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Perspectives on the European crises from a small open economy

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Introduction

It is a pleasure to be here at the LSE today and to speak at an institution that has long been at the forefront of economics and social sciences in general and that has such a rich history of bridging the gap between academia and policy making.

The title of today's lecture is "Perspectives on the European crises from a small open economy".

I will talk about some of the underlying causes as well as what I believe to be factors to be taken into consideration when confronting the challenges involved in handling the crisis.

In particular, I will focus on structural problems that Europe needs to address in order to improve the conditions for a sustained recovery.

I will also touch upon some of the recent political developments in the European Union.

These are challenging times for all of us here in Europe. We're now looking at the fifth consecutive year in which European governments are preoccupied with financial turmoil, weak public finances, anaemic growth and high unemployment.

The outlook for 2013 is meagre, with sluggish growth and high unemployment in large parts of Europe, but the current situation does not bear close resemblance to the state of affairs in 2008. The collapse of Lehman Brothers sent shockwaves through the financial system. Credit markets and interbank lending dried up, world trade plummeted, and European governments faced the prospect of another depression, with years of negative growth and a possible implosion of the financial system.

Next, the economic downturn and the linkages between national banking systems and sovereigns contributed to transform the financial crisis into a sovereign debt crisis that at times has threatened to break Europe apart.

Important measures have been taken to manage some of the most pressing issues, in particular with regard to the regulation of financial markets. Here the crisis brought new insights and, equally importantly, impetus for reform. A key insight is that we have improved awareness of the need to monitor systemic risks, and to design the rules of the game so as to protect the financial system, not individual firms. Higher capital requirements for banks are an important step.

Challenges for fiscal policy

Over the last few months we have been debating whether austerity or growth should be the main road for fiscal policy in the current environment.

I will take a pragmatic approach to this question. Clearly, there is no simple solution that applies to all countries. But let me emphasise two key considerations.

1. Secure confidence in the economy

The first point is that governments must at all times secure and safeguard the credibility of economic policy among households, firms and markets. Disorderly public finances generate uncertainty that push up borrowing costs and dampen consumption and investment.

Bearing this in mind, there must be a basis of confidence with regard to the sustainability of public finances.

Naturally, a delicate balance must be struck between strengthening public finances and restoring growth. But failing to safeguard credibility will result in neither of these two goals being achieved.

This is why it is erroneous to cast the policy choice in terms of a dichotomy between austerity and growth.

The policy must depend on the situation and the circumstances in each country.

The UK has paid close attention to the timing of fiscal consolidation, letting the fiscal balance improve gradually and in a manner that facilitates long-term growth. A weaker policy could have caused a general increase in the market's risk premia and have made both firms and households more reluctant to spend and invest.

The UK has had room to manoeuvre and has used it wisely.

By contrast, countries in worse condition have no choice but to act rapidly because they have to restore credibility and confidence in their economies and bring down borrowing costs if they are to get back on an even keel.

In particular, struggling EU Member States need to fulfil the commitments they have already made. And they need to do so at a pace that is adequate to restore market confidence.

Aggregate demand will react favourably to this restored confidence, whereas it is bound to be anaemic in its absence.

Countries in a stronger position do have the alternative to use fiscal policy to inject energy into the economy. Sweden agrees with the IMF and the OECD that countries with adequate fiscal space should use their strengths to support a sustained recovery.

Given the elevated risk levels, it is important even for countries whose position is relatively strong not to become complacent and abandon necessary safety margins that secure room for manoeuvre in the case of a protracted, or sharper, downturn.

Particularly, governments in a stronger position should give priority to boosting growth and employment in a long term perspective. This brings me to my next point.

2. Confront fundamental problems

The second point is that handling the crisis is not primarily about how well we manage short-term stabilisation. Instead, the crucial issue is our readiness to confront more fundamental questions that will determine long-term growth prospects and the scope for our European social model.

While Europe is bogged down in fiscal problems, the global economy is undergoing rapid change. Emerging economies in Asia and elsewhere are lifting hundreds of millions of people out of poverty.

The powerful structural transformation taking place around us will shape our economies for decades to come. It brings great potential but also formidable challenges. Europe will need to adapt to increasingly tough competition at all levels of the value chain.

Rapid changes to the international economic landscape can have a major impact on entire sectors and regions and deal severe blows to those losing their jobs.

We need to address the questions of how to reduce the risk of severe shocks and how to maintain our competitiveness on a basis of knowledge and quality, not low wages and poor working conditions.

Europe's problems run deep

The crisis has exposed the structural problems in many countries in Europe that where hidden during the boom years. Not all Member States have embraced globalisation and economic openness equally. For countries that failed to do so, the run-up to the crisis was characterised by declining competitiveness, overly regulated labour and product markets, and an absence of structural reforms to promote growth and jobs.

Since the year 2000, growth has averaged 1.4 per cent in the EU and 1.2 per cent in the euro-zone. This is less than the UK and OECD average, and well under Sweden's average growth rate of almost 2.5 per cent. Southern Europe has been losing competitiveness for a long time.

In terms of relative unit labour costs, Portugal, Spain, Italy and Greece all saw a loss of competitiveness of 20-30 per cent compared to Germany over the past decade (2000-2010).

Since then, Spain has recovered about half of that deterioration. The real effective exchange rate for Italy, on the other hand, has hardly improved at all.

Clearly, much remains to be done.

Promote jobs and growth

Structural reforms that improve the functioning of the economy are the key to improved growth and employment prospects in Europe. Europe cannot afford to postpone necessary reforms.

The European welfare state model is under increased pressure also from within. Ageing populations will significantly increase demand for welfare services over the coming decades. To address this challenge, debt levels will need to not merely stabilise but come down significantly, and one key factor in bringing down debt levels within the foreseeable future is to boost growth.

Europe needs to focus on reforms that increase productivity, raise competitiveness and set the stage for long-term economic growth.

Continued reforms are needed to ensure well-functioning institutions and a higher degree of competition, free and open worldwide trade as well as deregulation of national monopolies, product markets and regulated sectors, not least in domestic service sectors.

Pension and social security reforms will be required in many Member States to assure sustainable public finances. The functioning of labour markets must be improved in order to reduce long-term unemployment and social exclusion.

At the same time as public finances are restructured, it is also necessary to increase growth expenditures. Human capital formation through investments in education and R&D must be encouraged. Infrastructure spending must be scaled up.

I mentioned earlier that the supposed trade-off between austerity and growth is a false dichotomy. Here is a case in point.

Some of the most effective growth-enhancing structural reforms, such as pension and social security reforms, would strengthen public finances.

And other, equally important, reforms, such as deregulation of labour markets or increased domestic competition, do not have a negative impact on fiscal balances or domestic demand.

Europe is at a crossroads

I strongly believe in a growth-oriented and dynamic European Union.

The integration of Europe has brought great benefits to our once-divided continent. Through the development of the single market and the social market economy, the EU has promoted growth, social cohesion and poverty reduction.

The achievements of the European project must be safeguarded and reinforced.

Europe is now at a crossroads. The crisis has exposed structural problems in many countries in Europe that were hidden during the preceding boom. It is now imperative that we work together to get Europe firmly back onto a sustainable growth path.

Recent proposals aimed at building a fiscal union for the euro-area are far-reaching and can potentially threaten to build a permanent division of Europe.

Solutions to Europe's common problems should be discussed, negotiated, and agreed on in settings where all EU-27 states are represented. Separate structures, or joint structures on an uneven footing, would undermine, rather than support, European integration.

The crisis continues to pose formidable challenges for all of Europe. Our common interests - Europe's political, economic, and social development - remain the bedrock of the Union.

EU and euro-zone cooperation have been crucial in dealing with the economic crises and turmoil of the past few years.

We now need to facilitate a prompt economic recovery and make progress on structural reforms that boost productivity, competitiveness and long-term economic growth.

An open and growth-oriented Europe

From a Swedish perspective, it is obvious that we have much to gain from the UK playing a strong role in Europe. It is in our interest to safeguard an open and growth-oriented Europe. As a strong non-euro member with a sound pro-growth agenda, the UK can play a key role for long-term growth fundamentals.

A UK that turns its back on Europe would weaken both Europe and Britain. The relations and connections between our European nations run deep, with large mutual flows of investment, trade, capital, and labour.

It is now time to harness the strength of the single market and our shared European institutions in a way that supports a speedy recovery and a solid long-term trajectory.

Swedish policies to weather the crisis

What policies have enabled Sweden to weather the crisis?

Sweden is a small open economy, and exports make up a large share of our industrial production. This makes us vulnerable to external shocks. Sweden was hit hard when international trade flows plummeted in the wake of the global financial crisis that began in 2008.

Between 2008 and 2009, our GDP fell by more than 6 per cent. Since then, we have seen the beginnings of a recovery, but the crisis is far from over.

Sweden is clearly affected by the crisis, but compared to many other countries we have done relatively well throughout the worst economic crisis since the great depression of the 1930s. What explains Sweden's performance?

1. Strong public finances

One important explanation is strong public finances and responsible fiscal policy. Sweden entered the crisis with large surpluses and relatively low debt, reflecting responsible fiscal policy during the run-up to the crisis. When the recession hit, Sweden had enough fiscal space to provide some support to the economy without jeopardising fiscal sustainability.

Credibility was a prerequisite for such an expansive fiscal policy.

Sweden's public finances are among the strongest in Europe. This year, EU Member States are expected to run deficits of on average 3 per cent of GDP with average debt levels at 90 per cent, while Sweden is expected to run a deficit of just over 1 per cent and have a debt level around 40 per cent.

Strong fiscal institutions play an important role in boosting credibility. Sweden reformed its fiscal framework in the mid-1990s and has gone from being among the worst in Europe to among the best. And our public finances have followed course.

2. Structural reforms have improved the functioning of the economy

The deterioration of public finances in many countries not only reflects costly bail-outs and ineffective spending in the face of weaker demand, but also significant increases in unemployment during the crisis years.

The crisis has hurt jobs in Sweden and unemployment has increased too, but the impact has been cushioned. Employment in Sweden is now back above the level before the crisis, while employment is some 2 per cent lower today in the EU then before the Lehman crash.

Why has employment fallen in the EU and increased in Sweden? Sweden is a small, open economy. We are heavily oriented toward exports and Europe represents about half of our export market.

As mentioned, Sweden's strong public finances allowed for expansionary policies that stabilised demand without jeopardising our credibility. It should also be underlined that the expansionary fiscal programme in Sweden was heavily based on structural reforms that improved the functioning of the labour market.

In the 1990s, in the wake of another major economic crisis, Sweden succeeded in dealing with a number of important problems. But the labour market continued to perform poorly. For a long time it was characterised by weak development in private employment and growing social exclusion, with an increasing number of people on sickness absence or in early retirement.

At the peak, close to a quarter of the working-age population were dependent on benefit systems linked to sickness or unemployment.

The weak labour market performance in the 1990s and early 2000s was primarily due to serious long-term structural problems.

Taxes that are too high, benefit systems that are too generous, labour market policies that are ineffective and employers' social security contributions that are too high have tended to make labour supply and demand too low.

They also cause matching in the labour market to function poorly. The incentives to work or to move from part-time to full-time work were much too weak and it was too expensive to hire.

In addition, the business climate was much too poor. Few people have been prepared to start a business and get it to grow rapidly. Being an entrepreneur has simply not been sufficiently attractive.

The structural policies that the Swedish Government has pursued since 2006 rest on several cornerstones:

First, strengthen the incentives to work and improve the functioning of the labour market.

Second, make it easier, and less expensive, to hire and more attractive to start and run businesses.

Third, improve the quality of the education system.

Sweden has weathered the crisis well not just because we entered the crisis with sizable fiscal buffers, but also because the Government stuck to sound policies in the throes of the crisis.

As a result of prudent policies, the Government has been able to maintain necessary safety margins throughout the crisis. When growth in Europe was once again dampened last autumn due to the crisis, Sweden was strong enough to inject energy into the economy, even though the crisis was into its fifth year.

In the budget for 2013 we presented a programme to strengthen long-term growth. Infrastructure, lower corporate taxes and increased spending on research and development will make Sweden stronger as we go forward.

Expenditure on infrastructure is set to double between 2006 and 2018. For the first time in more than 100 years, the Swedish Government will initiate the construction of a new mainline railway. Expenditure on research and development is also set to increase sharply, safeguarding Sweden's position as being a country where public and private spending on research and development is among the highest in the world - about 3.5 per cent of GDP. And the corporate income tax has been lowered from 26 to 22 per cent. These measures reinforce Sweden's position of strength.

Conclusion

Let us not forget that European economic and political integration has brought prosperity and stability to all our countries. The crisis has highlighted some major structural problems in many countries in Europe that were less apparent during the preceding boom.

The magnitude of Europe's problems is reinforced by market volatility and macro-economic uncertainty. But there is no fundamental reason why these issues cannot be addressed and solved in a way that improves the competitiveness of our European economy and thus also strengthens the global role that Europe can play. But doing so will require courage and determination from national leaders.

Governments must secure and safeguard the confidence of households, firms and markets. States with deficits must pursue serious, substantial, and sustained fiscal consolidation, but the appropriate pace will vary from case to case.

The Swedish experience offers two key lessons. First, the starting point for recovery must be to secure credibility and market confidence. Second, governments must also confront more fundamental issues that will truly determine long-term growth prospects and the scope for our European social model.

In particular, Europe needs to focus on structural reforms that increase productivity, raise competitiveness and set the stage for long-term economic growth.