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Europe's Growth Challenges

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Frankfurt, November 19, 2010

Good afternoon. I would like to talk to you about one of the greatest challenges facing European policymakers today—how to ignite and sustain economic growth across the continent.

The postwar European model was built upon three pillars—peace, growth, and social cohesion. All three are critically important, and all three feed on each other. Today, Europe has a serious growth problem—a problem magnified by the earthquake of the global financial crisis. Today, with so many European countries under pressure from all sides, these challenges are more urgent than ever. If unaddressed, Europe's social model could unravel. It is time to renew the founders' commitment to ever-greater openness and ever-closer integration.

European growth

Europe enjoyed stellar growth in the decades after the war. Growth was then driven by technology catch-up, a stable macroeconomic environment, growing European integration, and a strong banking system. But these gains ground to a halt in the early 1980s.

Europe's living standards have stopped improving for one key reason—citizens are not reaching their full potential. To some extent, this reflects a conscious social choice to work fewer hours. There is nothing problematic here—after all, happiness does not come from income alone. But there is a dark side. Unemployment in Europe is chronically high, and employment participation is persistently low—especially among women, older workers, and the young. A key reason is that labor market institutions tend to reward privileged insiders at the expense of excluded outsiders.

Fundamentally, Europe is discarding too many of its people. We must never forget the immense human costs of joblessness—long-lasting income loss, worse health, higher mortality, lower children's educational attainment, and faltering beliefs in institutions and democracy. We face the very real prospect of a lost generation, distanced from the labor market, and marginalized from society.

Low labor utilization is not the whole story. In southern Europe, in the countries with the greatest competitiveness problems, productivity is also lagging behind. Infrastructure, innovation, and labor skills are not up to par and entry barriers are large in some sectors. Here too, the denial of opportunity is harming the economy.

Let's not forget the financial sector. Over the past decade, the financial sector focused more on sophisticated innovation, and less on being a true driver of economic growth. In Europe, it is difficult for start-ups to obtain funding. Small and medium-sized enterprises—key engines of growth—are the first to be cut off when pressures arise.

The global financial crisis brought these problems to a head. The euro area suffered from a deeper recession than elsewhere in the world—even the United States, the epicenter of the crisis—and is slower to bounce back. Inadequate governance in the euro area only made things worse. Close financial integration has brought great benefits, but it means that a problem with banks or sovereigns in one part of the euro area quickly becomes a problem for all. The area's institutions were simply not up to the task of managing a crisis—even setting up a temporary solution proved to be a drawn-out process. In the end, they did what they needed to do, but the sovereign crisis is not over.

In a sense, the wheels of cooperation move too slowly. Repairing the financial sector is taking too long, in part because policymakers are not paying enough attention to the pan-European dimension. The common European vision also seems lacking when it comes to fiscal governance, internal imbalances or labor reform. Europe needs a holistic growth strategy, where every country benefits from the efforts of others.

As the post-crisis world takes shape, Europe risks being left even further behind, especially as the dynamic regions of the world are bolting out of the stables.

A reform agenda

Europe must break the shackles of low growth, and stop settling for second best. This is the only way to save the social model and fulfill the common European destiny. It has done better before, and it must do better again.

We need movement on many different fronts. The first step will be to address two urgent problems. Fixing the financial sector must surely come first. Banks must have sufficient capital to support growth, once investment opportunities reappear in earnest, without incurring excessive risks. The Basel III agreement is a landmark in this respect. However, policymakers must also have the ability to deal decisively with problem banks, and must forge ahead with better supervision and better crisis resolution procedures. Here European financial integration, which has brought so many benefits, also presents special challenges. In the long run, the financial sector must do more to nurture growth—especially by supporting small businesses. Right now, these businesses rely too much on banks for financing, and venture capital markets could do a lot more to meet their needs.

Since the recovery remains weak, policymakers must initially take steps that support demand where it is possible. More generally, credible medium-term fiscal consolidation is crucial, with the pace tailored to country circumstances. Different countries face different challenges, but in all cases, job creation must be a priority. Growth without jobs is growth without value.

To provide momentum for labor market reform, I see benefit in launching a "Single Labor Market" initiative at the European level—a sequel to the "Single Market" initiative that harmonized good markets. The euro area cannot achieve its true potential with a bewildering patchwork of segmented labor markets. These barriers exacerbate the diverging economic fortunes that threaten the euro area today. It is time to create a level playing field for European workers, especially in the area of labor taxation, social benefits systems and portability, and employment protection legislation.

To complement these efforts, and to stay on the frontline of innovation, Europe needs to devote more resources to research and education. The euro area lags behind the United States both for publically- and privately-funded research and development. A more radical approach would be to transfer the research and university budget to the EU level.

In the longer term, let us also not forget that growth in Europe, and especially the euro area, needs to become more balanced. Just like we worry about global imbalances, we should worry about imbalances within the euro area. It is simply not true that surpluses are good and deficits are bad. For growth to be sustainable, current account deficits in some European countries will need to shrink, and, in parallel, in other countries—such as here in Germany—growth will need to become more domestically driven.

Long-term growth would also get a boost from a less restrictive approach to immigration. Europe seems to be fighting a losing demographic battle, with the labor force projected to decline significantly in coming decades. It makes sense to rely on immigration to address skills shortages, as has been done in North America. This could also make the social model more sustainable. However attractive it might seem from a near-term political perspective, Europe cannot solve its problems by bolting its doors.

A center-driven agenda

How can such a comprehensive reform agenda be best achieved? There is no single grand solution, but challenges on this scale can only be solved in a collaborative manner. Just look at the lessons of recent European history. When the agenda is driven by the center, things happen. Think of the single market program, or of monetary union. But when the agenda is left with the nations, things stall. Think about labor and service market reforms, especially through the Lisbon agenda.

Peer pressure has not served Europe very well. It's time to change course. The center must seize the initiative in all areas key to reaching the common destiny of the union, especially in financial, economic and social policy. Countries must be willing to cede more authority to the center. Mechanisms must be redesigned to give them the incentives to reform.

Progress is being made on a number of fronts, but we are still some distance away from an effectively functioning economic union—the missing "E" in EMU!

Many issues revolve around budgets. The most ambitious solution—extensively discussed in the academic literature—would be to create a centralized fiscal authority, with political independence comparable to that of the ECB. The authority would set each member's fiscal stance and allocate resources from the central budget to best hit the dual targets of stability and growth.

Such a leap toward European political integration appears unlikely in the foreseeable future, but we should exploit other ways of moving in this direction. There are at least two ways.

One is to shift the main responsibility for enforcement of fiscal discipline and key structural reforms *away* from the Council. This would minimize the risk of narrow national interests interfering with effective implementation of the common rules. Within the existing institutional context, the Commission—as the guardian of Europe's treaties—could play such a role. A separate, independent, institution could work as well.

Finally, it would make sense to increase the size of centrally-allocated budgetary resources. This means going beyond the current EU budget, strictly limited by the Treaty, to a system that uses more transparent EU-wide instruments—such as a European VAT, or carbon taxation and pricing.

Conclusion

Let me conclude this morning by taking you back where I started. After a calamitous half century, the people who rebuilt Europe were determined do to things differently, to set sail on a new course of cooperation and integration. In doing so, they banished the specter of conflict from the continent, something that had seemed impossible. As Robert Schuman, one of the founders of the European Union, said in 1949, "*We are carrying out a great experiment, the fulfillment of the same recurrent dream that for ten centuries has revisited the peoples of Europe—creating between them an organization putting an end to war, and guaranteeing an eternal peace.*"

And with this peace came rising growth and prosperity, and a degree of social cohesion that is the envy of the world. These gains are now under threat from low growth, poor employment prospects, and growing economic divergences. These fault lines have been around for a while, but the earthquake of the global financial crisis ripped them wide open.

The only answer is more cooperation, and greater integration. Now is the time to fortify the economic foundations of the union. None of this will be easy. But was the single market easy when first proposed? Was the single currency easy to design and implement? Europe has faced these kinds of challenges before, and overcame them. It can do so again. It's time to finish the job, to finally realize the common destiny of Europe.

Thank you.