Jean-Claude Trichet: The euro area economy - determinants of growth, competitiveness and the need for structural reforms

Speech by Mr Jean-Claude Trichet, President of the European Central Bank, at an executive briefing with the Premier Cercle/Wall Street Journal, Brussels, 10 October 2005.

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Ladies and gentlemen,

First of all I would like to thank Premier Cercle and the Wall Street Journal for inviting me here today and giving me the opportunity to share with you some thoughts regarding a number of issues which I deem of critical importance for the euro area economy. I would first like to draw a broad picture of economic growth trends in Europe as compared to the United States; based on this diagnosis, I would then like to stress how the issues of structural reforms are key to preserve and improve the economic performance of the European economy.

Assessment of the euro area’s growth performance

Let me start with an assessment of the euro area’s growth performance. Since the 1980s, real GDP in the euro area has grown on average at a pace almost one percentage point lower than in the U.S. Similarly, but even more importantly, per capita real GDP growth over the same period has not only been lower in the euro area on average, but the gap vis-à-vis the U.S. has also been increasing over the last decade.

Europe’s achievements should, however, not be underestimated. If one considers output per hour worked, the picture is somewhat different. Output per hour worked in the euro area, which was around 88% of the level of the U.S. in 1980, was equal to the U.S. level in the latter part of the 1990s. Over recent years, however, the pattern has gradually changed, such that labour productivity is again below U.S. levels by almost ten percent. I will come back to this shortly.

Despite some catching up in terms of output per hour worked, the level of output per capita has remained just over two-thirds that of the U.S. since the 70’s. The lack of convergence in output per capita to U.S. levels reflects the weaker performance of the labour market in Europe. This resulted from a lower level of participation rate, significant reductions in working hours per person employed in Europe and a higher level of unemployment since the first oil shock. More recently, however, there have been some positive developments, with stronger increases in European employment than in the past.

Since 1980, the average number of working hours per person employed in the euro area has been around 12% lower than in the U.S. The difference has gradually increased and latest estimates suggest that average working hours in the euro area is currently some 15% below U.S. levels. The lower level vis-à-vis the U.S. is partly explained by fewer actual working days per year, while the widening of the gap reflects the shortening of statutory full-time working weeks and the rising share of part-time employment. In the U.S. these latter determinants have remained broadly stable.

An important question which has featured prominently in the policy discussion is whether lower labour utilisation in the euro area reflects predominantly preferences or disincentives from tax and social contribution systems. In this respect, some data show that part-time employment in both the euro area and the U.S. seems to be partly of a voluntary nature and, per se, might thus reflect individual or cultural preferences. However, having said this, it should also be borne in mind that households are influenced by their institutional environment. This includes for example taxes, social security and pension systems. Such factors are providing disincentives to work.

Let me now continue with more recent developments. While the gap in per capita GDP growth vis-à-vis the U.S. has remained unchanged , the underlying explanation has changed. Labour productivity has evolved more favourably in the U.S., whilst labour utilisation has developed more favourably in Europe. On the latter, I hope and believe that these developments will continue, as the potential for catching up in this regard is very substantial. Both participation rates and average hours worked are low in the euro area and unemployment rates are high.

Why has there been a reversal of the catching up process of labour productivity growth vis-à-vis the U.S. since the mid-1990s? The answer is partly found in the usage of information and communication technologies, which has had a beneficial effect on labour productivity in the U.S. A word of warning may be appropriate here as these kinds of comparisons are unfortunately surrounded with uncertainties due to different statistical practices and statistical measurement problems. Nevertheless, when analysed by sector, it is impressive to see that, on top of the sectors that manufacture these technologies, it is the very rapid improvement in the service sectors that are using them – such as wholesale trade, retail trade, financial intermediation – that explains much of the difference. This feature of the U.S. economy explains, together with the relatively more unsatisfactory demographics of Europe, why European growth has been disappointing in comparison with the U.S. during the past decade.

Let me elaborate a bit on the role of demographic developments for the euro area. The importance of demographic factors as a source of growth in the euro area has been gradually decreasing over time during the past three decades. Although in the short to medium run demographic factors are not projected to become too grave a problem, in the longer run they are likely to become a major source of concern. In particular, the growth rate of the population of working age is projected to gradually decline, from current positive rates of around 0.4% per annum, and become negative within one to two decades in the euro area. As a matter of comparison, the growth rate of the population of working age has since the beginning of the 1980s averaged 0.5% in the euro area, while the corresponding figure for the U.S. is 1.1%. This difference has recently increased. The projected changing age structure moreover implies a gradual ageing of the population. If fertility rates do not rise, the adverse consequences arising from this particular feature could only be solved by an extension of the working life and/or substantial inward migration. Forward looking growth accounting exercises show that these adverse demographic developments would reduce average real GDP growth in the period up to 2010 below 2% and in the period up to 2020 further to around 1½% if no compensation is achieved through higher contributions from other supply-side factors. Taking into account these unfavourable demographic developments, only with ambitious and comprehensive reforms therefore, there is some scope for raising medium to longer-term output growth in the euro area or even simply sustaining the long term growth potential.

Structural reforms and future challenges

The implementation of appropriate reforms is key for sustaining or even raising medium to longer-term output growth in the euro area. In particular, there is a need to further boost labour utilisation and productivity. Back in 2000, the EU's leaders therefore adopted a blueprint of structural reforms – the so-called Lisbon Strategy – which was to turn the European economy into a highly competitive knowledge-based economy.

A key objective of the Lisbon strategy is to raise the employment rate. To achieve this, some euro area countries have started to implement the needed reforms to reduce the disincentives to work that are currently present in many European labour markets. Unemployment schemes have been amended and early retirement incentives have been reduced. As a result, the countries that have introduced measures aimed at increasing flexibility of the labour market witnessed a fall in actual unemployment rates and consequently in the non-accelerating inflation rate of unemployment – the so called NAIRU – which is the level of the unemployment rate that does not lead to inflationary pressures. Moreover, thanks to the implementation of labour market reforms the employment rate increased in most euro area countries, but the size of the increase differed across countries. In 2004 only three euro area countries met the interim Lisbon employment target of an employment rate of 67% and just one euro area country achieved an overall employment rate higher than 70%. The euro area-wide employment rate stood last year at 63%, while, for comparison, it stood at 71% in the U.S. Thus, if the 2010 Lisbon target is to be met, employment rates need to increase much more rapidly.

Boosting labour productivity growth is another central component of the efforts to enhance Europe's growth potential. Innovation and technological diffusion have an important role to play in this context. An article in the Economist recently pointed out that *"Europe's only chance of preserving its living standards lies in working smarter than its competitors rather than (..) cheaper".* In a world of pervasive globalisation and relentless technological change, our future prosperity will indeed depend on our ability to generate and exploit new knowledge and ideas. A key factor for promoting innovation and technological diffusion is research and development. Most innovations result from entrepreneurial activities or investment in research and development. In this field, Europe clearly suffers from a lack of private investment. The Lisbon strategy set a target that research and development spending should reach 3% of GDP, two thirds of which should come from private investment. In 2003 expenditure stood at 1.9% of GDP for the euro area, and only one euro area country currently exceeds the Lisbon target level. By way of comparison, the U.S. spends 2.8% of GDP on research and development. It is also important that efforts to achieve the Lisbon target should be accompanied by policies that enhance the gains from efforts and money spent on research and development.

Productivity growth can also be boosted by more and better education and training. The right skills and competences are required to reduce mismatches in the labour market and allow for a smoother reallocation of workers between sectors and firms. So far, investment in human capital development in Europe is insufficient. For instance, the number of European school-leavers who go on to complete higher education is inadequate for the knowledge-intensive economy. In the euro area, only Finland and Ireland have reached a comparable level with the U.S. in this field. Human capital improvements in these countries came together with a fast development of the sectors within information and communication technologies. As a consequence, they enjoy a labour productivity growth performance which is significantly above the euro area average. A comparison with the U.S. illustrates the knowledge gap very well: in the US, annual expenditure on higher education institutions per student represent 57.8% of GDP per capita, while in the euro area 35% is spent.

Creating well functioning, competitive and efficient markets is another key aspect of the Lisbon strategy. In a number of fields clear progress has been made. For example, most network industries are now fully or largely open to competition, in particular those in telecommunications and air transport and to a lesser extent in energy markets. And the reforms do pay off: the remarkable labour productivity growth performance in network industries in Europe over the last ten years provides a perfect example of the positive impact on labour productivity growth of easing regulations and fostering competition. We also need to make Europe an attractive place for businesses to operate in. Here, some progress has been made in the reduction of excessive business regulations, for instance by reducing the time and costs required to set up a business.

All in all, progress has been made to promote long-term productivity growth and to increase labour utilisation, but the extent differs widely across countries and policy areas. Although the structural reforms have been moving in the right direction, they have not been far reaching enough. In fact, we need to step up considerably the implementation of the necessary reforms in order to achieve the Lisbon goals. In particular more progress in labour market reforms is needed to attract more people into labour market and investment in research and development and human capital should be strongly encouraged.

What needs to be done is rather clear. But how to deliver it in an environment of rapid change is the more challenging question.

The difficulties faced with delivering the Lisbon Strategy in the first five years may be summarised under three headings: a lack of focus, a lack of adequate commitment and a lack of incentives. Or, as the Kok report put it in November 2004: The Lisbon strategy had become *"about everything and thus about nothing"; "Every body [was] responsible and thus no one". And there was a need for more 'naming, shaming [but also] famin"'*.

In view of these problems, the European Heads of State or Government clarified their position earlier this year. First, as regards the lack of focus resulting from the plethora of objectives and targets, they made it clear that the focus of the Strategy is now on growth and employment. Growth and employment are indeed the key to our future prosperity and the sustainability of our social model.

Second, regarding the insufficiently clear commitment, the Heads of State or Government also clearly set out the responsibilities of the European and the national level. Since the Member States are responsible for most of the policy reforms required for achieving the Lisbon objectives, they have now been called upon to take full national ownership of the Strategy. Countries have been asked to spell out how they will turn European commitments into real action at home in so-called National Reform Programmes, which are discussed with their national parliaments and social partners. Let us hope that this increased national ownership will be instrumental in beefing up the commitment to reform.

As for the third difficulty – namely the lack of incentives at the European level to stimulate reforms, it remains to be seen to what extent 'naming, shaming, and faming' will be strengthened. Some people have argued that the Commission should not assume the role of a schoolmaster faming good and naming bad pupils, and should instead play more a role of the coach. However, I would suggest that benchmarking Member States' performance can indeed provide incentives for reform and thus shore up the commitment to reform. Obviously, it can also be useful for a coach to compare his team with other, better performing teams and to identify the best and most appropriate role models. Is it wrong to look at how Ireland implemented well focused structural reforms to achieve such a leap in GDP per capita? Should we ignore how Finland succeeded in raising its employment rate by 7 percentage points in 10 years? And outside the euro area but following exactly the same monetary policy, does not Denmark present a remarkable example of a good functioning labour market in a social environment which has similarities with a number of European continental economies?

The European Union can also contribute in a direct way to the Lisbon goals. Most importantly, the benefits from the internal market in terms of growth and employment are still to be fully exploited. Today, the greatest unexploited potential clearly lies in the internal market for services. It is not through protectionism, but rather by unleashing the forces of competition in goods and services markets that we can tap the untapped potential of the European economy, fuel the entrepreneurial spirit and boost innovation.

Moreover, the EU budget can also help to achieve the economic objectives of the Union. In particular, it can ensure that expenditure is channelled towards growth-enhancing outlays, such as research and development and the improvement of human capital. Such expenditure will be more beneficial for Europe’s future than other outlays aiming to subsidise certain sectors.

Citizens need to understand the case for structural reform in order to welcome it. Therefore, better informing Europe’s citizens about the reasons for and the benefits of structural reform will be crucial for the success of the revamped Lisbon strategy. Indeed, a better understanding of the benefits from structural reforms could raise consumer and business confidence. The ECB, from its side, will continue to play its role in delivering the message that structural reforms are beneficial for the EU economy as a whole.

Let me conclude with the words of Antoine de Saint-Exupéry: “L’avenir, il ne s’agit pas de le prévoir, mais de le rendre possible.” (*“As to the future, the task is not to foresee it, but to enable it.”*) We can all foresee the future challenges of the enlarged Europe: increasing globalisation, faster technological change and a rapidly ageing population. If we want to enable Europe’s future, we need to turn these challenges into opportunities; more competitiveness, more innovation and more employment.

Thank you very much for your attention.