building. They will enable the Fund and members to address vulnerabilities that affect individual members and the global financial system within a framework that helps overcome some of the hurdles to individual action by emphasizing the benefits of joint action, with benefits for all.

Joint action will be especially important in addressing global imbalances. Neither changes in Asian exchange rates nor fiscal adjustment in the United States alone can defuse the problem of global imbalances. What is needed is a coordinated international effort to rebalance growth and demand. Europe can play an important part in this. Structural reforms which address supply-side constraints – especially in non-traded goods – and which raise domestic demand will revitalize growth. If growth and demand are higher in Europe, this will ease some of the burden of global adjustment arising from lower demand in the United States. Action by Europe will also make action by others politically easier. And of course, the higher employment and growth that would result from structural reforms would be very much in Europe's own interest. By helping itself, Europe can also help the world. I hope that it will do so. 