Jean-Claude Trichet: The European economy - current situation, prospects, challenges

Speech by Mr Jean-Claude Trichet, President of the European Central Bank, at the "Forum économique international des Amériques" Conférence de Montréal, Montreal, 30 May 2005.

* * *

Mr Prime Minister,
Mr Mayor,
Mr President,
Ladies and Gentlemen,

It is with great pleasure that I have come to attend the debate and discussion at the international economic forum of the Americas/Montreal conference, and more especially to address you today. The issue chosen for the forum this year, "Success at a time of turbulence", is especially relevant in a world beset by constant economic, financial and technological change. So I would like today to share the European experience with you. Allow me first of all to discuss the recent development of economic activity in the euro area, the better to underscore the prospects and to describe the challenges to be faced if Europe is to make its own contribution to the growth of a world undergoing in-depth transformation and thus tending to be turbulent.

The economy of the euro area: a stable macroeconomic situation, but economic dynamism that requires further stimulation

Since its establishment over six years ago, Economic and Monetary Union has helped to provide a stable macroeconomic environment. Over the past few years, the annual inflation rate in the euro area has remained slightly higher than our own definition of price stability, that is a rise in prices of less than 2 % and close to 2%. Yet this situation is more a reflection of temporary shocks linked in particular to the trend in the price of crude oil, than to any underlying inflationary trend, which remains generally moderate today. Inflation expectations have remained anchored at under 2%, in line with our definition of price stability. The fact that the run of oil price hikes has not jeopardised the stability of inflation expectations is no mere coincidence. It is a mark of success, showing the high credibility level of the young European Central Bank, which has proven capable of convincingly providing businessmen in an economic area with a population of some 306 million, with a stable anchorage point for their price expectations. Thus, as long as inflation and inflation expectations remain solidly anchored to levels compatible with price stability, monetary policy will make a crucial contribution to economic growth by fostering an exceptionally low interest level on the short, medium and long-term markets, and by creating an economic environment that entails minimal distortion and that helps businessmen to make the best decisions.

In the medium term, the euro area's prospects rest on crucial factors that should not be overlooked. Allow me to briefly run through them. On the external level, worldwide activity is fated to remain healthy and it is expected to help sustain European exports. On the internal level, investment should continue to benefit from financial conditions that are, historically speaking, exceptionally favourable in the euro area. It should benefit also from an improvement in businesses' results and their increased productivity due to past restructuring. Moreover, private consumption is likely to grow in keeping with the growth in real income that is expected to continue.

Yet in the shorter term, since the second half of 2004, growth in the euro area has been modest, below the area's potential growth rate. It is still positive, of course, but modest. There can be no doubt that the increasing cost of raw materials (with crude oil heading the list) has led to increasing uncertainty over economic prospects and that it continues to loom as a risk of far from secondary importance, as indeed do imbalances at the global level. Furthermore, consumers are taking their time to rediscover the path of confidence, doubtless on account of a still difficult situation in the labour market, of difficulties and delays in the implementation of basic reforms, and of a feeling of insecurity due to insufficient budget consolidation.

Sure enough, a good monetary strategy guaranteeing the solid anchoring of price stability is a necessary precondition for economic growth. It is not a condition that is sufficient in itself, however. A budget strategy guaranteeing healthy public finances and structural reforms making it possible to raise the level of potential economic growth are also crucial. An examination of the trend in labour productivity in Europe and in the United States is particularly enlightening in this connection.

Over the past few years, despite tangible progress in terms of overall employment growth and activity rates, a slowdown in the rise in hourly productivity in the euro area has been the main cause of the gap in economic growth between the euro area and the other major economy in the industrially advanced world, namely the United States. This, especially because over the same period of time the United States has enjoyed a strong boost to its hourly productivity, thanks in particular to its efficient use of new information and communication technology. Thus while growth in hourly productivity in the 1980s stood at 2.4% on average in the euro area and at 1.3% in the United States, that trend inverted between 1996 and 2004, with an annual average in the euro area and in the United States of 1.3% and of 2.5% respectively.

The lack of sufficient structural reform in Europe is, in my view, the main cause of the gap in economic growth between Europe and the United States that we have seen over the past few years. If we are to impart a fresh thrust to Europe’s growth potential and to help boost consumer and business confidence, we need to work on the European economy’s most crucial underlying weaknesses and to implement basic reforms. Allowing the labour market to work better with a view to boosting growth in employment and productivity, completing the establishment of a large single market, and promoting investment and innovation will be the best way of allowing the European economy to adapt to international competition, to foster the development of businesses, and to accelerate economic growth and the creation of lasting employment.

Structural reforms

I must say that – although uneven across European countries – significant progress in the implementation of structural reforms has been made, and such an effort should be recognised. However, there is still a long way to go. In Lisbon in 2000, Heads of State and governments have committed to make the European Union “the most competitive and dynamic knowledge-based economy in the world, capable of sustainable economic growth with more and better jobs and greater social cohesion”. The decision on the specific structural reform measures, their design and actual implementation should be left to the Member States. While getting closer to one another, EU countries still differ in many respects: in their structure, economic development and institutional setting. Leaving it up to the national actors to decide on their reforms is just the natural consequence of such differences. However, these reforms should take the EU consensus on policy priorities and objectives as a clear and common reference point. Again, let me stress that implementing structural reforms is not an easy task; it needs a lot of courage and determination on the part of governments, parliaments and social partners. However, these reforms are most definitely needed, along with stability-oriented monetary and fiscal policy, as an essential ingredient to ensure higher prosperity and job creation in Europe. Let me now focus on two areas where I think further progress is most urgently needed: labour and product markets.

In product markets, there are still considerable productivity gains to be reaped in Europe by removing the remaining barriers to competition that still remain at national and EU level. The creation of a common market based on the free movement of goods, services, people and capital is a cornerstone of the European Union since the Treaty of Rome. The completion of the single market, in particular in the sector of financial services, is of the essence.

An essential factor of technological progress and diffusion is human capital. Indeed, thanks to technological advancements, economic activity becomes increasingly knowledge-based and jobs shift from low to high-skilled workers. However, investment in human capital development in Europe remains insufficient, and a strong focus should be put on improving education and training systems. Europe also suffers from insufficient quantitative and qualitative efforts as regards investment in research and development (R&D). As an example at present only two EU countries exceed the target for R&D spending of 3% of GDP. All the other EU countries lag behind. More efforts in this field are clearly needed.

Further reforms in labour markets are also crucial in order to improve the flexibility of the labour market. It is essential to provide incentives for more people to enter the labour market. Increasing labour participation and utilisation is a core challenge for policy, particularly for females, the young and older workers. Some countries have started to implement reforms in order to reduce the disincentives to work. Unemployment insurance schemes have been amended and early retirement incentives have been reduced. Take for instance Denmark and Sweden, where various reforms to improve work incentives and avoid labour supply constraints have been implemented. In Denmark, measures aimed at reducing taxes on labour income. In Sweden, reforms mainly targeted older workers, immigrants and younger workers. Well, both Denmark and Sweden have already exceeded all the EU employment targets, including those for women and for older workers. These are two examples where the reform progress in this area has produced clear benefits. However, although unemployment insurance systems have been streamlined, in a number of cases, together with high marginal tax rates and social security contributions, they continue to provide a disincentive to take up work.

EU enlargement

Meeting these challenges has become even more important with the historic enlargement of the European Union in May last year from 15 to 25 Member States. Let me first stress that I am convinced that the enlargement entails opportunities and benefits for the EU. The economic benefits of enlargement are sometimes neglected in discussions, often overshadowed by fears, such as the risk of mass migration after opening up borders with the new Member States, involving increased pressure on labour markets and welfare systems of the other Member States. I do believe that the EU enlargement will contribute positively to economic growth and welfare in the EU as a whole. It will provide new opportunities to trade and investment flows. The enlargement of the Internal Market will strengthen the degree of competition as the accession of the new Member States has increased the number of suppliers within the Internal Market. In addition, enlargement has enhanced the scope for economies of scale, as the extension of the Internal Market increased the size of the market available to suppliers. This should translate in lower prices and increased productivity, thereby contributing to a higher potential growth. However, these benefits will not be realised automatically. Again, in this respect too, there are substantial benefits associated with the implementation of structural reforms. In particular, a forceful and prompt completion of the enlarged Internal Market in both the old and the new Member States is essential to fully exploit the benefits of the present enlargement.

Let me say a few words on the ERM II membership which has already been decided for six currencies out of the ten currencies of the new Member States. Having proceeded with the necessary structural adjustments, participation in ERM II can be an important means of anchoring exchange rate and inflation expectations, and of promoting discipline. It can help orient macroeconomic policies to stability, while at the same time allowing for a degree of flexibility, if needed, through the wide standard fluctuation band and the possibility of adjusting the central parity. In any case, there is not a uniform path to the adoption of the euro and each country will be judged on its own merits before adopting the euro. And, as required by the Treaty, the sustainable convergence of the economies concerned will be carefully checked both in the interest of the country concerned and in the interest of the euro area as a whole.

Fiscal discipline

Finally, I would like to discuss another major challenge that Europe is going to have to face over the next 50 years: an ageing population. A few figures may help to illustrate the magnitude of this challenge: According to the forecasts of Eurostat, the European statistics institute, the population of working age (people aged between 15 and 64) is going to drop from 67.2% of the overall population in 2004 to 56.7% in 2050. At the same time, the proportion of retired people (in other words, people aged 65 or over) is going to rise from 16.4% of the overall population in 2004 to 29.9% in 2050. These figures are self-explanatory. We are on the eve of an unprecedented demographic upheaval which is going to put a major strain on public finances. Ageing is going to translate into significant additional budget costs, generally estimated for the next few decades (and only for pensions) at between 3 and 5% of GDP in the majority of European countries. These forecasts show quite clearly that demographic change without appropriate reform is likely to weigh down very heavily on public finance. I would like to draw your attention to the most important effects of these developments on the sustainability of public finance and growth.

The pressure that an ageing population will have on public spending could threaten the sustainability of public finance. Without a change in policy, public spending due to ageing will lead to a growth in deficits and to an inevitable increase in the public debt. These developments will also reflect on businessmen's forecasts. A drop in confidence in Government signatures due to forecasts of an increased risk of default on the public debt could multiply “risk premia” and foster a financial environment less conducive to investment and growth.

With an ageing population, spending on share-out pension systems is going to increase at the same time as the social security contribution base decreases. In the light of such a situation, adjustments in the parameters of these systems, such as for instance a rise in the real retirement age, seem to be essential. And more fundamental changes to the structure of pension funding seem to be essential too. Growing pressure on the funding of public health systems also calls for courageous reforms.

Reform of social safety nets is one of the crucial factors, among many others, that will allow us to control the public debt, to guarantee the sustainability of public finance, and to boost growth potential. The immediate adoption of a strategy of ambitious reforms along with a firm and credible budget consolidation policy would help to boost Europe’s growth potential without delay. In the case of the euro area economies, boosting businessmen’s confidence in budget sustainability and in long-term economic stability as well as in the maintenance of a suitable welfare policy and of reasonable compulsory contribution rates would more than make up for the negative effects that the reforms and budget consolidation might have on demand in the short term. The larger the imbalances forecast, the more these “Ricardian”, non “Keynesian”, effects are likely to be seen. And an ageing population means major budgetary imbalances in Europe’s future, naturally if the countries concerned fail to take appropriate action.

In the face of a challenge of this nature, it is crucial to implement the new version of the Pact for Stability and Growth in a stringent manner. The Pact is essential from the standpoint of the Economic and Monetary Union’s cohesion, and in that connection it is one of the keystones of confidence in Europe’s economic stability, thus one of the keystones of investment and growth. So it is necessary to work with determination on budget consolidation and on bringing down the public debt in order to take on the challenge of an ageing population and to safeguard the credibility of the European budgetary framework.

Mr President, Ladies and Gentlemen, Europe is facing today five major challenges. Three of them are major challenges that equally apply to all the long industrialised countries. The last two others are specific to Europe and do not exist anywhere else in the world.

The diagnosis is now clear as regards the first three challenges – the challenge of new technologies, the challenge of globalisation, the challenge of population ageing – which does not mean either that they are easy to solve… For the first challenge, facilitate the deepening and broadening in the whole economy of science and technology, in particular - but not only - of information technologies. For the second, organise the new economic framework stemming from the generalisation of the market economy and the very fast economic development of Asian emerging countries. For the third, draw the consequences of population ageing in order to ensure the sustainability of public finances. The US, Canada and other industrialised countries must tackle the same issues.

But in addition – and this is a unique situation in the world, a privilege and at the same time a great historic responsibility – Europe must face two other challenges.

On one hand, Europe has engaged into a long-term process aimed at ensuring its unity on the basis of a voluntary Union between States. These States share in common some elements of their sovereignty and have already decided to create a single market with a single currency. This is a very ambitious historic transformation.

On the other hand, Europe must a the same time meet the challenge of a rapid geographic expansion of an immense historical magnitude. We were still 12 countries when the Maastricht Treaty was negotiated. We are now 25, and virtually already 27. In Europe, are therefore intertwined a unique “vertical” economic and political transformation and a geographic “horizontal” expansion of an immense significance.

Five major challenges to face, two more that the other industrialised countries. All these challenges are exciting, all stem from important successes – scientific progress, the economic take-off of big developing countries, progress in medicine, the deepening of the pacific unity of Europe, the fall of the iron curtain – but these challenges are also demanding and difficult. After the French referendum and before the Dutch referendum, we are facing today a difficult moment for Europe and for our 458 million European fellow citizens. It is not the first time, and probably not the last time. In his Memoirs Jean MONNET, whose ideas and action are at the roots of the European endeavour writes: “Those who do not want to start an endeavour because they are not fully sure that things will go as they have planned in advance, are condemning themselves to be immobile." I am sure that Europeans will together find the way allowing them to overcome present difficulties as they did it in the past.

The European Central Bank has a clear mandate given by the Maastricht Treaty. It preserves today and will preserve tomorrow, as it did in the past, price stability and confidence in the currency, which are necessary conditions to sustainable growth and job creations. Confidence is a key word in present circumstances. Europeans can rely on the ECB and on the Eurosystem as a whole to preserve and consolidate this confidence.

I thank you for your attention.