Commissioner Danuta Hübner
Fostering Catching-up and cohesion in the EU
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Ladies and Gentlemen,

Welcome to this second day of the Brussels Economic Forum. Yesterday's sessions focused on the global economy and on the current and future functioning of economic and monetary union. This morning we turn to the issues of catching up and cohesion in the EU. We will cover the general challenges of catching up and of EMU enlargement, and a variety of country experiences: Bulgaria and Romania, our newest Members; Spain and Portugal who have had very different experiences of catching up; and Slovenia which is the most recent member of the euro area. Before I hand over to our distinguished speakers, I want to highlight some of the issues which I hope we will cover this morning.

Let me start with some facts and figures. On Wednesday of this week the Commission adopted the Fourth Report on Economic and Social Cohesion in the Union. It contains several key messages. First convergence is occurring. Over the period 1997-2006, economic growth has been faster on average in the new Member States, including Bulgaria and Romania, than in the old: 4.1% versus 2.3%. Indeed in 2006, growth in the new Member States was around 6%, a substantial acceleration compared to 2005 and well above the 2¾% growth in the euro area. This was a further substantial step forward in the catching-up process, and the forecasts for 2007 and 2008 suggest that this pattern will continue. These growth patterns have led to an increase in EU-10 average income from 44.7% of the EU-15 level in 1997 to 55% in 2006. GDP per capita figures cannot of course give us a full picture of convergence, but they do give us a useful flavour of the situation.

Second, while this is a significant achievement the differences in levels of economic development remain large. Indeed with the EU 12 enlargement, the Union is confronted with unprecedented diversity. GDP per capita ranges from 33% of the EU average in Romania to 251% in Luxembourg. At the regional level the range is even more striking: from 24% in Nordest in Romania to 303% in inner London.

Third, the components of growth differ significantly among Member States. Most of the high growth in the regions in the new Member States is driven exclusively by productivity with little or no job creation. Yet productivity levels in these regions remain far below the Community average.

Finally, innovative capacity is a key element of competitiveness, and 86 regions have an innovative capacity, based on indicators such as patents, employment in high tech sectors, business R&D expenditure which is below the EU average. The great majority are located in the new Member States , Spain, Greece, Portugal and Southern Italy.

The Cohesion report also shows that EU cohesion policy has played an important role in the convergence process. It has supported much needed investment in infrastructure, human resources and the modernisation and diversification of regional economies. In doing so, it has helped to shift the investment pattern in Member States towards growth enhancing investments. It has contributed to reducing social exclusion and poverty by providing skills for the knowledge economy and reinforcing active labour market policies. It has helped to improve administration and public governance, particularly at sub-national level. And on the basis of all of these elements it contributed to the impressive growth performance of the poorer Member States.

The message from this is that while catch up in the recent past has been impressive, and while growth trends are positive, there is a significant challenge ahead. And real convergence will take time. If growth in the new Member States is twice as fast as in the EU 15, it will still take about 35 years for per capita incomes in these countries to catch up with EU levels. What policies do they need to put in place to ensure these growth rates? Later this morning, Vitor Gaspar will look at the cases of Spain and Portugal – both major beneficiaries of cohesion policy - and the lessons to be learned. From 1995 to 2005, Spain moved from 91% to 102% of average EU27 GDP per capita. In Portugal, the figure in 2005 was 74% compared to 79% in 1995. I want to focus on some general comments on the broader economic context for convergence.

My first point is on the clear need for the right policy mix - policies both for macroeconomic stability and for structural reform. These policies can be mutually reinforcing and together they can have a greater impact than the effect of individual reform measures. This linkage is an explicit feature of our Growth and Jobs Strategy. Member States reported to the Commission in 2006 on their progress with this strategy. The picture suggests that a more integrated and comprehensive approach to reforms is taking root.

My second point is on the Stability and Growth pact which provides the macro-framework for convergence and preparations for euro adoption. The benefits of this framework are well known, as are the challenges. I want to mention only a few specific aspects. First, while the ultimate objective of joining the euro area is shared by all new Member states, each country faces specific circumstances and challenges and so will have to find its own path for getting there. The process itself – the quality of the policies adopted – also matters. Second, I believe that the structural changes which the new Member States need on their way to euro adoption are in their own interest, regardless of the euro. The euro is an additional stimulus: it provides a clear end-goal on the political agenda which should help to lock in sound economic policies and to keep the momentum of reform going. Third, governments will benefit from maintaining a consistent message aiming at euro area entry as early as feasible. Of course, joining the euro can only take place when the economies are ready. But by setting ambitious yet realistic target dates, the process can be driven forward more successfully.

My next point goes to the core of this morning's session. The catching up process means that the economic structures of new Member States will continue to undergo significant change as they prepare for euro area membership. These structural changes, whether in the composition of industrial output, in the functioning of labour markets, or the development of the financial sector, are on a greater scale than those experienced by current euro area members. This process of real convergence of economic structures may produce differences in economic dynamics, including the rate of growth and the magnitude of fluctuations. Consistent application of the convergence criteria to past and future euro area members is critical for the integrity and credibility of the process. But at the same time it is essential that we have a full understanding of the implications of this real convergence in economic structures for nominal convergence. This of course will be one aspect of this morning's session. In this context I want to raise three issues related to the convergence criteria.

On public finances, the 2006 convergence report shows that many countries will be within the reference value for the deficit criterion by 2009 or 2010. The government debt figures are striking – Estonia less than 2% of GDP, Lithuania below 18%, Romania below 12%, Latvia below 10% - and this aspect of the criterion is unlikely to be problematic. The point I would like to emphasise here, however, is on the quality of public service provision. If we compare catching-up economies with more advanced economies, one key difference is in the level and quality of public service provision – general infrastructure, public transport, health. In a way, future members of the euro area face a double challenge: they have to improve these services to meet the legitimate expectations of their citizens, while at the same time - as for all EU member states - shifting public expenditure to policies which are essential for competitiveness: education, research and development, innovation and ICTs. And they will have to do so in a context of rapid economic growth, where fiscal policy will need to maintain a strong countercyclical stance to avoid overheating. In certain cases, this may require fiscal restraint even where the Treaty reference value is not at risk.

On inflation: for catching-up countries whose GDP growth rates are double the euro area average, there are particular challenges in meeting the inflation criterion. There are the Balassa-Samuelson effects based on differences in productivity developments in the tradable and non-tradable sectors. There is far from being a consensus on these effects, not least because of difficulties in measuring them. But there are additional factors – tightening labour markets and skills mismatches, and bottlenecks in sectors such as construction. The latter are driven in part by buoyant housing demand as credit conditions ease, and partly by essential infrastructure investment. In the years ahead there will also be changes – sometimes significant - in excise duties on items such as fuel and tobacco, and on-going changes in regulated prices for public and social services, public transport, rents, water and energy prices. Controlling inflation of course is not just about being fit to join the euro area – it is a key element to safeguard competitiveness and long-term macroeconomic stability.

As far as the exchange rate is concerned, there is a need to examine carefully the extent to which the real changes in the economy mentioned above may require real exchange rate changes if the new Member States are to maintain competitiveness. This has to be seen against a background of large current account deficits in the new Member States, some of them well over 10% of GDP. These deficits to a large extent have been financed by foreign direct investment which may limit vulnerability. The inflows are also facilitating technology transfer which over time should have a positive effect on competitiveness. This pattern is consistent with the rapid catch-up of the economy: foreign inflows compensate for lower domestic savings, as domestic agents increase consumption faster than current income in anticipation of future increases in permanent income. The challenge will be to ensure that the current account does not reach levels in the medium-term which are inconsistent with underlying fundamentals. To that end, investment needs to be channelled to sectors that will contribute to productivity growth.

This leads me back to conclude with a few words on EU cohesion policy, as it can help to mitigate this external constraint, both directly thanks to the financial transfers, and indirectly by improving investment conditions which should encourage continued FDI. But the contribution of cohesion policy is both a tremendous opportunity and a challenge. As a percentage of GDP, the contribution of the policy to the new Member States will be substantial, ranging from 3 to 4%, and between 15 and 25% of Gross Fixed Capital Formation. This is a real opportunity to reform the supply side of the economy, and to promote the shift in public investment towards competitiveness which I mentioned earlier.

The boost to the demand side must, however, be handled carefully to avoid overheating, labour shortages, consequences for inflation and interest rates, and possible upward pressure on exchange rates as a result of the capital inflows. We have tried to minimise these risks in two ways: first, by insisting that Member States design and implement their investments with clear reference to the framework for macroeconomic stability; and second by implementing a genuinely integrated approach to development so that physical investment programmes are complemented by timely actions to reduce the supply-side constraints including on the labour market.

We will of course be monitoring very closely the situation as it unfolds. And of course we will continue to deepen our understanding of how catch-up and cohesion can best be pursued. Our speakers this morning have much to say on that so it is my pleasure to hand over to them.