Growth and Stability in the EU: Perspectives from the Lisbon Agenda – Results from the 32nd Economics Conference

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Introduction

The double challenge of population aging and increasing global economic competition has put structural reforms with a view to fostering and securing sustainable long-term growth high on the agenda of every European country. Structural reforms in areas such as research and innovation policies, education and training as well as market regulation are acknowledged to have major economic implications, e.g. for growth, employment and public finances. However, a few months before the upcoming mid-term review of the Lisbon agenda, which was drawn up in 2000 and which aims at making the European Union (EU) the world's most competitive and dynamic economy by the year 2010, it is evident that structural reforms are lagging behind the ambitious Lisbon goals. The 32nd Economics Conference of the Oesterreichische Nationalbank (OeNB), which took place in Vienna on May 27 and 28, 2004, centered on two broad issues, namely on the main reasons behind the lack of delivery of the Lisbon goals, and on the question whether there is room for improvement for the Lisbon strategy in general.

The conference was divided into three sessions. Session 1 was dedicated to strategies to achieve the Lisbon goals. Session 2 dealt with the implications of structural changes for financial markets and monetary policy. Session 3 focused on the main challenges ahead.

Reforms to Foster Long-Term Economic Growth

In his opening speech, *Klaus Liebscher,* Governor of the OeNB, particularly emphasized the successful efforts of EU Member States over the last decades to build up a modern and competitive economic environment. The completion of the Single Market and, most recently, EU enlargement constitute significant cornerstones in the European integration process. The Lisbon agenda agreed upon by the European Council in March 2000 is of particular importance as it generates the preconditions for sustainable high-quality jobs and social cohesion in a larger union. Governor Liebscher mentioned that after some years of moderate reform progress the more favorable cyclical environment combined with low inflation should facilitate the further implementation of structural reforms to achieve the Lisbon goals. Setting clear priorities and defining clear responsibilities is crucial to make Lisbon a success. Finally, Governor Liebscher stressed the significant role of communicating structural reforms in an appropriate way in order to increase public acceptance of reforms.

Martin Bartenstein, the Austrian Federal Minister of Economic Affairs and Labor, reviewed the major achievements Europe has made in terms of job creation and new technologies manifested for instance in today's widespread dissemination of Internet in schools. However, 18 million of unemployed people and the low growth suggest that Europe is running the risk of de-industrialization. More supply-side, rather than demand-side, policies are required to effectively counter this risk. In this respect, Bartenstein reviewed the recent reform initiatives in Austria, such as the pension reform and the group taxation scheme, and mentioned that Austria is ranked no. 3 regarding the implementation of the Lisbon goals. He mentioned in particular the female employment rate, which has considerably increased in recent years and now stands at a level above the Lisbon goal of 60%; the employment ratio of the elderly is still below the Lisbon goal of 50%, though.

In his keynote speech, Commissioner *Mario Monti* of the European Commission stressed the importance of the Lisbon strategy as a guiding principle for policies. The goals have perhaps been too ambitiously expressed but the challenges ahead require their timely implementation. As caveats he mentioned unsatisfactory mainstreaming of the policies and insufficient "teeth of implementation." In analogy to the Stability and Growth Pact, which derives its economic justification from negative externalities of excessive budget deficits of individual Member States in the monetary union, Monti held the view that structural policies are also associated with externalities. As a consequence, he mentioned that the Lisbon agenda, which is more widely shared in terms of objectives in comparison with the Stability and Growth Pact, should be more binding. Furthermore, he stressed the interrelations between the Lisbon process and other areas of economic policy, such as industrial policies and policies fostering competitiveness. He claimed that Europe should play a more active role in promoting industrial development by putting greater emphasis on industrial policies that prevent in particular fragmentation of national markets and violation of the Single Market principle. Finally, he said to expect a smooth decision-making process owing to the Constitutional Treaty, which should positively contribute to growth.

Session I: Strategies to Achieve the Lisbon Goals

While the Lisbon goal of enhanced growth is not an end in itself, it nevertheless has to be at the very top of the EU agenda to safeguard the sustainability of the European social model in the light of enlargement and aging. This was stressed by *André Sapir,* who highlighted the main policy recommendations provided in the Sapir Report that touch economic as well as institutional aspects. Starting from the observation that in the last 30 years the EU Member States have lost about one percentage point of potential output growth, Sapir argued that the Lisbon agenda is the right strategy since it addresses the shortcomings of the Single Market program that failed to boost economic growth. The Lisbon strategy maintains the completion of the Single Market, promotion of innovation and, most importantly, that the reallocation of factors of production is complemented by measures in labor and social policies. The main problems of the Lisbon strategy are the high level of coordination required, the lack of clear-cut responsibilities and the risk of free riding. Furthermore, too many objectives and instruments that are too weak are major impediments to reaching the Lisbon goals. The reform proposals of the Sapir Report are oriented towards institutional and budgetary aspects: The "open method of coordination" should focus its scope and strengthen its implementation, the EU budget has to be redirected towards knowledge investment, and greater attention has to be paid to the quality of national budgets. Sapir also mentioned the crucial importance of the upcoming months for overhauling the Lisbon process along the lines suggested.

The discussant *Dennis Snower* of the University of London addressed the shortcomings of labor market policies and underlined the crucial role tighter surveillance of the competitiveness of labor markets plays for achieving greater coherence between macro and labor policies. His controversial proposal to introduce unemployment and skill accounts can be regarded as part of a strategy to make labor markets more similar to financial markets.

While it is commonly agreed that human capital is an important source of growth, the issue which educational features are better suited to promote long-run growth is highly controversial. *Dirk Krueger* of the University of Pennsylvania argued that the European focus on vocational education is one reason behind the "technology deficit" observable since the 1980s. While the specialized and skill-specific training schemes common to many European countries were appropriate during the technologically calm times of the 1950s and 1960s, they may have hindered European technology adoption and economic growth from the 1980s onwards. Hence, reducing the growth gap of Europe vis-à-vis the U.S.A. requires educational reforms that place a greater emphasis on flexibility in educational choices to be made at the upper secondary level and focus more strongly on general education.

The Lisbon objective to raise the ratio of research and development to GDP to 3% requires an increase in the number of researchers in the EU by about 700,000. *Georg Winckler,* Rector of the University of Vienna, discussed the increased demands for more human resources against the background of financing restrictions on the part of the government. According to OECD estimates, industry funding of university research is particularly high in the U.S.A. and the United Kingdom (with about 6% each), and in Canada with nearly 11%, but lower in European countries.

Josef Christl of the OeNB welcomed four eminent experts to the panel on "Successful Structural Reforms," all of whom had closely followed the design and implementation of structural reforms in their home countries. *Monika Arvidsson* of the Swedish Trade Union Confederation claimed that structural reforms and deregulation aimed at increasing competition should yield the maximum possible advantages for consumers and citizens. Although many public operations, like procurement and network services (e.g. gas and electricity), have by now been liberalized and exposed to competition, she made a case for being restrictive about commercializing welfare services like schools and nursing, not least because of the sizeable failure risks involved. In Sweden, the rise in productivity has been accompanied by mounting prices, which means that some economic actors have reaped part of the consumers' gain from the deregulation. On the other hand, competition policy does not aim at lower prices only; after all, Sweden, being a small open economy, is highly exposed to global competition. The accelerated growth in productivity has also been fostered by a policy towards low inflation, stable public finances and an improved efficiency in the use of resources. The reforms met with broad acceptance because wage earners felt cushioned by social insurance granted in case of a job loss due to rationalization. Besides supply-side measures, consideration should also be given to a balanced aggregate demand. Furthermore competition authorities should be endowed with sufficient resources to enforce and monitor reforms to the consumers' advantage.

Mads Kieler of the Ministry of Finance of Denmark focused on taxation and labor market reforms. Presently, Denmark has one of the highest employment shares and GDPs per capita, irrespective of its tax ratio of about 50% (the tax base has been widened and there is symmetric income/capital taxation) and a generous welfare system for people affected by structural changes. Denmark's good performance is attributable to its designing flexible institutions, pursuing a highly active labor market policy and having centralized as well as decentralized wage bargaining. The reforms manifest themselves in a high participation rate of women and a wage distribution that has not widened. In particular, young people are entitled to unemployment benefits for a period of six months, after which time they have to take subsidized jobs or enroll in training programs. At the same time, the government introduced temporary leaves, parents' leave, sabbaticals and pre-early retirement for the long-term unemployed. Comprehensive social security systems are therefore not necessarily tantamount to rigid structures, nor do high taxes automatically reduce the labor supply. In Denmark, labor market participation is thought to be key to achieve long-run sustainability of public finances in an aging society. Even if productivity growth yields a higher tax base, future social insurance expenses will rise. Therefore, policymakers have been striving to match the stronger demand for skilled labor with an increase in the labor supply.

Jussi Mustonen of the Confederation of Finnish Industries and Employers observed that the reforms in the early 1990s were a reaction to a severe crisis. At that time, it was commonly accepted that exploding public debt had to be brought under control. Expenditures were cut with promises of secure future social security benefits. Taxes were reduced to enhance investments and markets were fully liberalized before EU and EMU entry. This yielded above-EU-average productivity growth. Nevertheless, the pension reform was insufficient, with pension contributions relative to wage income decreasing after structural reforms. Increased global competition, not least due to EU enlargement, is the main challenge of today. Therefore, the current government has set up a strategy program to meet future challenges, which is entitled "Successful Finland in the future" and consists of target definitions for four pillars: labor markets, taxation, welfare systems, knowledge and R&D. These challenges are also a European issue, however. Unfortunately, the Lisbon strategy is somewhat unfocused and contains contradicting goals. To achieve the necessary reforms, cooperative solutions are the best to be implemented but the hardest to achieve.

Erhard Fürst, Federation of Austrian Industry, argued that generally the Lisbon agenda should be complemented by sustainability, not only in economic and social terms, but also on an ecological basis. He observed that, so far, small countries were more successful in implementing reforms. This might have been due to easier decision-making processes, corporatism, or to a stronger need to adapt in the face of the smaller domestic market. Nevertheless, in Austria the quality of public expenditures has deteriorated (investment cuts are obviously easier to implement than transfer cuts). Although Austrian trade unions have traditionally been growth-oriented and therefore quite flexible with respect to companies' needs, structural reforms had been hard to implement until the end of 1980s. The current "reform government" was welcomed at first, but its acceptance has since then deteriorated. The government launched numerous reforms: the pension system was reformed, and R&D expenditures increased by ½ percentage point, promoted by a newly established National Foundation for Research, Technology and Development as well as by an improved tax treatment of R&D expenditures. At the educational level, a Fachhochschulen system was introduced, and the recent university reform is expected to create a framework for closer cooperation between academia and firms. Finally, a corporate tax reform lowered taxes for companies and improved group taxation. Still, according to Erhard Fürst, much has to be done: a health care reform is pending, the efficiency of the federal system is modest and there is no competition in municipal services' prices.

In his keynote speech, *Edgar Meister,* Deutsche Bundesbank, analyzed whether the new capital adequacy rules as proposed in the major revision of the international standard on bank capital adequacy, widely known as Basel II, would interfere with the goals of the Lisbon agenda. In particular, he dealt with the issue of whether the Basel II framework would financially constrain small and medium-sized enterprises (SMEs), a fear sometimes expressed in political debates. Meister argued that Basel II would generate positive macroeconomic effects that would help achieve the goals of the Lisbon agenda. Specifically, the new capital adequacy framework would strengthen the stability of the financial system owing to the inherent incentives for banks to improve their risk management systems and practices. Moreover, Basel II would improve the allocation of capital by further reducing the gap between regulatory and economic capital. With respect to SMEs, he noted that the modified rules applying to SMEs would not restrict their access to credit. He further pointed out that the internal ratings-based (IRB) approach proposed in the Basel II framework forces banks and SMEs to increase their mutual exchange of information. This may lead to a "renaissance" of relationship banking, i.e. the "Hausbank" principle.

Session 2: Financial Markets and the Lisbon Strategy

The introduction of the euro has promoted the integration of financial markets further, which should facilitate a smooth transmission of monetary policy to the real economy. However, as noted by *Nuvo Alves,* Banco de Portugal, heterogeneous structures still persist across the euro area countries. Alves investigated whether these persisting market frictions and fragmentations have an adverse effect on the conduct of monetary policy. He found that financial markets do not cause any significant distortions in the transmission of monetary policy. This surprising result, which is derived from a general equilibrium model with competitive financial intermediaries and frictionless financial markets that mimics the empirical features of the literature quite well, is tentatively attributed to three aspects: First, expectations regarding the future path of monetary policy seem to be an important element in enhancing credibility. Second, credit market frictions do not seem to be consequential in the euro area. And third, there still exist heterogeneous distributive effects of a monetary policy shock. Whether these effects are of relevance to the optimal monetary policy in a monetary union is highly uncertain. Even though financial markets already seem to be efficient in the transmission of monetary policy to the real economy, further removing existing frictions, as maintained by the complete implementation of the Financial Services Action Plan, is warranted. The discussant, *Beatrice Weder,* Johannes Gutenberg University of Mainz, mentioned that the inconsistency of the results found in micro studies and Alves' findings at the macroeconomic level, an inconsistency also identified in other areas of economic research, calls for further research.

E. Philip Davis, Brunel University, provided an overview of potential implications of aging and ongoing pension reforms for financial and monetary stability. Davis reviewed the main transmission channels linking aging to growth through saving, investment, the current account and labor productivity, which was followed by a discussion of the main risks of pension reforms or reliance on unsustainable pay-as-you-go pension systems to monetary and financial stability. Regarding the latter, numerous potential risks may lead to banking crises, bubble bursts and financial crises; the probability of such risks materializing, however, declines with the degree of efficiency of financial markets in general. Monetary stability is affected to the extent that aging raises the real interest rate, decreases inflation due to increased precautionary savings as a potential consequence of pension reforms, increases inflation due to dissaving of retiring baby boomers or as a consequence of a declining workforce. Hence, at different points of the aging process deflationary and inflationary pressures may arise, but as stressed by Davis these mechanisms will evolve gradually and thus give central banks time to adapt. The controversial issue whether monetary policy should respond to the financial stability objective was also raised; Davis suggested a monetary response to misaligned asset prices. *Klaus Schmidt-Hebbel,* Banco Central de Chile, mentioned the skeptical view held by many central bankers about pursuing a financial stability target. As an alternative they would propose a monetary reaction to the extent that asset prices affect output gap and inflation projections, and to extend the policy horizon to take account of potential asset market and lending booms. In discussing the macroeconomic impact of pension reforms, Schmidt-Hebbel referred to the experience of the reform in Chile launched in 1981 that represented a radical shift to a privately managed fully-funded pension system. On average, the overall growth effect of this reform is estimated to have boosted growth by 0.5% per year.

The Austrian Minister for Finance, *Karl-Heinz Grasser,* discussed topical policy issues related to the Stability and Growth Pact and emphasized that sound public finances are necessary to create appropriate conditions for sustained growth.

Session 3: Challenges on the Way

Andrew Hughes Hallet, Vanderbilt University, presented the paper "The European Economy at the Crossroads: Structural Reforms, Fiscal Constraints, and the Lisbon Agenda" jointly written with Svend E. Hougaard Jensen (CEBR and SDU) and Christian Richter (Loughborough University). The authors studied the incentives to enlarge a monetary union under alternative assumptions about the extent of market reforms within the union and accession countries. This might explain why some countries, while not qualified, would be willing to join EMU, whereas other countries – albeit qualified – might be unwilling to join. Lack of labor mobility and/or wage/price flexibility or fiscal reforms entails costs for both new entrants and for the existing union. Countries will therefore be willing to join a union when there has been sufficient reform, and when markets are more flexible than their own. On the other hand, existing members will call for the same properties in their partners. Fiscal restrictions may exaggerate the incentive mismatch and delay necessary reforms. Overall, if the expected benefits (e.g. a decrease in unemployment) are lower than the costs of joining EMU (exposure to asymmetric shocks and asymmetric rigidities), a country will be less willing to join EMU.

In his discussion, *Georg Busch,* European Commission, contrasted this paper with Bayoumi's findings (1994, A formal model of optimum currency areas). Bayoumi argues that the incentives for a small "out" to join a monetary union will always be higher than the incentives for the union to accept a new member. An analysis should take into account the relative power position of a small "out" versus a large "in." Busch also questioned the assumption of automatic free riding of the rigid on the flexible economy. Besides, joining EMU entails the loss of the exchange rate as an instrument to adjust to shocks. Eventually, to date it has not been observed that EMU is moving towards inflexibility.

Dalia Marin, University of Munich, addressed the fear of many citizens that Eastern enlargement would lead to substantial job losses, in particular losses of high-skilled and IT jobs. According to the results of her investigation such fears are not justified, at least for Austria and Germany. Eastern enlargement has led to surprisingly few job losses because jobs in Eastern Europe do not compete with jobs in Austria and Germany. In contrast, low-cost jobs of Eastern European affiliates have been helping Austrian and German firms to stay globally competitive. The most skill-intensive activities have, however, been outsourced to Eastern Europe to address the human capital scarcity in Austria and Germany that became particularly severe in the 1990s. At that time, high-skilled job transfers to Eastern Europe accounted for 10% of Germany's and 48% of Austria's supply of university graduates. It follows that R&D subsidies do not suffice to address the skill exodus to Eastern Europe. Rather, investing in education and training and liberalizing high-skill labor movement will be more effective.

In his discussion, *Christian Helmenstein,* Institute for Advanced Studies, Vienna, emphasized that following a new international division of labor, the export concentration of Eastern European countries has increased during the past years, while it has remained the same for Austria and Germany. Decreased diversification does not automatically lead to a higher exposure to asymmetric shocks as vertical FDI plays a major role in intra-industrial trade patterns. Finally, the intensity of labor migration is also crucial for the economic future of all countries. If migration is not too high in the near future, then Austria and Germany might again become a high-income/high-skilled economy. If migration happens to be too intensive, then a transition to a low-income/low-skilled economy is likely. Hence, R&D subsidies might be inefficient. Education and attraction of skill-intensive industries are presumed to be more effective.

Otmar Issing, European Central Bank, highlighted important linkages between structural reforms and the conduct of monetary policy and vice versa. At the outset, he, however, emphasized that the European countries must proceed with structural reforms, in particular in the areas of labor markets, research and development, innovation, education and the Single Market to achieve a higher long-run growth path with higher real income. To this end, the instrument of numerical targets as a benchmark for the progress with structural reforms should be strengthened to increase the necessary pressure on underperforming countries. He then focused on the interplay between structural reforms and monetary policy. Structural reforms that create a more flexible environment tend to facilitate monetary policy and increase its effectiveness. For example, more flexible labor markets would absorb negative supply shocks with a smaller short-term increase in inflationary pressures. This would allow monetary policy to react less strongly, and price stability would in turn be easier to maintain. Moreover, such a flexible economic environment would also help keep the volatility of inflation and output in check. On the other hand, the stability-oriented single monetary policy and the systematic monitoring of the stability of the financial system, an activity where the national central banks play a major role, positively contribute to a stable macroeconomic environment, in which structural reforms are easier to implement.

Anne Brunila, Finnish Ministry of Finance, elaborated on the issue of structural reforms and fiscal sustainability. She first identified two major challenges common to all EU Member States, namely population aging as well as increasing international competition and globalization. Both factors aggravate the financing of the welfare state. Population aging creates strong pressures for increasing public expenditures for pensions and health care, while potential savings in education and unemployment expenditures are likely to be relatively small. Moreover, aging also tends to lower labor supply and productivity, which in turn reduces potential GDP growth. At the same time, international (tax) competition makes it difficult to increase tax revenues. In the light of these challenges, reforms would be needed to enhance the growth potential and to secure the long-term sustainability of public finances. Brunila moreover pointed out that the broad range of reform areas includes trade, financial markets, product markets, labor markets, tax and benefit systems and the public sector. Given the uncertain distribution of the costs and benefits of reforms across the economy and over time, the impact of structural reforms is often difficult to quantify, however. Broad-based pension reforms are necessary but still not sufficient. It would be vital to implement complementary structural reforms to raise both potential growth and employment.

Heinz Handler, Austrian Institute of Economic Research, remarked that structural reforms should address all aspects of public sector involvement, in particular the legal setting, the efficiency of the government and the impact of government-sector on private-sector productivity.

Summary

Josef Christl, OeNB, summarized the core issues that had emerged during the conference. He remarked that the Lisbon agenda is highly ambitious and that the implementation is lagging behind. The effort to reach the goals set out in Lisbon should therefore be stepped up. There appears to be a broad consensus that structural reforms are absolutely necessary; nevertheless, priorities must be set in the first place. Reforms geared towards making labor markets more flexible are all-important. Competition policy also plays an important role. Moreover, the quality of public finances should be enhanced. Numerical targets provide a useful device for benchmarking the results achieved through structural reforms. A sound financial system and stable prices are necessary preconditions and help implement structural reforms. Last, but not least, the communication policy needs to be improved. After all, it is essential that there is broad public agreement about necessary structural reforms.