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Growth and Competitiveness. Speaking points

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First of all, I wish to express my deep condolences to the people affected by the storms in Valencia, and especially to the families who have suffered losses. I also want to express my gratitude to all people working on the land, to the firefighters, to the police and to all those who are doing their very best in trying to help with this tragedy. Christine Lagarde asked me to convey her condolences and solidarity, and she told me that the ECB is flying the Spanish flag at half-mast in front of the main building of the ECB.

I wish to thank Ana Botín and the Banco Santander team for their invitation to this International Conference. It is a pleasure to be here with you today.

Let me start by formulating a question: **Why is long-term Growth and Productivity of particular importance for a central bank?** And why then does it make sense for me to address you today on this issue. The reason is primarily two-fold:

- **First**, because in the implementation of monetary policy we need to assess the cyclical position of the economy, and this requires to estimating the gap between actual and trend growth. Moreover, in pinpointing the desirable monetary policy stance, a view on the natural interest rate has proved important, a key determinant of which is long-term growth and productivity.
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- And **second**, in the specific case of European monetary union, secular weak growth and productivity, as at present, could complicate the conduct of monetary policy going forward. This low growth environment stresses fiscal policy hinders social cohesion and makes it difficult to advance on real convergence and on all those elements that are crucial for a well-functioning monetary union.

How can we raise long-term growth?

- In this presentation, I would like to emphasise **what we can do** to enhance growth potential, rather than at European level, especially at the national level.

- For a few months now we have been discussing the Letta and the Draghi reports, and the potential actions to be adopted at the European level. These solutions are clearly desirable and need to be promoted, but some will require time and a difficult political consensus before they can be effectively implemented.

- In my view, individual Member States have significant scope at the same time to promote potential growth and contribute to this global goal.

- In other words, recognising the importance of European-wide measures should in no way inhibit the ambition of national policies.

Economic growth drivers

- To address this topic, let me go back to basics. Let's look at the three **factors of the production function: human capital, physical and technological capital, and productive efficiency in the combination of these factors.**

- I want to highlight the **significant differences in key inputs affecting long-term growth among European partners**. This could be useful to identify best performers that could become valuable case studies for countries that lag behind.

- Let me illustrate **the differences across countries in these crucial inputs, starting with human capital.**

The importance of human capital

- When analysing differences in labour input, we consider not only headcount or hours worked, but also human capital aspects. This encompasses **investments in schooling, on-the-job training and learning about the economic system.** These investments directly improve individuals' knowledge and productivity, and can also enhance the efficiency of others through productive interactions.

- From a business perspective, research shows that **firms' productivity is highly correlated with their staff's educational attainment level**. Specifically, firms at the productivity "frontier" have a higher proportion of high-skilled workers than firms at the median of the productivity distribution. Interestingly, while firms at the productivity frontier systematically differ in the use of general skills (as measured by educational attainment), they differ even more in their use of specific skills such as management, communication and ICT. Indeed, ICT skills are particularly valuable in the current technological transformation. However, there are significant differences in how European tertiary education systems attract students into these new skills.

Differences in the share of tertiary education students in STEM fields

- To illustrate this point, **note the substantial differences shown in Figure 1 regarding the share of tertiary education students in STEM fields.** This difference is particularly concerning because it reflects a **disparity in the flow** of young people enrolling in the educational system, **not just in the stock of students**.

The importance of physical and technological capital

- Improving human capital benefits growth not only directly, by increasing productivity, and indirectly, via interactions, but also through its complementarity with capital. There is a wealth of literature documenting the complementarity between human capital and new technologies ("skill-biased technical change"), suggesting that increasing human capital could positively impact technical change. Specifically, there is a clear relationship between human capital and technology diffusion (e.g. the adoption of information and communications technology).

Differences in the use of AI

- Focusing on the physical capital aspect, we observe big differences in the adoption of new technologies in Europe.

- I illustrate this point with a chart showing the percentage of firms using artificial intelligence technologies. Other metrics can be even more striking, such as the **adoption of cloud computing services**.

Total factor productivity]

- Lastly, we need to examine the third element, the interplay of factors that cannot be explained by increases in human, physical or technological capital.

Difference in venture capital financing

Let me also stress that apart from the interaction between human capital and technology adoption, it is also likely that **human capital influences innovation**, adding another layer of heterogeneity. Indeed, there is evidence that supporting universities and reducing barriers to STEM education, especially for under-represented groups, has significant long-term effects on innovation and growth.

- While educational disparities undeniably play a significant role in shaping innovation, economists have identified several other critical factors that influence this dynamic. Notably, **high-skilled migration presents substantial challenges.** And we also see marked differences among European countries.

- Additionally, the **reliance on bank or market financing varies greatly among firms in different countries,** impacting their ability to innovate and grow. Furthermore, **inefficient insolvency rules** can stifle entrepreneurial ventures by creating an environment where failure is overly punitive, thereby discouraging risk-taking and innovation. Addressing these multifaceted issues is essential to understand differences in innovation across countries.
- On this issue, the transfer of knowledge and the diffusion of innovation to the entire economy, are particularly important. In this mechanism, venture capital markets have proved very relevant.

- And here, differences on **venture capital investment** also differs among European countries, as can be seen in this chart.

Quality of institutions

- An additional element that is sometimes overlooked is the **quality of institutions**, and more specifically the efficiency with which public administrations operate including the quality of the legislation and implementing agencies.

- There is broad consensus in the academic literature that **the institutional framework, and more specifically the quality of institutions and the degree of trust** they instil among economic agents, is crucial in determining long-term growth.

- This hypothesis, which earned **Acemoglu, Johnson and Robinson this year's Nobel Prize in Economics**, is illustrated by the correlation between an index of government effectiveness, constructed by the World Bank, and GDP per capita. Besides the notable correlation of 74%, it is interesting to observe the **significant heterogeneities in government effectiveness** across European countries.

Conclusion

- To conclude, allow me to stress that **understanding and implementing best practices** in Europe is crucial for fostering long-term growth.

- In particular, understanding the institutional frameworks of **high-performing European countries** can provide valuable insights for the rest.

- The advantage of adopting best practices from within Europe is that **our institutions are more comparable and relevant to our own context** than those of the United States or China.

- By aligning our policies and institutions with those of our successful neighbours, we can create a **more cohesive and effective economic environment**, **driving sustainable growth and prosperity across the continent**.

- And as a bottom line let me leave you with the following takeaways:
    - There is ample room for leveraging best practices across European countries to enhance aggregate trend growth and productivity.

    - In addition to badly needed European-wide initiatives, there is substantial homework to be done at the national level.