The European Surprise Ahead

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There is no denying the fact that the economy of Europe has had a bad press during the last few years.

To a large extent this has been justified.

After a long period in which the economic gap between Europe and the United States – measured as GDP per capita – was closing, we have seen it widening significantly during the past decade and half or so.

To a very large extent this has been the result of the remarkably resurgence in the US economy during this period. Fundamental structural reforms during the 1980's and 1990's – the curbing of inflation, lower taxes, less regulation - produced an economy significantly more agile and flexible than before, and this happened to coincide with the introduction of a bundle of revolutionary new technologies, notably the information and communications technologies.

Together, this produced the remarkable development in productivity in the US economy we have seen, most clearly since the mid-1990's, and which has produced non-inflationary growth rates significantly above what previously was believed to be possible.

It was the feeling of Europe slipping behind that lead the heads of state and government of the then 15 member states of the European Union in early 2000to initiate the so-called Lisbon process. The ambitious goal was to create the most dynamic knowledge-based economy in the world by 2010.

Wildly ambitious, some might say.

Today, in Brussels, the European Commission is publishing ts assessment of what has happened since, and its recommendations on the road ahead, prior to the mid-term review of the Lisbon process by the heads of state and government in mid-March.

They will state that much too little has been done and much too little has been achieved.

They will call for giving a new urgency to the reform process throughout the by now 25 member countries of the European Union.

They will point at the grave dangers ahead for the cohesion of Europe, for the financing of our welfare systems, for our employment and for our future pension obligations if we do not succeed in the years to come.

I certainly don't want to distract in any sort of way from that message. It is as urgent as it is important.

But I want to give the message that significant change is underway, that there are emerging strengths and that we might even be on the verge of a new European economic renaissance. All provided - of course – that we not only stay the course, but increase our determination to carry it through.

Politics first - because politics is always paramount.

Here, in Prague in the very hearth of Europe, the importance of politics is obvious to each and everyone.

Century after century, events here in Bohemia have shaped the future of Europe, and politics in the rest of Europe has often determined the future here.

It was in May of 1618 that some notables were thrown out of the windows of Prague castle, ending up on the dung heap below, giving the world the word defenestration, and marking one of the starting points for the great reshaping of Europe and the world that took place through the Reformation and the Thirty Year's War.

The defenestration was the beginning of the end of an era – and the dawn of something new, although it took time to fully arrive.

Much later, it was here a new state was formed in 1918 as the European empires of the past were falling to piece in the aftermath of the Great War, with great new hopes for the future.

But already in 1938 these hopes were crushed as Europe allowed Hitler to carve up the new country, only to take it over completely a year later.

A decade later, after a new devastating war, the February 1948 Communist coup here in Prague marked the beginning of the Cold War as a Stalinist dictatorship of the worst sort was imposed on the country.

I come to Prague for the first time as a very young student in the momentous month of August of the momentous year of 1968.

There was joy on the streets. Spring had given way to summer. Everything seemed possible. There was hope of a Europe beyond the prison camps and the barbed wire.

I left the country literally at the same time as the Soviet tanks started to roll in. The spring and summer gave way to a dark, dark winter of repression, stagnation and hopelessness that lasted until the year of the great European transformation of 1989. Freedom came to the lands of Bohemia and Moravia.

It is since then that we have all been involved in the recreation of Europe. It's been done with politics first and with the economy coming second. But gradually you will see that the political changes will pave the way for a great transformation also of the economic landscape.

What we have seen here in Europe during the past decade and a half has been impressive by any historical standards.

A new currency has been created, accelerating the integration of its present twelve participating countries from Finland in the north to Portugal in the south. Not without its challenges – but far more successful than most had believed.

And a hundred million people from ten countries that until very recently were either parts of the Soviet Union or heavily integrated in its outer empire have or are on the verge of entering the European Union and its integrated single market.

From Tallinn in the north to Sofia in the south, the magnetism and the model of the European Union have given us the smoothest and most successful regime change in modern history. To bring down the old was relatively straightforward – it's building the new that's been the real challenge.

From May 1st of last year, the European Union encompasses 25 nations and approximately 450 million people.

But there is much more to come. Romania and Bulgaria will be full members within two years. Croatia, and later the other countries of the Western Balkans, will follow. Negotiations will open later this year with Turkey. We might safely assume that at some point in the not too distant future Ukraine will apply for membership as well.

In a decades time – by 2014, a century after the big European disaster of 1914 – I think we can safely assume that another 100 million people, now primarily from South-eastern Europe, will have entered the European Union, its political structure and its increasingly open and integrated market.

It’s the by far most significant and promising peaceful changes that we have ever seen in the history of Europe. Ever. It’s not armies of conquest marching – it is ideas of integration advancing.

This is happening at a time of very profound changes in the world as a whole. We are living in the third phase of globalisation – and we now see it accelerating. And we are living in the midst of the most profound revolution in science and technology ever – accelerating as well.

In simple terms, this third phase of globalisation means that nearly half of the world’s population is now entering the global system of production and consumption, changing it beyond recognition. It’s a vast change stretching over decades.

We know how it started.

The beginning of the Chinese reforms in 1978 when collectivized agriculture de facto collapsed and the communist ideas of economy had to be abandoned. The complete collapse of the Soviet system, perhaps best symbolized by the fall of the wall in 1989. And the beginning of more profound changes in India in 1991 with an important liberalization of its economy.

In China we now see the effects of a quarter of a century of opening up its economy. There are very few corners of the global economy still left unaffected. Last year, with the best global growth for a quarter of a century, vividly demonstrated the new importance of China.

The changes in the east of Europe and in India are far more recent. We have only seen the beginning. The impact of the Chinese changes did not end in the late 1980’s. They accelerated. And the same we will certainly see here.

I would argue that in the years ahead we will see more profound changes in the economic landscape of Europe than we will see in any other part of the world.

The reason is rather simple.

Every economy today is profoundly affected by the increase in competitive pressures resulting from the acceleration of globalisation. This certainly affects the European economies as well.

But in addition, the economies of Europe are profoundly affected also by the deepening and widening of the European single market and its resulting increase in competitive pressures.

In the entire world, you have one great process of increasing competition. In Europe, you have two processes of increasing competition. Accordingly, we have competitive pressures increasing in the European economies faster and stronger than in any other part of the global economy.

And this is bound to be a driver for change stronger than in any other part of the global economy.

Of course the US economy is profoundly affected by the changes underway in the global economy. The debate on China testifies to this. But the European economy is more open to the outside world and in itself undergoing a far more profound change of liberalisation and deregulation.

Europe is thus likely to be the scene of the real action in the years to come.

Much has been written about the reluctance of the governments of Europe to move sufficiently fast on the necessary structural reforms. Labour markets are too rigid, regulation often too cumbersome, climate for entrepreneurship often too complicated, taxes often too high, resistance to change often too obvious.

There is much truth in this description – but at the same time it is grossly oversimplified.

There are parts of Europe doing remarkably well. Ireland and Finland are two countries that have improved their position dramatically during the past two decades. Denmark wouldn't be out of the place on the list as well. For years, the Netherlands did very well. The United Kingdom and Spain have also been growing steadily.

If there is a pattern, it looks as if small is truly beautiful.

The smaller economies have been adapting faster. The larger have been slower in seeing the writing on the wall.

In fact, if you look at the statistics, the problems are to a very large extent a problem of Germany, of Italy and to a certain extent of France. And with the German economy being approximately a third of the Euro zone economy this is obviously important.

But as competitive pressures are increasing relentlessly, so are pressures for change, and gradually we are seeing change happening also in these larger economies.

There is change from below when the individual firms and industries change and adapt, and there is change from above when political decisions are taken on changes in the regulatory environment or in other respects.

In Germany today – to mention the largest of the countries - we see quite a lot of both. The politicians might complain that there is too much of the changes coming from below, and the businessmen might complain that there is still too little of the change coming from above. But change there certainly is.

If you look across the landscape of manufacturing industries in Europe today – since long the backbone of our economies – you actually see a remarkable vibrant, changing and competitive industry.

This is reflected not the least in the export figures. In spite of its very heavy dependence on imported energy, Europe does not suffer from a crippling trade or current account deficit. Exports are truly booming – not the least to the booming economies of Southern and Eastern Asia.

And this is spite of a Euro driven up by a dollar falling down. The competitive position of European industry is impressive.

A significant part of the change we have seen in the manufacturing sector is the restructuring happening through the relocation of production to the new member states of the European Union.

It's been going on for some time – and it is now accelerating.

Look at the automotive sector – always an important one in Europe. You first saw parts of the component industry going east. And now you increasingly see the industry as a whole moving east.

With only one exception, every decision to build a new production facility in this sector in the last few years has turned into a decision to build in one of the new member countries.

This is not just a question of significantly lower labour costs. It's also a question of responding to the very significant reforms of the regulatory and tax environment undertaken by a number of these countries.

These countries are eager to try to start closing the gap in living standards with the countries of the western part of Europe. On average, the 10 new member countries have a GDP per capita app 40 % of that of the old Union of the 15.

In order to do this, they know that they have to pursue pro-growth policies in order to attract investment, keep their talent and generate entrepreneurship and innovation.

They know that there is no such thing as state-dominated development. They have seen the Five-Year Plans. They want growth – not stagnation.

As they adopt different pro-growth policies, they are truly beginning to change the economic landscape of all of Europe.

The 10 new member countries together represent just 5 % of the economy of the Union. But I would argue that the impact they are having – on the enterprise level as well as on the policy level – is many times that. And that it is increasing fast.

Let me mention just one example of this – the flat-tax bandwagon now rolling through Europe.

It started with Estonia way back in 1991, as they decided on a 26 % flat income tax. Soon they were followed by Latvia and Lithuania. And later they themselves decided that the success of their approach made it wise to take down the tax rate further – it's now 24 %, heading towards 20 %.

The three Baltic countries have been, are and are likely to remain the true tiger economies of the new European Union with growth rates of 5 – 6 percent a year.

For anyone that went to Tallinn a decade and a half or more ago – it was very difficult in those Soviet days – the change is truly mind-boggling.

Then there were only eight telephone lines between Sweden and all of the Soviet Union. The telephone directory was considered a state secret.

Now, there is a helicopter shuttle every 20 minutes between the city centre of Tallinn and nearby Helsinki. And in terms of use of the new information and communications technologies, Estonia is establishing itself as one of the vanguards of Europe.

The second wave of the flat-tax bandwagon – after the success of the Baltic tigers – was initiated by Slovakia. Having lost out on the first wave of reforms in Central Europe under a backward-looking nationalist regime, it was keen to accelerate its transformation, and decided on a radical policy of leapfrogging the rest.

Slovakia has now introduced a flat 19 % tax rate for incomes, VAT as well as capital. It’s not been without its problems, but there is no doubt that the overall results are impressive.

The country has gone from a black hole for reforms to a magnet for investments and a model for others.

When present investments plans are finished in 2007, Slovakia will be producing more cars per capita than any other country in the world. The European leader today – Belgium – produces 11 cars per inhabitant and year. Slovakia will be producing 6 – 7 cars per year and inhabitant.

Others are following.

As a result of the election late last year, Romania has just introduced a 16 % flat tax. And we see vigorous debates in the other Central European countries.

In Poland, the Civic Platform which is likely to emerge as the strongest single force in the elections later this year is discussing a 15 % flat tax. Here in the Czech Republic the opposition ODS – expected to emerge strong in the elections scheduled for next year – is talking in similar terms. In Hungary, both the government and the opposition is starting to note that they really don’t have much of a choice.

And the big question further down the road is when we will see a third wave of these reforms starting among the old EU member state.

Already an expert group in the Ministry of Finance of Germany has recommended a 30 % flat tax for that country. I think something along these lines will happen – but I don’t expect it to happen fast.

As we speak, there is an election campaign going on in Denmark. A new Parliament will be elected a week from now.

In its election promises for the coming years the Venstre party of Prime Minister Rasmussen is highlighting the need to respond to the competitive pressures coming from the East. First among the list of priorities for the coming years is a significant rise of R & D expenditures to continue to improve the competitive position of the Danish economy in face of the twin challenges of globalisation and an expanding Europe.

It's just an example of how the pressures for change are shaping the new political priorities throughout Europe.

The logic of what is happening is thus clear. Competition is transforming the economic landscape in two different and reinforcing ways.

First, by individual firms changing rapidly and not the least by taking advantages of the opportunities offered by the new member states.

Second, by governments changing the regulatory regimes in response also to changes done by other governments. They might sometimes be somewhat reluctant, but there is no real alternative to entering the new race for reforms.

The World Bank issues a report every year looking at the business climate throughout the world, focusing on where they see significant changes in the conditions for business and growth.

Its latest assessment of reforms in the business climate in the global economy stated that "the major impetus for reform in 2003 was competition in the enlarged European Union. Seven of the ten top reformers were incumbent or new European Union members."

"Slovakia was the leading reformer… Among the top 10 reformers, 2 other EU entrants – Lithuania and Poland – significantly lightened the burden on business."

"Thirty-six of 89 reforms – in starting a business, hiring and firing, enforcing a contract, getting credit and closing a business – happened in EU countries."

There is thus far more happening in the European economies than they are normally given credit for. We are still fixed on what is not happening – and we risk missing important parts of what is happening.

Much certainly remains to be done.

If we look at the difference in performance between the United States and the European Union during the past decade, two things stand out.

The first is the greater flexibility of the US economy after its wave of deregulation. The second is the greater use of different information and communication technologies. And it's the combination of the two that really brought about the productivity and growth revolution.

It’s not enough to buy computers and insert them in old structures. That’s just costly.

Old structures are created according to the conditions of old technologies. It’s when structures are fundamentally altered that we can unleash the potential of the new technologies and see the revolution in productivity.

It’s not Microsoft or IBM or Intel or Dell that is the true success of the US economy. It’s when all other industries have started to change their ways of working with the new technologies that we have seen the results.

When you analyze the difference between the US and the European economies during the past decade, an interesting pattern emerges.

Of course there is a larger ICT producing sector in the US economy, although there are industries even here were Europe is doing very well, with telecommunications in the forefront.

But the difference is really in how the IC technologies are used in the other sectors of the economy. It’s through the transformation of sectors like wholesale and retail trade, banking and finance, and different parts of the service sector that the US economy really races ahead in terms of productivity – and Europe is left behind.

Since 1995, the productivity growth in the ICT using – not producing – sector of the US economy has been close to 5 % a year, while it has been less than 2 % for the corresponding sector in Europe. For the ICT producing sector, as well as for the non-ICT using sector, the difference has been far less.

It’s the use of these technologies throughout the economy, and in a transformational way, that makes the difference.

The lesson for Europe is clear.

As change is accelerating in our economies, we must both improve our way of using these technologies in more transformational ways, and increase our overall level of use of them.

We are making progress – but more is called for.

And we must start looking far more seriously on how to change also the service sector in our economies.

Change is well underway in the manufacturing sector. It will accelerate.

But the service sector is 70 % of most of our economies. And we have so far seen far less change here. This has to be one of the major tasks in the years to come.

The so-called service directive now under discussion in the European institutions aims at the opening up of this important sector of our economies to more of competition and trade across the old boundaries. It’s not uncontroversial – there are always old vested interests fighting their rearguard battles – but in the one form or the other it will happen.

And the rewards can be huge. In most service sectors, less than 5 % is exported to other member states. A more open and vibrant service sector might increase this to 15 – 30 % according to recent studies. The gains in productivity and performance would be huge.

There are large differences across different parts of the service sector.

Let's just mention the health sector. Today, it's the focus of discussions in many European countries. Old structures. New demands. Rapidly rising costs. A demographic challenge ahead. Reforms are imperative in most countries – we all want high-quality care - but more difficult than in many other areas.

The potential of ICT technologies in this area are obvious. Networked as well as personalized quality health care systems are clearly the wave of the future.

In some important respects our European countries should have better possibilities here than in the US. Our health care systems are less fragmented, our legal systems are less bizarre and we have more of a tradition of the secure exchange of sensitive information than is the case across the Atlantic.

Obviously, health care systems are and will remain different in different countries. But it is equally obvious that we could benefit from more of an exchange of information and experience as we move the reform processes forward in this sector that is so important both because of its economic weight and because of its importance to our citizens.

During the coming weeks, there will be much discussion of how to revise and move the so called Lisbon process forward.

More firmness in implementing the single market. Faster progress on the integration of financial markets. Better national action to improve the climate for entrepreneurship. Increased funding of R & D in both the public and private sectors. The scrapping of old national monopolies in different sectors. A new focus on the service sector.

All of this is important.

But my main message today is that the main driver for change will be the double force of increased competition as globalisation accelerates and Europe becomes a larger and larger and more and more integrated market.

There will be a race for reform between governments and an imperative for change within business. And there will be more of this in Europe than anywhere else in the world.

We already see it. But it will continue for years – decades - to come.

Enlargement will continue. Not only the Baltic tigers and the reformers of Central Europe, but also a dynamic Turkey and a come-back Balkans. A further 100 million citizens of the Union within a decade sounds perfectly realistic.

And the ambition extends beyond this. We are talking about a Common Economic Space with Russia that would certainly be a free trade area and could eventually extend beyond that. And Ukraine will certainly move substantially faster towards this goal. And there is the declared ambition to extend these aspects of economic integration to the countries of North Africa as well.

In political terms, much has been achieved in the last decade and a half. Europe has never in its history been to free, so secure and so prosperous as today.

And this is the necessary base also for the accelerating change of our economies.

The European Union is already the largest integrated economy in the world. It's the by far largest trading power in the global economy – Germany alone is the world's number one exporter. It is the largest single market for more than 130 other nations across the world. It's the largest source of development aid.

This is the European Union of today's 25 member nations and 450 million citizens. But that's just the beginning. If we add up the different parts of the vision indicated above, we arrive at an integrated and open economy of close to a billion people, stretching way into Asia and covering all the shores of the Mediterranean.

Putting it into a global perspective, it's the most significant liberalisation of the global economy since Deng Xiaoping decided to unleash the productive powers of more than a billion Chinese nearly a quarter of a century ago.

We have only seen the beginning. More old things will be thrown out of the windows. Our common task is to pave the way for the continuation.

Europe is transforming itself – and changing the world.