THE 2010 LUDWIG ERHARD LECTURE

THE EURO AND THE WORLD:

BETTER GOVERNANCE FOR SUSTAINABLE PROSPERITY

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1. Introduction

Ladies and Gentleman,

Let me thank you for your kind invitation to address such a distinguished audience, especially as the lecture is named after Ludwig Erhard, the father of the "economic miracle" of the post-war Germany.

As the late sociologist Ralf Dahrendorf wrote in his marvellous little book *Reflections on the Revolution in Europe* in 1990, a country in transition needs a constitutionalist leader to guarantee political legitimacy and another leader of 'normal politics' to drive necessary economic reforms. Germany had these leaders in Konrad Adenaeur and Ludwig Erhard.

Even though the economic challenges standing before Mr. Erhard over 60 years ago and before us today may not be comparable, I see some parallels. Quite like the post-war Germany, we need to rebuild our European economy battered by a deep crisis. Much thanks to Ludwig Erhard and his reforms, Germany made it happen against most if not all odds. The foundation of Erhard's policy was the currency reform in June 1948, a shock therapy that suddenly freed most prices and all rationing. We have come to know the result as *"Wirtschaftswunder*".

Can we hope for another "miracle" to happen – this time in Europe?

Luckily for us, there is nothing supranatural in Erhard's "miracle". The *Wirtschaftswunder* was a down-to-earth programme of economic reform, built on the principles of monetary stability and free market to encourage entrepreneurship, bring economic efficiency and facilitate job creation.

2. Stability and growth go hand in hand

Let me start with a general remark. There is a school of economic thinking which argues that macroeconomic instability is insignificant in the long run and only the rate of growth matters for welfare. This has of course been disputed by many macroeconomists who have underlined the devastation that recessions can create.

But many of the same macroeconomists were, just a few years ago, convinced that the instability issues have been largely solved. In the pre-crisis period "The Great Moderation" was regarded as evidence of successful macroeconomic policy, based on automatic fiscal stabilizers and on monetary policy aiming at price stability or low inflation.

Now we know better. Macroeconomic instability can cause large and long-lasting damage, thus remaining a stubborn policy challenge.

At the same time, there is no denying that the rate of economic growth is essential for our citizens' wellbeing. This is a very concrete European challenge. The projected 1½ % average annual growth rate in the EU in the coming decade, in the absence of major structural change, is simply inadequate to generate the jobs we need. Neither is it sufficient to redress the consequences of population ageing.

Therefore, just as in Erhard's programme, we must focus on both stability and growth. There is not one without the other – they go hand in hand.

With this in mind, I'll discuss three sets of issues central for promoting stability and growth in the EU: (1) economic governance, (2) growth-enhancing structural reforms, and (3) global economic governance.

3. Strengthening economic governance in the euro area

The findings of the Euro Monitor, which were presented here earlier today, display very clearly the severe problems of fiscal sustainability and the divergences of competitiveness in the euro area. While national policy makers, of course, bear the main responsibility for the situation, it is clear that also our EU framework for policy coordination has failed.

Stability and Growth Pact was created to ensure that no country would pursue fiscal policy that would endanger financial and economic stability of the other member states and the euro area as a whole. It has not done that, mainly for two reasons.

For one, because it has not been applied as rigorously as intended. Second, because the Stability and Growth Pact was not sufficient in scope, as it has left non-fiscal economic imbalances outside the scope of surveillance. Ireland and Spain are unfortunate examples of this.

It is indeed important to keep in mind why we have undertaken the comprehensive exercise of reinforcing economic governance. It is because our policy framework failed to prevent unsustainable fiscal and economic developments in many member states, with devastating consequences for their economies, and risking a financial and economic meltdown of the euro area as a whole. Containing the crisis has been a huge and politically delicate challenge, which has required extraordinary actions by the EU, its member states, the ECB and the IMF.

The failure is due to our incapacity to intervene early enough to prevent unsustainable developments and to enforce policy recommendations strictly enough when that was warranted according to the rules jointly agreed. In addition, the scope of the surveillance has been too narrow.

Whatever the precise details of the new coordination mechanism will be, the reform must address these shortcomings. That means in particular that the Member State governments must commit to prudent fiscal policy making – and accept that if they deviate from such path, there will be consequences. This is necessary, if we are seriously aiming at containing the risks to financial and economic stability in the euro area.

To address these shortcomings and systemic weaknesses, the EU has embarked on a comprehensive programme to strengthen of economic governance. Following two communications earlier this year, the Commission published a package of legislative proposals four weeks ago. Later this week, President Herman Van Rompuy will present the work of the Task Force led by him to the European Council.

Let me very briefly recap what is in the Commission proposals.

First, we propose to reinforce the Stability and Growth Pact. We want to introduce a concept "prudent fiscal policy making" to make the adjustment towards a medium term budget objective more operational and binding. Debt sustainability will be monitored more closely by setting a numerical benchmark for a satisfactory pace of debt reduction.

Second, we propose to broaden economic surveillance to identify and redress macroeconomic imbalances and divergences in competitiveness. This will be based on a scoreboard of economic and financial indicators (probably very similar to the Euro Monitor), and when unsustainable developments are identified, we will carry out in-depth country analysis and issue country-specific recommendations.

I know some *refuseniks* doubt the value of this type of surveillance. I'm wouldn't be so sceptical. Some of the simulations we have done suggest that such an approach would have signalled unsustainable development in the cases of Ireland and Spain well before the crisis hit.

Third, we need to effectively enforce economic surveillance through the use of appropriate incentives and sanctions to strengthen the credibility of the EU fiscal framework. These would kick in at an earlier stage of the surveillance process and be gradually tightened, unless corrective action is taken by the member state concerned. Very importantly, we also want to make the consequences of bad behaviour more automatic – i.e. semi-automatic – and thus less subject to political deliberation.

In principle, there would be an alternative to policy action based on clear rules. It is market discipline. Unfortunately, market discipline alone is not very effective, and can come at very high costs. As we have seen, markets typically have not restrained excessive borrowing by the governments or the private sectors until it has been too late. And when the markets have reacted, the reaction may have been excessive.

Financial markets tend to be volatile and prone to excesses in ways that one normally does not find in product or labour markets. The inherent instability of financial markets, underlined by John Maynard Keynes and Hyman Minsky, made them call for government intervention, extending from demand management to financial regulation. For a while this message got lost, but few would question its relevance now.

Therefore, based on empirical experience, I don't think we can afford to trust that markets alone could take care of guaranteeing financial stability. While the long-run incentive effects are likely to work in the right direction, in the short run the market reactions tend to be destabilising.

Thus, in my view we must put the first and foremost emphasis on a strong pre-emptive and preventive framework of economic governance, which will have to include a strong and semi-automatic sanctions regime, as proposed by the Commission, so that there would simply be less need for market discipline. However, as it is better to be safe than sorry, we need a crisis resolution mechanism of a permanent kind.

Its design must be done with care. We need to analyse the functioning of the current temporary arrangements, and, on that basis, assess options for a permanent crisis resolution mechanism (which we indicated already in our May Communication). When designing the options, we must keep in mind that the mechanism will have to minimise moral hazard and strengthen the incentives for member states to pursue sound fiscal policies and for investors to pursue responsible lending practices.

It is also politically clear, and to my mind analytically well-grounded, that any permanent crisis resolution mechanism will only fly with such orderly arrangements that pre-emptively minimise moral hazard, strengthen fiscal discipline and ensure responsible lending. And vice versa: there will be no orderly arrangements without a permanent mechanism.

Many ideas have been floated about how to contain moral hazard and induce some market discipline into a future crisis resolution mechanism. Some rely on common action clauses, some on statutory debt restructuring arrangements. I have an open mind in this regard, with one very firm qualification. Any acceptable arrangement involving private sector involvement must be orderly enough to ensure financial stability, which is the ultimate aim of our policy on crisis resolution.

To avoid any misunderstanding, let me underline that these ponderings and forthcoming proposals can and will concern only the future design of any post-2013 permanent mechanism. As I have said so many times, the current sovereign debt problems will be handled according to the current and firmly agreed policy, which excludes sovereign debt restructuring.

Following the work of the Commission and Task Force and contributions by member states, the discussion on governance reform has intensified. Let me refer to the forecast that the always encouraging and inspiring columnist Wolfgang Münchau made in the Financial Times yesterday: "The eurozone thus ends up with tough rules, poor implementation, no effective framework to deal with private sector imbalances, and an officially instituted mechanism that encourages default".

I think this is frankly a wrong conclusion, for two reasons.

First, the Task Force achieved very positive results benefitting from the significant inputs from the Commission and reached a broad convergence towards the Commission legislative proposals. Inter alia, the semi-automacity of sanctions and the broader economic surveillance, the cornerstones of the Commission package, were preserved.

Second, we have so far seen only the end of the beginning of the decision-making process. The normal legislative process is only starting now, with qualified majority rule in the Council and co-decision with the European Parliament, based on the Commission's proposals.

I count on the Community method, which generally makes the EU work and deliver, to do so now as well, and thus further reinforce our new framework of economic governance. We need reinforced and rigorous economic governance for the sake of stable and sustainable growth, which is critical for the employment and welfare of our citizens.

My forecast is therefore as follows: The eurozone will end up with tough rules, semi-automatic implementation, an effective framework to deal with broader macroeconomic imbalances, and – yes – a permanent crisis resolution mechanism that encourages responsible lending policy by investors and responsible fiscal policy by governments.

The crisis was profound enough to bring about a genuine policy change, in fact a genuine economic union to match the monetary union. The future generations will say that that crisis certainly was not wasted.

4. Accelerate policies for sustainable growth

Fiscal and macroeconomic stability are necessary for long-term sustainable economic growth. However, we need to address the growth challenge directly.

During the crisis, world GDP saw the first fall ever recorded in national accounts. The EU and the euro area were particularly hard hit, with GDP falling by 4% in 2009. The crisis had a large negative impact on the productive capacity of our economies, and subsequently on employment.

We thus urgently need to reinvigorate growth. A serious question remains however: Do we get ambitious reforms implemented and implemented early enough to really make a difference? Is there sufficient sense of urgency now that the recovery is underway?

To reinforce the drive of the Europe 2020 reform agenda and to support fiscal consolidation, we have to act swiftly and strongly by frontloading growth-enhancing reforms. The coming 6 to 9 months will be crucial. In my view, we will not succeed unless we all – in the Member States as well as at the EU level – accelerate the implementation of reforms.

Member States have already agreed to submit to the Commission their draft National Reform Programmes by mid-November, and include their revised assessment of macro-economic and structural bottlenecks to growth. Member States will be encouraged to commit themselves already in these programmes to accelerated implementation of key structural reforms as part of their strategies for growth and jobs.

The Commission supports Member States in this frontloading exercise. We have engaged in substantive discussions with the authorities of all Member States individually.

In addition, the Commission also pursues the frontloading of EU-level actions. We have proposed measures to this end (e.g. ensuring the effective implementation of the Services Directive, Community patents and project bonds), given their synergies with national growth policies.

Tomorrow, the Commission will adopt a Communication on developing our internal market. The Single Market Act, prepared by my colleague Michel Barnier, will spell out our priorities to maximize the benefits from the internal market.

We all know that many reforms that enhance long-term growth are not only policy-wise complicated but also politically difficult. But there are many good examples of bold reforms which have given tangible results even in a few years horizon. Let me mention a few.

Many commentators have pointed to the remarkable resilience of employment in Germany at the face of an unprecedented slump in economic activity last year. I believe that without the comprehensive labour market reform introduced in 2002, the situation would have been much worse. The reorganisation of the employment services and the changes regarding unemployment benefits brought the much needed flexibility to the labour market, which is now paying off.

Significant structural reforms are being adopted also in other parts of the EU. The reforms which are being adopted in Spain aim to reduce the duality of the labour market, where the apparent flexibility is currently attained only with high social costs borne by temporary workers. The estimates by the Spanish government suggest that the reform is likely to have significant positive impact on potential growth and employment.

Smart structural reforms increase the growth capacity but can also support macroeconomic stability. Pension reforms are a case in point. They enhance fiscal sustainability but also increase labour supply and hence growth. Pension expenditures in the euro area are projected to increase by almost 2.5 percentage points of GDP by 2060. In Sweden, however, due to a major pension reform of 1999, pension expenditures are projected to remain broadly stable.

More recently, significant measures to increase the sustainability of public pensions were introduced in Italy. Most importantly, the statutory retirement age was linked to life expectancy as from 2015. Owing to this provision and previous reforms, pension expenditures are projected to remain broadly flat until 2040 and to fall thereafter.

These examples show that effective reforms are doable. It may even be possible that the reformers survive the subsequent elections. The recent Latvian parliamentary elections are an encouraging example of that.

5. More legitimate and effective global economic governance

I have concentrated on European policy. Global developments are of course important, even crucial, for us. Europe therefore plays an active and constructive role in global economic policy making.

Global imbalances hamper the current recovery in many parts of the world and reduce the potential for job creation. These threats can only be tackled by a cooperative approach. This is far from easy.

Yet, the results of the G20 finance ministers' meeting in Gyeongju last weekend are encouraging. The problems caused by imbalances were clearly recognized, and all participants committed to reducing them, e.g. by moving towards more market determined exchange rate systems and to refraining from competitive devaluation of currencies.

Equally important was the agreement on the IMF reform. Reflecting their increased economic weight, the emerging economies' representation at the IMF executive board will be increased and the over-representation of Europe reduced. This is no loss for Europe. On the contrary, it should help bind all parts of the world to responsible, cooperative policy making.

All in all, the Soul Summit of G20 in two weeks has all the preconditions to be a successful meeting. G20 is well alive and delivering.

6. Concluding remarks

Governance, growth and global coordination are all intertwined. The Commission's proposals amount to a great reinforcement of economic governance. It is now the joint responsibility of the Council and Parliament to move the legislative process forward without delays and provide a final product that tackles the shortcomings in a credible way.

Likewise, we face a serious growth deficit. Now it is time to deliver, time to implement the national reform programmes and take the flagship initiatives forward. As we have seen, finding sufficient political backing for the necessary reforms is far from easy. That takes quite some persuasion and perseverance from the policy makers. Do we have it?

Many doubt this. But I trust that in the end these steps will be taken. The boldness and the foresight, which back in time helped Ludwig Erhard to produce the German economic miracle, will need to find counterparts in today's Europe. There are already positive examples. Many countries have taken bold steps in fiscal consolidation in very difficult circumstances. I don't see why this could not be extended to structural reforms and reinforcing economic governance.

Let's recall the story in which Ludwig Erhard was confronted by General Lucius Clay, who had been warned by his advisors that Mr. Erhard’s decisions on economic reforms were a terrible mistake.

“*Pay no attention to them*”, Erhard responded, “*my advisors tell me the same thing*”.