

Promoting sustainable and inclusive growth and convergence in the European Union

Speech by Guntram Wolff at the Informal ECOFIN Meeting, Bucharest, 5 April 2019

based on the Written Contribution by

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- Thank you for the invitation. We were asked to write on what we think should be the economic priorities for the EU in the next 5 years.
- The European Union can look ahead at the next five years from an overall good economic position (at least from a structural perspective). Employment is comparatively high, the recovery has been uninterrupted for several years and income inequality, although slightly higher, remains less pronounced than anywhere in the world.
- But the EU faces nevertheless formidable economic challenges. In the short-term, there is the potential for strong macroeconomic weakening, resulting partly from uncertainty generated by the global trade conflict.
- The EU also has a long-term growth and productivity weakness, which has become even more visible as other major economies have boosted their technological capacities.
- The EU and in particular the euro area suffer from a lack of convergence and its social cohesion is threatened.
- Let me illustrate some key facts with the following charts.

CHARTS 1,2,3,7 of the paper and a chart on the decline of top marginal tax rates for corporate income, personal income tax and inheritance tax.

- What do we therefore recommend as economic priorities for the next 5 years?
- The EU must put together a European growth strategy that focuses on innovation while addressing climate change and improving social cohesion.
- The growth agenda is really opposed by two groups of people: those who think that the benefits of growth accrue only to the rich and those who

think that growth is incompatible with reducing greenhouse gas emissions.

- It is no longer enough to talk about growth alone: it has to be equitable and sustainable.
- Growth requires investment, research and innovation. This should also be more clearly visible in the new European multiannual financial framework.
- The current debate on industrial policy is welcome. For example, the EU needs a clear European digital agenda. How to deal with data, networks and the use of data is one key priority. How to improve basic research and facilitate application of research for commercial purposes, for example in the context of AI? How to ensure that companies can scale in a well-integrated single market? How to improve conditions for growth?
- But the EU should be careful avoid falling into the protectionism trap.
- Some of the recent contributions to the topic of industrial policy and how to deal with China have, in our view, been too strong on the side of protectionism and too weak on the side of increasing our innovation capabilities. And competition policy in particular is a delicate field. Weakening merger control does not necessarily lead to more innovation, on the contrary. Moreover, less competition can increase inequality.
- It is imperative to avoid falling in the trap of short-term gains at the expense of long-term sustainable outcomes.
- To achieve its climate goals, the EU must ensure that it becomes greenhouse-gas emission neutral by 2050 or earlier.
- Industrial policy can be supportive of decarbonisation but, above all, regulatory and price measures will need to be toughened. Ultimately, we consider a carbon tax on emissions in all sectors as an indispensable price mechanism that should also drive private innovation.
- There is also clearly an international dimension to the climate strategy: how to deal with carbon border adjustment when activity shifts abroad and how to support low income countries in adapting climate neutral technologies as they develop.
- Still, let's make no mistake: A European climate strategy will imply a massive transformation of all economic activities.
- This will pose major economic and social challenges. Citizens will be affected in their daily lives if one was serious about addressing climate

change (for example, think of the daily commute by cars or labour mobility leading to weekly air flights)

- Distributional concerns will therefore have to figure prominently in this transformation.
- More generally, the benefits of growth need to be distributed more fairly in our societies. While social policy is and should remain a national responsibility, the EU needs to ensure that the single market, a key asset to promote growth and economic well-being, does not undermine the ability of countries to raise taxes on capital income, wealth income and inheritance.
- A rising tax burden on the working middle class might have already become incompatible with Europe's social market economy.

CHART convergence (chart 4 in the paper)

- Let me come to our second big point, convergence. SHOW MAP
- Convergence in the EU and in the euro area is a necessity: the European growth strategy cannot be blind to sustained regional growth differences. An EU in which economic growth does not spread through all of its major regions will be politically challenged and is undesirable.
- The paradox is that many of the policy instruments to address this problem remain in the hands of national policymakers, even though the way they use them has significant implications for the rest of the EU.
- One key issue that my colleague Maria Demertzis has written on extensively is the quality of institutions. We see that countries with weak institutions tend to have not only lower convergence, but also less trust in national government. A negative feedback loop. Good governance is key and primarily in the hands of national policy makers, even though the EU provides technical support. The EU can play a much more catalytic role in this respect.
- But beyond the domestic factors behind low growth, there is also the issue of the systemic drivers of divergence.
- In the euro area, further measures are needed to address those.
- A well-functioning financial system is fundamental for growth. Let's be under no illusion: high and sustained differences in funding costs across the euro area hamper growth and investment in those parts that have high funding costs.

- Real interest rate differentials (even if the rates themselves are currently at historically low levels) are driven by sovereign spreads and inflation rate differences. Sovereign spreads still feed strongly into funding conditions for companies and households.
- It is therefore imperative to complete banking union and for capital markets to become more integrated. A decoupling of national sovereigns from banks and the financial system would allow to improve funding conditions in significant parts of the union, supporting growth and convergence. A euro-area safe asset would bring benefits in that regard but is difficult to establish. This debate is well-known and trade-offs are well understood. On Capital Markets, it may be time to think in a little more innovative ways.
- The EU budget and the euro area budget are instruments to support convergence. It is important to carefully evaluate, which types of programmes actually work. It is also important to create a euro area budget mechanism that functions well and with clear and effective governance structures.
- Finally, let me talk about the EU's macroeconomic management. Sovereign spreads are welcome in supporting fiscal discipline but they also hamper the ability of some countries to use fiscal policy, should there be an economic downturn. This could further reduce convergence and leave parts of the EU behind.
- With interest rates at the zero lower bound, monetary policy will have little to contribute to stem the next downturn: Fiscal policy will have to play a bigger role. This should be one key topic on the minds of this group.
- More responsive national fiscal policies are therefore of great importance to better respond to cyclical downturns. In the next euro area wide downturn, it will be fundamental that the Eurogroup finance ministers quickly coordinate a joint response.
- In our view, EU fiscal rules need to be reformed to improve the macroeconomic management of the euro area.
- Let me stop here. Thank you very much.