Jean-Claude Trichet: Structural reforms and growth, as highlighted by the Irish case

Keynote address by Mr Jean-Claude Trichet, President of the European Central Bank, delivered at the Whitaker lecture organised by the Central Bank and Financial Services Authority of Ireland, Dublin, 31 May 2004.

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Ladies and gentlemen,

It is a real pleasure for me to speak at this inaugural lecture in honour of Dr. T.K. Whitaker, for several reasons.

Firstly, in doing so I have the satisfaction of honouring a great man, a great European and a great Central Banker. Dr. Whitaker is a man whose inspiration and efforts were used at a critical time in Irish history to bring Ireland on a journey of transformation from economic stagnation to a position of stunning and exemplary economic success.

Secondly, you, Dr. Whitaker, deserve to take the satisfaction and pride of knowing that your contribution to the success of the Irish economy has not been bounded by Ireland's shores. Rather the process of transformation that you began over four decades ago has become a model for the millions of new citizens of the European Union. The new Member States of the EU have had to confront economic challenges whose magnitude and long-term importance are similar to those that faced Ireland when you began your work. Thanks to Ireland's economic success, to which you devoted your life, we can be confident that economic reform works.

Today I have the opportunity to highlight the importance of structural and fiscal reforms in an enlarged Europe. Ireland's contribution in this area is not confined to inspiration from its exemplary policy record. The Irish Presidency of the European Union is working to stimulate progress in structural reform through its prioritisation of the Lisbon Agenda. Together with the great events of European Union enlargement and the progress being made in other areas, this should be a source of pride for Ireland.

Speaking about Ireland's EU Presidency, and noting that the outgoing President of the European Parliament, Pat Cox, is also Irish, I cannot resist mentioning with pride my own Celtic roots as a native "Breton"!

Before experiencing economic spring, Ireland has had to go through a long winter of economic inertia. For decades after the establishment of Ireland's independence a climate of economic and social pessimism became prevalent in a country which appeared to have little to offer its citizens but the prospect of emigration and low revenues. Between 1951 and 1958, as Europe's economy rebounded, Ireland's relative GDP per capita actually fell from 75 to 60 per cent of the EU average.

It was the year 1958 in which an important turning point was made in Irish modern economic history: The Programme for Economic Expansion was published under your leadership and inspiration as the then Secretary of the Department of Finance.

This publication pointed a way out from what appeared to be an intractable downward spiral of weakening economic activity, high inflation, low living standards, chronic unemployment and a level of emigration that was comparable to the birth rate. With its emphasis on free trade, increased competition and the need to end protectionism, this document pointed the way to an Ireland that was to become economically more open, industrially more diverse and increasingly confident of its future.

Your inspiration was followed by your action as Ireland's top public servant. In the same year of 1958, the Industrial Development Authority was created, bringing the stimulus of foreign investment into the Irish economy. Subsequently, you guided Ireland's programme of trade liberalisation and structural reform in the 1960s. Economic growth accelerated as a result. In 1973 Ireland acceded to the EU in a process to which you played a significant role as Governor of the Irish Central Bank.

So far I have looked backward but in true Central Banking style I have done so only so that I may look forward, in particular to the challenges facing Europe now. In an enlarged Europe, the vision you have displayed in inspiring, designing and implementing economic reform in the 1950s is very relevant to us today.

Allow me now to focus on this theme and in particular on the important topics of structural reform and fiscal consolidation, explaining for each of them their merits, including in light of the Irish experience

Economic and Monetary Union has been highly successful in fostering macroeconomic stability in Europe. The ECB has provided its own contribution to this success through the safeguarding of price stability in the euro area. However, important efforts are still needed to fully realise the advantages of a stable single currency. Structural reforms that are designed to increase the flexibility of markets offer the key to achieving higher sustainable growth, increasing employment, promoting innovation and securing the sustainability of social security systems in the EU. They furthermore enhance the capacity of the participating countries to cushion macroeconomic shocks. By contrast, the more rigid labour, product and financial markets are, the higher will be the employment and income losses experienced in response to changing domestic and global economic conditions.

It is widely recognised that structural reforms are needed to improve the prospects of the euro area. Given that demographics in the EU are less dynamic than in other economies, including the US, the case for a decisive implementation of structural reforms is even more pressing.

This is not to say that there has been no progress in structural reform across Europe in past years. Indeed, a number of governments have made important and significant steps to address structural rigidities in their countries. Progress has been uneven however and we still have a distance to cover before reaching the goals that have been set.

The impetus from determined structural reforms in capital, labour and product markets would set in motion a virtuous circle of increasing confidence: the more credible the reforms are, the more confidence they will create, and the more confidence is created, the sooner positive results will be visible. So, I would like to give you some examples of where I think further progress with structural reform is needed in Europe, to enhance job creation, growth and economic resilience.

One of the most difficult and persistent challenges facing Europe is to reduce structural unemployment and elevate the level of activity rate. In 2003, 9% of the labour force in the European Union was unemployed, a level of three percentage points higher than in the US. The rate of youth unemployment was more than double that of adult unemployment. The overall rate of activity is around 62 % in the euro area where it is as around 75 % in the United States. Some countries have started to reform their social security systems and unemployment schemes and early retirement incentives have been reduced. But more progress of this type is necessary to attract more people into the labour market, particularly as Europe's populations become older, and to reach the goal which has been set up in the LISBON agenda, namely a rate of activity of 70 % by 2010. In a number of cases, together with high marginal tax rates, the legal and regulatory environment in Europe continues to provide a disincentive to take up work and to continue working later on in life. And, there are still, in certain sectors of activity, a large mismatch between skills and vacancies, implying the need for improved education and training. Finally, wages should more strongly reflect regional and sectoral productivity differences.

EU countries also made progress in product market reforms during the 1990s, having positive effects on the integration and level of competition in goods markets, but barriers to competition and innovation in Europe remain. Attention should be paid in particular to the share of EU Internal Market legislation not yet transposed into national laws, the incomplete integration of the service sector, where most new jobs are created, and remaining regulations that hamper the internal market. Progress on this front is extremely important as many forms of national regulations hamper integration and competition and keep prices above levels observed in more integrated markets. Furthermore, state subsidies and in particular sectoral aid continue to distort European product market. The Lisbon target that R&D investment should reach 3% of GDP, with two-thirds financed privately, is not yet achieved.

Finally much progress has been achieved in capital market reforms, not least due to the introduction of the euro. But the further integration of national capital markets towards a truly European financial market could make an even more important contribution to safeguarding against country-specific shocks. It would also result in greater availability of risk capital - particularly for innovative enterprises - and, more generally, in a reduction in financing costs for productive investments. Structural reforms in capital markets should aim to allow a more effective allocation of savings toward the most rewarding investment opportunities. Further efforts should also be made to promote foreign investment in the euro area in order to attract additional capital and promote a greater transfer of technology.

In this context, one has to consider the astonishing experience of Ireland, which recovered from poor economic and fiscal conditions in the mid-1980s to an impressive pace of economic activity and sound

fiscal position in no more than a decade. In addition to a favourable macroeconomic environment and the benefits derived from participation in the European Union, the economic recovery was grounded on far-reaching home made structural reforms in the labour, capital and product markets.

The strengthening of the labour market was strongly underpinned by a supportive policy framework. A strong pickup in labour supply and impressive productivity gains were associated with favourable demographics and, more recently, an increase in skilled immigration. Furthermore, unemployment was dramatically reduced through a more efficient matching of individuals and job vacancies. Labour market participation, including that of women, was increased through structural reforms to reduce tax wedges and the human capital of the labour force was upgraded through a significant investment in education. Ireland's economic success can therefore be linked to the transformation of its labour market into a plentiful supply of competitively priced and quality labour resources.

Important successes were also made through structural reform within product and capital markets. The liberalisation of trade and investment through the Single European Market programme had positive effects on output and productivity and put downward pressure on costs and prices. Goods markets became more integrated. Research and development supported the dynamic gains from faster growth. Foreign direct investment also made a very significant contribution to Ireland's growing economy. This streamed into Ireland, placing the country as one of the premier host countries for US foreign direct investment in the world during the 1990s. The EU's Structural and Cohesion Funds were well used to improve Ireland's infrastructure and educational system. Moreover, Ireland developed a transparent regulatory framework.

To conclude on structural reforms, I think the key issue now is to bridge the gap between strategy and implementation in Europe - to identify the best policy practices and make structural reform happen. The European Union has a number of useful institutional instruments and processes in place, such as the Broad Economic Policy Guidelines, the Employment guidelines and the Spring European Council, to foster implementation. In this respect, the ECB has always backed the diagnosis, the agenda and the goals that were adopted by the Lisbon European Council in 2000. The Presidency Conclusions of the Spring 2004 European Council delivered a message of determination and confidence which reinforced the validity and relevance of the Lisbon process. We have a consensus on the "road map". The issue today is to improve "navigation", to improve the decision making process and the effective delivery of the reforms. Convincing the people of Europe that all European citizens will be better off thanks to these reforms is absolutely key. The success of Ireland was largely due to the fact that the Irish citizens were rightly convinced that this road map would improve their own situation.

Moving to the second topic of my speech, i.e. fiscal policies, let me stress that we Europeans have been very bold in creating a single currency in the absence of a political federation, a federal government and a federal budget at the euro area level. Some observers were indeed arguing that without a federal budget of some significance the policy mix would be very erratic, depending on the random behaviour of the different national fiscal policies of the member countries. They were also arguing that without a federal budget it would be impossible to weather, with the help of the fiscal channel, asymmetric shocks hitting one particular member economy. In this respect, the very existence of the Stability and Growth Pact actually allows to refute these two arguments: first, the Maastricht Treaty and the Pact provide a mutual surveillance by the "peers"- i.e the Ministers of Finance - of national fiscal policies; second, by calling upon Member States to maintain their budget close to balance or in surplus over the medium term, the Pact allows the automatic stabilisers to play in full in countries facing an economic downturn, without breaching the 3% ceiling for the deficit. Beyond these economic underpinnings, other considerations are worth mentioning: a fiscal policy set according to rules adds to macroeconomic stability by providing agents with expectations of a predictable economic environment; this reduces uncertainty and promotes longer term decision making, notably investment decisions, and economic growth; in addition, sound fiscal policies contribute to lower risk premia on long term interest rates and thus support more favourable financing conditions; finally, fiscal discipline prevents spill-over effects from one country to another in the form of higher interest rates.

Some people argue that fiscal consolidation is detrimental to demand and economic activity. I would maintain that wealth and expectational effects of well-designed consolidation programmes might very much reduce and possibly even outweigh the traditional Keynesian multiplier effects of fiscal policy on demand and activity. If fiscal consolidation is perceived by the private sector as a credible sign that public spending will be permanently lower in future years, households will revise upwards their expected permanent income in anticipation of lower future taxes. Therefore, current and planned consumption will also increase.

In addition, fiscal consolidation might improve long-term financing conditions by way of less demand on the savings pool (reducing crowding out) and lower risk premia on government paper. Hence, wealth effects prompted by lower nominal and real interest rates would support larger consumption. Furthermore, following more favourable financing conditions, private investment is also likely to increase.

The case for expansionary effects on the supply side, via an improved competitiveness of the economy, is also important. If fiscal consolidation can induce moderating effects on wage demand, relative unit labour costs might decrease, with positive medium-term effects on real GDP growth through a greater competitiveness of the productive sector. Such effects are buoyed if lower expected tax rates and more efficient public expenditure enhance the working incentives and the investment environment.

It is also important to recognise that fiscal policies can promote growth and employment via appropriate reallocations of the level and composition of government taxes and expenditures without hampering in any respect the fiscal rules. Reducing inefficient public spending can reduce disincentives to work and help to finance tax cuts. Furthermore, public expenditures can be redirected towards productivity-enhancing physical and human capital accumulation rather than, for example, the provision of subsidies for declining industries.

In this respect, the dramatic acceleration of output in Ireland in the post 1987 period can be associated with a vigorous and successful project of fiscal consolidation starting in 1987. This programme was based on tight expenditure control via subsidy cuts, social security reform and a streamlining of the public sector and control of public expenditure.

Ireland’s experience, similar to the Danish experience in 1983-89, clearly shows how policies geared to fiscal consolidation do not necessarily entail contractionary effects on real aggregate demand and economic activity. On the contrary, in these two countries, in spite of the tightening policies undertaken, the rate of growth showed a significant increase in relation to previous years. In particular, in these countries, significant budget consolidation based on spending reduction enhanced the long term fiscal sustainability and increased the policy credibility of a more favourable tax regime.

Regarding Ireland, the budget deficit was reduced from 10.1% of GDP in 1986 to 1.7% in 1989, while the debt ratio declined from 113% of GDP to 100.4% of GDP; over the same period GDP growth accelerated from 0.3% to 6.2%; the overall consolidation effort, as measured through the structural fiscal balance, amounted to 5.1% of GDP over these three years. In the years afterwards, Ireland continued to enjoy high rates of GDP growth and kept large structural fiscal surpluses (almost always above 5% of GDP), thus allowing for a steady and rapid decline of the debt ratio (which reached 32.4% of GDP in 2003).

The Irish and Danish experience brings evidence that expansionary expectation effects may dominate on the contractionary effects of a fiscal consolidation. In both cases there is a considerable evidence that the consumer boom was prompted by the wealth effects of cuts in public spending, as a signal of lower future taxes, concomitantly to the wealth effects implied by the fall in interest rates. On the supply side, a low tax environment has underpinned the pick up in economic activity in Ireland.

Coming back to Europe as a whole, confidence among European citizens is vital for a stronger economic recovery and sustained growth. The ECB’s Governing Council recognises that the still moderate level of consumer confidence is related in part to the debate about the appropriate path for fiscal policy and structural reform in many countries in the euro area. Also for this reason, progress with the implementation of the necessary structural reforms and more determined efforts to establish sound fiscal positions over the medium term are key to stronger confidence.

The successful implementation of structural economic and fiscal reforms requires significant and tireless efforts of explanation, pedagogy and adequate public communication. Over time, everybody will benefit from more growth, employment and opportunities. These gains from reform are often overlooked in the public debate. In fact, there is a formidable challenge to gain the support of public opinion for implementing structural reforms.

What are the implications in the current economic environment? Fiscal imbalances are quite significant in a number of EU countries with deficits and public debt ratios being too high. For these countries, there are solid economic reasons to argue that credible fiscal consolidation would boost growth in net terms, the so-called “Ricardian” effect being more important than the “Keynisian” effect. Reducing such imbalances is likely to have positive expectational effects of a more favourable tax regime and better financing conditions in the future.

Moreover, we would probably all agree that tax and spending ratios in some countries are too high and unfavourable for investment and economic dynamism. Expenditure-based fiscal consolidation and reform that would credibly reduce disincentives to work, invest and innovate could have significant confidence effects even in the short run.

To conclude, I would like to return to the Lisbon reform agenda set in 2000, which was ambitious, but at the same time, absolutely necessary. It was clear that implementing effectively the necessary reforms would be a real challenge and this challenge requires that we win the heart and the trust of the people. Indeed, many European countries are currently at a crossroad. First, and as regards public finances, countries are faced with the option of either profoundly reforming their public expenditure and social security systems or putting their long run sustainability at risk. Second, I am convinced that economic activity, employment and innovation in the EU can only be lifted to a new, structurally higher, level by far-reaching and progressive structural reforms. These must go hand in hand with fiscal consolidation. The long-term advantages of following such a strategy far outweigh the short-term costs of its implementation. I therefore strongly encourage and support those governments that have the courage and leadership to follow this path and hope that other countries will follow their positive example.

Dr. Whitaker, let me express my profound admiration for the example you have shown to Central Bankers everywhere in your endurance and constant commitment to the public good. The fruits of your life’s work are all around us today and will play a role in inspiring policy reform in Europe. I for one, Dr Whitaker, salute you for your work, and thank you for the inspiration you have given all of us.

Thank you for your attention.