



**“The Hamburg Summit: China meets Europe”**

Keynote Speech

by

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# Economic reforms: European and Chinese challenges

## Introduction

Relations between China and Europe are currently closer than ever before. This is ultimately a result of the growing interdependence between these two partners and the ensuing need to address common policy challenges through cooperation in today's global environment.

The strength of the economic links between China and Europe is undeniable. In my capacity as a euro area central banker, let me provide some evidence pertaining to this vast region of Europe, which in around one month's time will span 17 different countries. The euro area is, alongside the United States, the main destination for Chinese exports, with an export share of 15% in 2008. But it is equally impressive – when looking, in turn, at euro area exports – that euro area exports to China *tripled* between 2000 and 2009, at a time when the share of the United States in total euro area exports was decreasing from 17% to 12%. The pace of this development has been particularly striking during the financial crisis: China's share of total euro area exports rose from 3.8% to 6.2% between the first quarter of 2007 and the second quarter of this year, increasing by an extraordinary 70% since the first quarter of 2009. It is also interesting to note that Chinese foreign direct investment in the euro area, while still at a relatively low level, has shown consistently strong growth since 2004. The people of Europe have now become used to the idea of some of their firms being owned by companies located in China.

It is therefore no surprise that our countries have significant shared interests. The point I would like to make today is that our common strategic concerns pertain not only to the continuance of a bilateral and global free trade environment, but also to the pursuit of domestic models in terms of growth and economic governance that prove sustainable and do not exacerbate macroeconomic or financial stability vulnerabilities over time. This would place the close relationship between our two economies on a solid footing in the long term.

Such relations must, in turn, be seen against the broader, multilateral background of the upgrading of the G20 in response to the financial crisis, which has been crucial in further involving all systemically important countries, including China, in international policy cooperation. In particular, the G20 Framework for Strong, Sustainable and Balanced Growth is a promising means of fostering collective action at the global level. If this goal is to be achieved, the ECB considers it vital that all G20 members fully live up to the commitments made within the Framework.

Against this backdrop, I will first discuss the policy challenges currently confronting euro area authorities and the responses that are being adopted. I will then talk about those factors which – both in my understanding and, as far as I can see, in the view of the Chinese authorities – make the pursuit of economic reforms a central objective in China, too.

## **1. Euro area**

There has recently been a tendency among commentators to regard Economic and Monetary Union (EMU) as being in need of far-reaching reform. This view has been encouraged by the emergence of tensions in certain euro area sovereign debt markets in 2010, which has caused some observers to reappraise the prospects for the single currency.

These criticisms stem from three challenges currently facing the euro area:

- first, the excessive debts and deficits in a number of member countries;
- second, the considerable divergence across the euro area in terms of competitiveness and member countries' sizeable current account imbalances;
- third, the challenge of preventing and managing crises, given the lack of a clear euro area framework for this purpose.

These challenges refocus attention on certain indispensable aspects of what it means to be part of a single currency area.

The challenge of excessive public debts and deficits serves as a reminder of the need for countries in EMU to pursue sustainable fiscal policies. Fiscal sustainability is a *must* in a union with a centralised monetary policy, but decentralised fiscal policies, and a central bank which – for very good reasons – is prohibited by the Treaty on the Functioning of the European Union from engaging in the monetary financing of public deficits. Moreover, fiscal policy has to be geared towards maintaining domestic demand in line with sustainable growth and price stability.

The challenge of intra-euro area imbalances underscores the importance of countries keeping nominal price and cost developments in line with those of the euro area as a whole. Otherwise, losses in competitiveness will ensue which cannot be offset by the exchange rate or the single monetary policy, which by definition can only be geared towards price stability in the euro area as a whole. This also underscores the importance of avoiding unsustainable current account imbalances, which imply vulnerabilities such as excessive credit growth or dependence on external financing.

The challenge of preventing and managing crises draws attention to the need for euro area countries to genuinely treat their economic policies as a “matter of common concern” – as they are obliged to by the Treaty – and exercise effective peer pressure. Intrusive mutual surveillance is a necessary precondition for participation in a highly integrated economic and financial area. As we have seen this year, a failure in terms of surveillance can quickly result in a crisis in a member country which – no matter how small the country – spills over to the rest of the area via cross-border holdings of that country’s sovereign debt and more general confidence effects.

While these challenges are genuine and serious, I do not agree with the conclusions that some commentators have drawn. Such criticisms overlook two very important aspects of the euro area that tell a different story about its resilience.

- *First, the euro has been successful, in its first 12 years, in many important areas which do not require reforms.* The euro has brought stability, with inflation averaging 1.98% and inflation expectations remaining solidly anchored. The euro has facilitated economic integration, with financial integration increasing by around 25-30% in those EU countries that first adopted the euro and trade integration increasing by an average of 5-10% since 1999. Those countries that have remained more competitive have benefited significantly in terms of trade in view of the absence of exchange rate fluctuation. The advent of the euro has also been associated with the stronger correlation of business cycles and a reduction in the dispersion of annual inflation rates and real GDP growth rates across euro area countries. Indeed, nowadays such dispersion is comparable to the dispersion seen across the various US states. And the euro has established itself as the second international currency. Given these achievements, it would be distressing to imagine a world without the euro. What would have happened to individual euro area economies during the deepest economic and financial crisis in decades?
- *Second, the major efforts that are already being made to address the root causes of the euro area’s challenges are sometimes overlooked.* Euro area countries are currently leading the way in prioritising a swift return to fiscal consolidation, which will have important confidence effects. The IMF currently predicts that the euro area’s aggregate fiscal deficit will be 5.1% of GDP next year. This compares with 9.7% of GDP in the United States, 8.1% of GDP in the United Kingdom and 8.9% of GDP in Japan.

The EU is also introducing a reinforced economic governance framework which will place our community on a more stable footing in the future.

EU governments have agreed to put in place stronger procedures for the surveillance of fiscal policies, paying more attention to government debt levels and creating stronger incentives, such as sanctions, to ensure compliance with recommendations. Sanctions for excessive deficits will be imposed much earlier than before. Progress is being made in the improvement of national fiscal rules and frameworks and government finance statistics, which will help to enshrine responsible fiscal governance in national law.

Governments are addressing the issue of imbalances by pursuing structural reforms as part of the “Europe 2020” initiative and setting up a new macroeconomic surveillance framework, with an alert mechanism based on scoreboard indicators that should identify and correct macroeconomic imbalances and vulnerabilities at an early stage. As imbalances are more detrimental in a single currency area, there is a stronger enforcement framework for euro area countries, backed by non-financial sanctions.

Leaders of euro area countries have committed themselves to setting up a permanent crisis management mechanism for the euro area when the current stability facility expires in June 2013, which should provide a more predictable framework for steering the single currency through crises. Seen in combination with the steps being taken to improve crisis prevention through the planned reform of fiscal and macroeconomic governance, there are grounds for confidence in the euro area’s ability to weather difficult periods in the future.

That said, there are still areas of that reformed governance framework where the ECB would like to see further progress. We would like to see greater automaticity in the implementation of fiscal surveillance procedures. We would also like to see stronger sanctions, such as financial sanctions, under the macroeconomic surveillance procedure. This procedure should concentrate firmly on euro area countries experiencing sustained competitiveness losses and large current account deficits. It should be based on transparent and effective trigger mechanisms and give its assessments and recommendations a high degree of publicity at all stages of the surveillance process.

The euro area is undeniably facing many challenges. But these challenges do not invalidate our achievements to date or the steps that are being taken to reform economic governance and address them at the source. I am confident that euro area authorities will do whatever is necessary to steer the single currency through its current difficulties, ensuring its future stability.

## 2. China

Turning to China, I very much welcome the fact that the Chinese authorities have placed the gradual rebalancing of growth at the heart of their policy objectives. The 12th five-year plan, due to be finalised in March next year, testifies to these efforts, which should not be seen in isolation, but as part of the broader efforts made by systemically relevant G20 members with a view to rebalancing their economies. In Pittsburgh last year, G20 members with significant external deficits pledged to implement policies to support private saving and/or embark on fiscal consolidation, while members with significant external surpluses committed themselves to strengthening their domestic sources of growth, as well as allowing greater flexibility in their exchange rate policies, as decided in Toronto. One year later, in Seoul a few days ago, G20 leaders pledged to “pursue the full range of policies conducive to reduc[ing] excessive imbalances”, the “timely identification” of which will be facilitated by “indicative guidelines to be agreed by [...] Finance Ministers and Central Bank Governors” in the first half of 2011.

It is against this backdrop that we have to look at the Chinese growth model. This model began three decades ago, when the country embarked upon a courageous process of reforms, and relies upon a large pool of domestic savings and cheap labour, with growth being driven mainly by investment and low-cost exports. In this context, China’s macroeconomic policy framework is built on three mutually consistent pillars: a managed exchange rate; a closed capital account; and the pursuit of some degree of monetary policy autonomy, mainly via administrative measures.

The achievements of this model over the past three decades are unquestionable. First, China’s output has grown by an average of around 10% per year since those economic reforms began in 1978, with the economy showing remarkable resilience even during the recent global financial crisis. In terms of levels, China’s GDP now accounts for less than 40% of US GDP in market exchange rate terms, but around two-thirds of it in terms of purchasing power parity. Looking ahead, some observers expect China to surpass the United States as the world’s largest economy as early as 2020.

Strong and sustained economic growth has fuelled an eightfold rise in per capita income. And as a result, the poverty rate – the percentage of the population that has an income of less than USD 1.25 per day – has declined to less than 16%, down from 85% when the reforms began. In other words, China has managed to lift more than 600 million people out of poverty in the last three decades.

China’s export development is equally outstanding. It has increased its world market share from less than 1% in 1980 to 8% today, and in 2009 it dethroned Germany as the world’s largest exporter.

However, the apparent successes and resilience of the Chinese economic model do not necessarily mean that this model will prove equally sustainable over, say, the next 15 years.

Indeed, it is interesting to note that some of the major long-term factors that have been driving China's strong economic performance may reach a turning point in the not too distant future. These are (i) the continuous growth of demand for Chinese exports, (ii) favourable demographic developments, and (iii) the sustained accumulation of physical capital. As regards the first factor, it seems unlikely that China's export growth can continue to persistently exceed 15% per year, given projected domestic demand trends in advanced economies. Also, historical experience with export-led economies suggests that there are limits to the process of gaining market share. The turning point on the demographic side looks to be further off, but is even more critical. China's dependency ratio – the ratio of people of non-working age to people of working age – is expected to start rising again by 2015 at the latest. This means that the number of people who cannot save and can only consume – the youngest and oldest sections of the population – will increase. This, coupled with the progressive drying-up of labour supply from the agricultural sector, will reduce the saving rate and the resulting domestic funding of investment. It will probably also bring about wage increases that impinge upon the cost competitiveness of Chinese exports. Finally, historical experience with industrialised economies also tells us that the marginal return on capital diminishes as countries grow richer and accumulate more capital per worker. This means that in China a transition is needed from an economy driven by growth in factor inputs to one driven by efficiency and productivity improvements.

The declines in these long-term structural factors are a fundamental reason why economic reforms are also very important in China, even if in the short run these developments may not result in immediate challenges to the long-standing economic model. The Chinese authorities have, however, identified other, partly related developments – the emergence of domestic and external imbalances – as key factors calling for more urgent reforms.

First, the share of private consumption in GDP has declined further. In the first nine months of 2010 the contribution made by consumption to GDP growth fell to 34%, down from the pre-crisis average of 39%, while the contribution of investment picked up to stand at 59% (against a pre-crisis average of 49%). Second, overcapacity in some segments of the economy and the limited efficiency of capital – especially in the public sector – have been additional sources of concern. More than half of the RMB 4 trillion stimulus enacted during the financial crisis has resulted in investment in public infrastructure, which has further increased the already sizeable role played by the public sector in the economy.

Third, the share of the service sector in GDP has remained small. Given that the service sector is considered to be the most labour-intensive of the three major sectors, its underdevelopment has had negative implications for overall employment. Fourth, income inequality has been on the rise. Average urban income is now three times higher than average rural income. And the income gap between urban households with high incomes and those with low incomes has also been increasing.

Of course, given the complexity of the structural reforms involved, China cannot become a consumption economy overnight. This will take time. And for this very reason it is important to start now in order to ensure that the transition process is as smooth as possible.

However, the benefits of these structural reforms could be substantial. To give you an idea of just how substantial, I would like to quote a recent study by the Asian Development Bank<sup>1</sup>. It estimates that without policy reforms China's real annual GDP growth will slow to an average of 5.5% for the period 2010-30 as a result of less favourable developments in the structural factors I have just described, namely export demand, demographics and capital accumulation. According to the findings of the ADB study, policy improvements in areas such as education, research and property rights could instead increase GDP growth by at least 1 percentage point over that period.

Chinese measures to achieve more balanced growth have also included, over the past five years, very important exchange rate reforms. Both in July 2005 and in June 2010, the ECB and other euro area authorities publicly welcomed China's moves towards a more flexible exchange rate regime. The potential for exchange rate adjustment implied by these decisions needs to be further exploited. Given the importance of China's role in the global economy, further flexibility of the renminbi would be another element conducive to more balanced growth. Greater exchange rate flexibility could help in achieving the objective of improving economic efficiency and market-based resource allocation. It would allow greater control over domestic monetary policy and help to adjust the policy stance in line with GDP growth in a timely manner in order to prevent the emergence of inflationary and asset price pressures.

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<sup>1</sup> Lee, J.W. and Hong, K., "Economic Growth in Asia: Determinants and Prospects", *ADB Economics Working Paper Series*, No 220, Economics and Research Department, Asian Development Bank, Manila, 2010 (forthcoming).

In conclusion, I would like to emphasise once again that, given the global nature of the challenges at stake, *all* major economies should do their part by striving to implement the policy measures collectively agreed in order to rebalance global growth patterns.

Multilateral cooperation is not the easiest way forward. However, in the absence of cooperative policy action, the pain that purely market-driven adjustment would bring about in the transition phase could prove too severe for us to simply dismiss this course of action today.

Given their size and importance, Europe and China both have a key role to play in the global resolution of the crisis. It is important to understand that a stronger, more sustainable and balanced global economy – which is in all our interests – can only be achieved if policy-makers from all countries work together.

We still cannot be sure that the G20 Framework will be implemented effectively. It is therefore paramount that the systemically most relevant countries fully live up to the commitments made in Pittsburgh, Toronto and Seoul.