Jean-Claude Trichet: The challenges for the European economy in 2004

Speech by Mr Jean-Claude Trichet, President of the European Central Bank, at a conference organised by Foro de la Nueva Economia and The Wall Street Journal, Madrid, 29 January 2004.

* * *

Ladies and Gentlemen,

Thank you very much for this invitation. It is a great pleasure to be here in Madrid at the invitation of Foro de la Nueva Economia and the Wall Street Journal. I have been asked to address two issues. First, the state of the euro area economy, and second, enlargement and its impact on the European economy. I think these issues are well chosen, given that they are currently ranking high on the agenda of economic policy making. I choose to subsume them under the heading "Challenges for the European Economy in 2004", to indicate that these issues not only require diagnosis but also implementation.

The state of the euro area economy

Past and future

Central bankers should be looking forward, and that is what I will do in a second. But let me start with what lies behind us - I think this is important to put the current state of the economy into perspective and to fully acknowledge the challenges ahead. By mid-2003, a succession of adverse shocks had held down economic activity in the euro area for almost three consecutive years. These shocks were related to the bursting of the ICT bubble and the fall in equity prices, to the surge in oil prices and the sharp deceleration in global trade, to concerns about corporate governance and yet a further fall in equity prices. And, importantly, they were also related to geopolitical factors such as the September 11 terrorist attacks and its consequences. The continued high uncertainty that was inevitably associated with this succession of shocks left clear marks on business and consumer confidence.

Now it appears that the geopolitical and economic tensions are receding, and that a recovery is under way. Euro area real GDP picked up in the second half of last year, and the latest information on production and confidence is consistent with an ongoing recovery in economic activity. Barring adverse shocks, the growth momentum of the euro area economy should strengthen in the course of 2004. We have of course to remain prudent and cautious as regards forecasting. However, if unanimity amongst forecasters means something, then the chances for a continued recovery are good: all available forecasts from both official and private sources imply a strengthening in growth. This expectation is also in line with developments in financial markets.

I would like to stress also that a number of conditions necessary for a recovery in domestic demand are in place. In the course of the past years, firms have made considerable progress in adjusting their balance sheets and enhancing profitability. Moreover, interest rates are low by historical standards and financing conditions are favourable. Demand continuing to develop positively, remaining deleveraging efforts of the corporate sector are unlikely to withhold an upturn in investment. A positive sign in this respect is that exports and imports of capital goods between euro area countries have recently picked up.

When all relevant factors are taken together, there are reasons to be cautiously optimistic about the growth outlook: currently available forecasts imply that in the course of the year real GDP could reach rates of growth in line with those of potential output.

What about the outlook for prices? Inflation proved to be somewhat stickier in the second half of last year than we previously expected. This had mainly to do with some adverse developments in food and oil prices. Moreover, towards the end of last year it became clear that governments would raise a number of indirect taxes and administered prices. As a result, the short-term outlook for inflation had become less benign. But taking together all pertinent elements we expect that HICP inflation comes back progressively to levels which would be in line with our definition of price stability : less than 2 %, close to 2 %.

The prospect for 2004 of growth improving progressively up to potential and inflation being in line with price stability looks good. Let me hasten to add that there is no reason at all for economic policy makers to be complacent in any respect. A number of uncertainties are still present in the overall outlook for sustainable growth, related in particular to structural impediments in some regions and lack of savings in other regions of the world. Also, a no-shock assumption is certainly the most sensible starting point for a central projection, but experience says that shocks can always happen. The challenge associated with the economic outlook thus implies much more than a cyclical recovery back to potential growth. What is also needed are efforts to make the euro area economy more resilient to shocks and to augment its long term growth potential.

The case for structural reforms

Some observers have raised concerns that potential output growth in the euro area has declined over the past years. Only a few years ago the same observers propagated the idea of a "new economy" and higher potential output growth. Empirical estimates of potential output growth - by construction - typically move somewhat over the economic cycle and this should not be confused with changes in the sustainable rate of growth. With the benefit of hindsight we were right to have been relatively cautious when the new economy paradigm was discussed at the time. Instead we advocated the idea that whatever the benefits of ICT, they would be best reaped over time by making clear progress in the removal of structural rigidities. Given that demographics in the euro area are less dynamic than in other economies, including the US, we need even more improvements in terms of higher productivity growth, rising labour force participation and declining structural unemployment. The case for decisive structural reforms is pressing.

This is not to say that there was no reform progress in Europe in the past years, just that it is far from being achieved. Unless Member States step up their efforts they will not be able to achieve the Lisbon targets, according to which the European Union, by 2010, should become "the most competitive and dynamic knowledge-based economy in the world". For the time being, however, it seems that the US economy has not only benefited more strongly from the growth opportunities offered by ICT, but has also shown a better adjustment capacity during the past downturn. Let me give you some examples of where I think further progress is needed in Europe to enhance growth and economic resilience.

Most EU countries have undertaken initiatives for labour market reforms in recent years, but more progress is needed in attracting people into the labour market. The target employment rate of 70% of the working age population set in the Lisbon agenda is still far off: we were still at the level of 62 % in 2002. Some countries have started to reform their social security systems. Unemployment benefit systems have been streamlined, but in a number of cases, together with high marginal tax rates, they continue to provide a disincentive to take up work. Larger contractual flexibility, such as for part-time jobs, helped to expand employment in certain segments of the labour market. But further reforms are needed that allow wages to reflect more strongly regional and sectorial productivity differences. In addition, the skill requirements posed by a knowledge-based economy imply that governments should intensify their efforts to improve education and training systems.

EU countries made a lot of progress in product market reforms during the 1990s and this is an encouragement to do more. The share of EU Internal Market legislation not yet transposed into national laws is still too high. Progress on this front is extremely important as market entry barriers in the form of national regulations continue to hamper competition. Especially in the services sector - where most new jobs are created - excessive regulation persists. In addition, the Lisbon target that R&D investment should reach 3% of GDP, with two-thirds financed privately, is still far off.

The Lisbon reform agenda set in 2000 was both absolutely necessary and very ambitious taking account of the starting point, and it was clear that implementing effectively the necessary reforms would be a real challenge. Public support needs to be gained in particular from those that profit from protection, subsidies or social security systems - which in modern welfare states can be many. And this challenge has probably increased during the economic downturn of the past years. On the other hand, the fiscal pressures associated with the downturn were probably a trigger for governments to step up reform efforts. Indeed, many European countries are currently at a crossroad, faced with the option of either profoundly reforming their social security systems or putting their sustainability at risk.

In this context, let me stress that structural reforms lead to lower deficits. Sound fiscal policies imply a strong emphasis on structural expenditure reform. Public expenditure needs to be diverted away from improductive areas and poorly managed transfer systems, towards uses that enhance productivity and the accumulation of physical and human capital. There is a close relationship between structural reforms and sound fiscal policies. Together, they enhance confidence and improve the economic situation on a lasting basis. In this sense, the rules laid down in the Stability and Growth Pact are an indispensable element in promoting policies aimed at strengthening economic prospects in the euro area. 2004 will be a crucial year for preserving and enhancing the credibility of the institutional framework.

As regards the Stability and Growth Pact most recent events, I would only say that the Governing Council shared the concerns of the Commission on the ECOFIN Council conclusions of 25 November 2003 and made it public. The Commission is the guardian of the Treaty and the Governing Council of the ECB respects the recent Commission's decision to seek legal clarity.

I already said publicly that the Governing Council does not see a need for changes in the Treaty, and the Stability and Growth Pact in its current form is appropriate in its view. That being said, the Governing Council is in agreement with the Commission that the implementation of the Stability and Growth Pact could be further improved, in particular as regards the analysis of structural balances and strengthening the incentives for sound fiscal policies in good times. Clarity and enforceability of the fiscal framework should also be enhanced.

What is the role of monetary policy in all this? Ensuring price stability, as well as confidence in the euro is our contribution to sustainable growth, in particular through historically low medium and long-term market rates. This contribution is naturally more efficient in an environment where governments, parliaments and social partners make their respective contributions to enhancing confidence and potential output growth. In this respect, there are strong complementarities between sound policies in the different policy areas. By delivering the necessary structural reforms, I believe that governments and social partners could set in motion a virtuous circle of increasing confidence, favourable growth prospects and success in the reform process.

The ensuing "culture of stability and confidence" would be the best advertisement for countries about to join the European Union. This brings me to the second issue.

Enlargement and its impact on the European economy

In 2004 the European Union faces the challenge of enlargement: its largest expansion ever. Ten countries in Central and Eastern Europe and in the Mediterranean will join the EU on 1st May 2004. These countries together, with 75 million people, comprise a population of about one fifth of that in the present EU. The economic weight of the new Member States, however, will be lower. Their total GDP represents, at market exchange rates, around 5% of that of the current EU. The task at hand for the new Member States is to advance real convergence, while locking in inflation at low levels, preserving the soundness of the financial sector and making determined efforts towards fiscal consolidation are all of the utmost importance. Overall, the progress made so far in acceding countries is encouraging.

The impact on the European economy

Assessing the impact of EU enlargement on the European economy is a complex question. Despite the considerable complexity surrounding this issue, one thing that is clear is that EU enlargement will provide new opportunities to trade and investment flows. Many of these effects are visible because of the high degree of economic integration already reached between the present Member States and the acceding countries. Lower trade costs and an increase in competition associated with the enlargement of the Single Market will have a significantly positive impact on growth in the European economy as a whole, even if the effects of enlargement will not necessarily be distributed equally across countries, regions and sectors. Some economic sectors may gain more than others because of an increased demand for their products from the new Member States.

As concerns the growth prospects in the new Member States, it is clear that EU membership will have a very positive effect. Full integration in the Single Market and the impact of the EU Structural and Cohesion Funds are likely to foster the catching-up process in those countries. It is important to keep in mind, however, that the Funds can only exert a positive impact on the catching-up process if countries have a stable macroeconomic environment and institutional and microeconomic structures that are conducive to growth.

Through which channels could EU enlargement affect the European economy? I will focus on two. First the flows of trade, capital and labour, and second the likely increase in competition.

Let me start with the flows. The abolition of existing import tariffs and the lowering of *trade* barriers support cross-border trade between the EU and the acceding countries. This process has to a large extent already taken place and the acceding countries as a group have become a main trading partner of the EU. From the acceding countries' perspective, the EU has become by far the most important trading partner. The so-called Europe Agreements have been an important driver of trade integration over the past years. These agreements established a free trade area in many industrial products by removing tariffs and quantitative restrictions.

Enlargement can also affect the European economy via the liberalisation of *capital* flows in acceding countries. Acceding countries liberalised capital movements early in the reform process, anticipating the obligations of EU accession. Foreign direct investment constitutes by far the largest share of total cumulative net private capital inflows to the acceding countries, reflecting also the role of FDI as a financing source in the privatisation process. The prospects for FDI flows after enlargement are very impressive if one considers that private investors are likely to price in a very substantial diminution of risks associated with the entry into the European Union.

The opening up of EU labour markets may also entail a flow of labour from the acceding countries to the EU. Whereas most obstacles to trade and capital flows have been abolished, several EU countries have maintained most legal and administrative barriers to the immigration of labour from acceding countries. After enlargement, EU countries are allowed to use transitional periods to postpone the free movement of labour from acceding countries. In many Member States, this aspect of enlargement has been discussed widely and the literature on this topic has been growing strongly. Many of these studies seem to suggest that overall migration flows to the EU are likely to be small relative to the size of the workforce in the EU, though large uncertainties surround these estimates.

Coming to the second channel, enlargement will lead to a widening of the Single Market and most likely to an increase in competition both for the acceding countries and for the present Member States. Taking the experiences with the Single Market as a benchmark, this could reduce price pressures (via a decrease in mark-ups) and enhance productivity (by exploiting economies of scale). Together, this could contribute to an increase in the sustainable rate of growth in the acceding countries and in the present EU. The size of this effect depends on the implementation of the much-needed structural reforms in both the present and the new Member States.

Moving towards the euro

Before I end, let me say some words on the adoption of the euro in the new Member States. The new Member States are expected to adopt the single currency at some point in the future. In fact, while not yet adopting the euro, they will be committed to striving towards the eventual adoption of the euro. The main aim of the Eurosystem in the process towards euro adoption is to ensure that the monetary integration of the new Member States proceeds in a smooth manner and in line with the Treaty provisions.

The Governing Council of the ECB published a policy position paper on exchange rate issues relating to the acceding countries on 18 December last year. This document consolidates into a single comprehensive policy text the previous positions of the Eurosystem on the matter.

As the acceding countries differ greatly in terms of economic structure, exchange rate and monetary regimes, and in the degree of nominal and real convergence already achieved, they will need to be assessed on a case-by-case basis throughout the process leading to their adoption of the euro. In this respect, no single path towards ERM II and the adoption of the euro can be identified or recommended. Various strategies may be feasible, provided they are based on sound economic reasoning, conform to the existing institutional framework and contribute to the high level of sustainable convergence which is essential when joining the euro.

The principle of equal treatment will continue to apply throughout the entire process of monetary integration. Adopting the euro is an irrevocable decision and it is of the utmost importance that countries fulfil the convergence criteria not only nominally but also in a sustainable manner before they enter the euro area, as required by the Maastricht Treaty. There will be no additional criteria but neither will there be a relaxation of the criteria.