The test of progress Europe, the euro and the future

Sabine Lautenschläger says now is the best time for the reforms that are necessary to ensure Europe's well-being

"T*he eurosceptic genie is out of the bottle and won't be put back"*, said Nigel Farage on 23 June 2016, while the British were still voting on whether they wanted to remain part of a united Europe. The majority didn't want to, as we now know. But the eurosceptic genie is not only haunting the people of Britain. After the Second World War, Europe represented the future for many people; today, a large number are having doubts about Europe's future.

In many countries, parties critical of a united Europe are in the ascendant. Think of the Front National in France, the Freedom Party in the Netherlands, the Five Star Movement in Italy and the Alternative for Germany party. For me, Europe is the future: politically, because Europe stands for peace and freedom; economically, because Europe offers, with its common market, freedom of movement of persons, goods, capital and payments, and the freedom to provide services. These freedoms have enabled Europe to grow together, boosted the economy and brought prosperity to us all.

The same applies to the euro. The euro is an important part of Europe's integration and it offers significant economic advantages. As the currency of the common market, it stimulates competition and makes trading and investing easier right across Europe. At the same time, it is an international currency and thus gives Europeans greater political influence on the international stage.

Despite all these things, the euro is now mainly associated with the crisis. And yes, the euro area has been through a severe crisis. Growth has slumped, prosperity has been wiped out and many people are worried about their future livelihoods, especially, but not only, in the crisis countries.

But the euro area has coped with the crisis and is recovering. Now there are some people saying that this recovery won't last as it is only being driven by a loose monetary policy. It's true that the ECB played a key role in fighting the crisis. It's also true that the ECB's monetary policy is helping the economy to recover. And it's true that monetary policy by itself is not enough to strengthen the euro area economy in a sustainable way and create prosperity for all.

Let's take a closer look at these things.

The ECB's monetary policy

The ECB did a great deal to help combat the crisis, starting with the banking turmoil in 2008, the sovereign debt crisis from 2010 onwards and later the prolonged low inflation. In doing so, it took a number of measures. Some of them form part of conventional monetary policy, others are new or, at least for the euro area, unusual.

We need more reforms in the euro area. And now is the best time – in a nascent recovery reforms are easier to carry out than in the midst of a crisis

Thus, when inflation remains too low for a long time it's a conventional measure for a central bank to lower interest rates. The idea behind this is as follows: the lower the interest rates are, the more attractive it is for companies to invest and for people to consume. Demand goes up, as do prices.

Yet this conventional monetary policy virtually became a new instrument in June 2014. For the ECB cut the deposit rate for banks to below zero – the zero lower bound was breached. Since then, banks have had to pay interest on their deposits at the ECB.

Do you find it strange to pay someone in order to lend money to them? It is at the very least unusual, but there is a reason for it in this case. The idea is to encourage a bank to lend its money elsewhere – for example, to businesses. That is one effect of negative rates.

And there is a second effect – aimed at investors in the financial markets. It was made clear to them that short-term interest rates could fall below zero. Mindful of this, investors adjusted their interest rate expectations downwards; long-term interest rates have fallen. This has strengthened the desired effect on investment and consumption.

The low interest rates are now being severely criticised, particularly in Germany. It's claimed that the ECB is penalising savers, destroying the banks' business models and ultimately doing more harm than good. My point of view in this debate has always been that low interest rates are justified.

Interest rate cuts are the 'normal', the called-for, monetary policy measure of a central bank when inflation is well below the objective. This is all the more the case when inflation remains low, when inflation expectations show no signs of improvement, when growth is very weak and unemployment rising. In such circumstances every other central bank would have cut interest rates.

That I am more critical of some non-standard monetary policy instruments, such as the purchase of government bonds, is well known. However, the world keeps on turning and the debate moves on. The situation seems to be improving in the euro area. Consumer confidence in December was at its highest for 18 months. Unemployment is at a seven-year low. A broad-based recovery is under way – across countries and sectors.

At the same time, inflation in the euro area rose significantly – from 0.6% in November to 1.1% in December. In Germany inflation even stood at 1.7% in December. And unsurprisingly, some are calling for the ECB to put a quick end to its loose monetary policy.

In terms of the desired level of inflation, it's been a long, cold winter. We are now seeing the first ray of sunshine – that's good. Is this ray already having a warming effect and does it herald the spring? Is inflation really back? Perhaps one or two more rays of sunshine are needed; they'll bring a bit more warmth.

Higher inflation is currently being driven mainly by energy prices and they could well have only a temporary effect. What's more important here is underlying inflation, from which the very volatile energy and food prices are excluded. And underlying inflation in December was just 0.9%, after 0.8% in November. This rise was largely due to the fact that package holidays became more expensive in Germany. However, this does not tell us much as the prices of package holidays are always fluctuating.

Does this mean we still have to wait a long time before exiting accommodative monetary policy?

In my view it doesn't mean waiting until the last doubt about the return of inflation has been dispelled. It is rather a matter of not risking a reaction to a temporary inflation spike – which then might lead to longer, exceptional monetary policy measures.

All preconditions for a stable rise in inflation exist. I am thus optimistic that we can soon turn to the question of an exit. That's why we need to be ready to act when the time comes. For loose monetary policy is like a strong medicine for someone who's very sick. It works, no doubt, but it also has side effects – and some of the unconventional measures have stronger side effects than others. And while the intended benefits of these measures wear off over time, the side effects and risks increase.

That's why it's important to stop taking the medicine as soon as possible, but not too early either. Otherwise, we risk having a relapse. And let me reassure you that, to stick with the metaphor, I am an optimistic doctor who believes in self-healing powers and gladly stops prescribing the medicine sooner rather than later. And, above all, as with many medicines, you shouldn't abruptly stop loose monetary policy, but slowly cut the dose – such a policy has to be reduced gradually.

In any case, loose monetary policy can help put a patient back on her feet, but by itself it can't ensure that she'll go on long walks again. Monetary policy cannot create sustainable growth. Other things are necessary. Sound economic structures form the basis for long-lasting growth; reforms are the right therapy.

Structural reforms for more growth

We need more reforms in the euro area. And now is the best time – in a nascent recovery reforms are easier to carry out than in the midst of a crisis. And they pay off, as many examples have shown. Consider Ireland and Spain: these countries have reformed their economy and become more competitive; their economies have grown and unemployment has fallen.

But in other euro area countries, unemployment remains very high, especially among young people. Labour markets are often too rigid to respond flexibly to change – regardless of whether the change was triggered by a crisis or shifts in technology. The same applies to goods markets and the general business environment – here too, strict rules or excessive red tape reduce flexibility. All of this is important for the countries in crisis. But the problem goes beyond those countries.

Take productivity growth. Put simply, productivity measures how much a worker can produce in a given period of time. When productivity rises it means that each worker produces more than before. A good 20 years ago productivity in the euro area was growing steadily – in 1995 productivity growth was around 2% per year, as in the rest of the world.

Today, however, we are a long way behind. Productivity in the euro area is 0.5%. The global average is still just under 2%, the emerging countries over 3%, the United States and other industrialised countries just under 1%.

This in itself is a problem. But there's another factor: an ageing society. In future, a shrinking number of young people will be working for an increasing number of old people. So it's all the more important that productivity grows. And that makes reforms necessary.

Often productivity improves because of innovations. But for that, it's vital that innovations spread. This occurs, for instance, through competition: new businesses, which can produce better and at lower cost thanks to innovative methods, squeeze out older companies. The economist Joseph Schumpeter called this 'creative destruction'.

For that to happen, the environment has to be right. In many countries, for instance, entrepreneurs still have to overcome major bureaucratic obstacles simply to set up a business. Once they have done that, they need capital and labour in order to grow. That brings us back again to flexible markets, which can react to new and changing demand.

And finally, businesses need markets on which they can sell their products. In that context, it is important to complete the common European market. That applies particularly to the digital market, which is set to become even more important in the future.

Growth and prosperity

We need reforms for the economy in the euro area to grow sustainably. Hardly anyone questions that. But is that the end of the debate? Will people regain confidence in Europe and in the euro when the economy is growing again? I think growth plays an important role, but we also have to look beyond that.

Theodore Roosevelt said: *"The test of our progress is not whether we add more to the abundance of those who have much, it is whether we provide enough for those who have little".* Translated into the language of economics, it means: we must not only pay attention to growth but also to the distribution of the wealth it generates.

Compared with other regions, income and assets in western Europe have traditionally tended to be quite evenly distributed. But as in many other countries, inequality is rising – and has been for decades. There are many reasons for this, ranging from rising unemployment, a larger number of single parents, reduced spending on education through to steady de-industrialisation.

Rising inequality is a complex phenomenon. Some people therefore seek to explain it in simplistic terms by referring, for instance, to globalisation or European integration. That's how we then have a link between the distribution of wealth and criticism of Europe, as I mentioned at the start this article. And indeed, studies are showing that there is a relationship: increasing inequality provides fertile ground for euroscepticism.

And inequality is not a problem that only affects Europe. The World Economic Forum in its current *Global Risks Report* says that inequality is one of the key risks to the global economy. These are all reasons for not focusing solely on growth in our deliberations. Distribution of its benefits must always be borne in mind as well. That concerns on the one hand national welfare systems.

On the other hand, it also concerns equal opportunities: how can people be put in a position to benefit from technological progress, globalisation or European integration? And there are many who say that the winners and losers of such trends differ in one respect particularly: in terms of their education.

The well-educated benefit from international trade, open borders and new technological opportunities. Education is key if we want to create equal opportunities. We have to take action here if we are to pass Theodore Roosevelt's 'test of progress'.

Conclusion

Europe is a target of criticism – no question about that. In this article I have concentrated on economic issues and concluded that:

First, monetary policy must get ready for better times.

Second, reforms are necessary to ensure our well-being – and now is the best time for this.

Third, prosperity must be of benefit to all – equal opportunities are crucial.

And finally: we need a united Europe; we need free trade and a common currency. As Barack Obama said: *"A nation ringed by walls would only imprison itself".*

But the unity of Europe is of course much more than just a common market and a common currency. And prosperity is much more than just material wealth. Europe also means common values.

After the Second World War, it was all about ensuring peace. It was about creating a free and open society which steadily builds on the bedrock of democracy. But here too, the advantages of a united Europe must benefit everyone. Europe has to be a home where its citizens can feel just as European as they feel German or French. A home where everyone can move freely and benefit from the opportunities that arise.

This is a major challenge for politicians, but I am convinced that they can master it. I would therefore like to end by paraphrasing another former US President. Bill Clinton said something about the United States which I will adapt to our continent: *"There's nothing wrong with Europe that cannot be cured by what is right with Europe".* ■

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