Jean-Claude Trichet: Structural reforms in the euro area

Speech by Mr Jean-Claude Trichet, President of the European Central Bank, at the Council on Foreign Relations, New York, 24 April 2006.

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It's a pleasure for me to be here at the invitation of the Council on Foreign Relations to share with you my views particularly on structural reforms in the Euro Area.

Economic performance of the euro area

Let me start with a brief assessment of the euro area's economic performance by recalling a few facts. Over the last years the euro area witnessed an improvement in the utilisation of labour, which increased on average by 0.2% per year between 2000 and 2004.[1] This mainly reflects the rise in the euro area employment rate from 61.5% in 2000 to 63.6% in 2005[2], being accompanied by a significant decline in the aggregate unemployment rate from 10.5% to 8.6%[3]. Remarkably, employment growth in the euro area showed resilience to the economic slowdown at the beginning of this decade, with employment growing on average by 1.1% over the period 2000-2005, compared to 0.9% in the US.[4]

However, the employment rate in the euro area remains low by international standards – for example, the employment rate was 71.2% in the US in 2004[5] – and the unemployment rate is still much too high – compared with, for example, the unemployment rate of about 5.0% in the US in 2005[6]. Furthermore, since the launch in 2000 of the Lisbon strategy - a comprehensive agenda of structural reforms aimed at profoundly transforming the EU - the annual growth rate for the euro area has averaged 1.8% per year[7] (compared to 2.8% in the US), thus remaining somewhat behind its main competitors. When comparing the euro area economic performance to the US, there is evidence of increasing disparities in growth. Since the beginning of the 1990s, the gap in per capita income growth between the US and the euro area has continuously widened - by 0.8% on average per year during the 1990s, increasing to 1.3% per year from 2002 onward[8].

The main explanatory factor behind these developments is the diverging trend in hourly labour productivity growth between the euro area and the US. During the 1980s hourly labour productivity growth was increasing at an annual rate of 2,5% in Europe as compared to 1,3% in the USA. During the 1990s, hourly labour productivity in the euro area grew on average by 1.8%, decelerating to 1.2% at the beginning of this decade. By contrast, US hourly labour productivity growth rose from a yearly average of 1.5% in the 1990s to 2.8% in the present decade. These disparities can broadly be explained by technological progress and the diffusion of innovation. For example, Total Factor Productivity (TFP) growth, which is rightly considered as a pertinent proxy of technological progress, significantly declined in Europe from an annual average of 1.1% during the 1990s to 0.7% between 2000 and 2004, while it accelerated from 0.7% to 1.2% over the same periods in the US. In addition, ICT investment, which is a good indicator of the diffusion of innovation, represented 6% of GDP in the US over the period 2000-2004 compared to 3% in the euro area.[9]

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1 Groningen Growth & Development Centre database (GGDC) of Groningen University.

2 Second quarter 2005 Eurostat LFS data.

3 Eurostat.

4 Eurostat.

5 OECD (2006) Factbook. Figures for 2005 not yet available.

6 Bureau of Labor Statistics.

7 Eurostat.

8 Eurostat.

9 Source Groningen database.

The need for structural reforms

The lack of sufficient structural reform in Europe is, in my view, a major cause of the gap in economic growth between Europe and the US. I will therefore now turn to structural reforms that have the potential to increase both euro area labour productivity growth and labour utilisation and therefore the long run growth potential. These structural reforms must aim at what the Netherlands' former Prime Minister, Wim Kok, once summarised as "Europe needs more people in work, working more productively".

Looking ahead, the euro area economy is facing a number of important challenges, including rapid technological change, ageing populations as well as accelerating globalisation. These challenges will require major efforts to increase the adjustment capacity of the euro area in general and of workers in particular.

Without aiming to be exhaustive, I should like to highlight some of the key priorities for reform in four main areas, namely getting people into work, increasing competition, unlocking business potential and supporting an innovative environment.

First of all, well-functioning labour markets are extremely important in fostering high economic growth. The divergent pattern displayed by growth and labour utilisation in the US and in Europe has prompted some economists to suggest the existence of a 'European model' and a 'US model', related to the trade-off between labour use and productivity.[10] One view is that the lower levels of GDP per capita growth in Europe reflect European preferences for more leisure. However, we should bear in mind that lower participation rates are not necessarily solely associated with personal preferences, but are also triggered by legal and regulatory environment, tax systems and social institutions. Benefit systems that are too generous discourage job search, early retirement schemes encourage early withdrawal from the labour market – employment rates for older workers aged 55-64 stood at just 40.2% in the euro area in 2005[11] and at around 60% in the US[12] – and marginal tax rates that are too high discourage labour market entry and have a downward effect on average hours worked. To increase labour utilisation and get people into work, necessary labour supply side measures include the reform of tax and benefit systems to address these problems and increase incentives to work. Measures aimed at reconciling motherhood with professional life, such as the provision of child care would contribute to raising participation rates. Furthermore, the use of flexible forms of work such as part-time and temporary work would also provide further working incentives.[13]

High unemployment rates in the euro area and in particular high youth unemployment rates, amounting to 17.8% in 2005, stresses the need to spur not only labour supply but also labour demand.[14] In this context, there is a need to promote wage flexibility and to address labour market rigidities. Furthermore, adjustments to the level of employment protection legislation are needed where they impede the hiring of younger and older workers in particular.

Increasing competition towards establishing efficient and well-functioning product markets is another prerequisite for higher medium to long-term growth.[15] A lack of competition harms productivity trends by limiting production efficiency and by reducing the incentive to innovate. In the EU, some progress has been made in this regard. For example, several network industries, like telecommunications and air transport, are now fully or largely open to competition. 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. For example, in the telecommunication sector which was largely liberated in

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[10] See Blanchard, O. (2004): "The economic future of Europe", The Journal of Economic Perspectives, vol. 18, pp. 3-26; and also Gordon, R. J. (2004): "Two centuries of economic growth: Europe chasing the American frontier", CEPR Discussion Paper, No. 4415.

[11] Eurostat data.

[12] OECD Employment Outlook 2005. Figure is estimated for 2005.

[13] See, for example, Genre, V., R. Gomez-Salvador and A. Lamo (2005): "European Women: Why do(n't) they work", ECB Working Paper Series, No 454, March 2005.

[14] Eurostat data.

[15] For a further extension of this topic see European Commission (2004), "The link between product market reforms and productivity: direct and indirect impacts", the EU Economy: 2004 Review.

the course of the 1990s, hourly labour productivity grew on average by 8.5% in the euro area over the period 1996-2003 compared to 6.9% in the US.[16]

Policies that are needed to further improve the functioning of product markets include the extension and deepening of the EU internal market. With service-related activities representing around 70% of value added and employment in the euro area (against almost 80% in the US), much more competition in EU service markets is required. Overall, a higher competition in services markets would promote a more dynamic economy, increase the growth potential of Europe and of the Euro Area and create more jobs. On 16 February 2006, the European Parliament approved a draft directive aimed at a free market for services in the European Union. This is welcome as it goes in the right direction even if we would have preferred a bolder move.[17] I would stress particularly the necessity of a very rapid and expeditious implementation of the new directive on services. Not only because as I have already said the reason why Europe is lagging behind the US in terms of productivity increases is very much due to poor behaviour of the services sector in this respect, but also because improving productivity in "nontradables" would permit Europe to contribute more efficiently to a cooperative solution of global imbalances.

The third prerequisite for higher growth in the euro area is the unleashing of entrepreneurial potential by creating a business- and entrepreneurial-friendly economic environment. This includes lowering costs imposed by public sector administrations for existing firms and business start-ups. Let me illustrate this with some figures. According to the World Bank, in 2004, the average cost of starting a business with up to 50 employees in the euro area (excluding Luxembourg) is estimated to have been around ten times larger than in the US[18]. The immense importance of this issue is increasingly appreciated by the successive EU presidencies and European governments and several initiatives at national or EU level have started to implement actions for a "better regulation".

Fourth, to fully exploit productivity potential, the labour and product market reforms just mentioned need to be accompanied by policies that help to diffuse innovation and technological change. This includes, inter alia, measures to support innovation by higher investment in research and development (R&D). In 2004, roughly 1.9% of euro area GDP was spent on R&D. The US spends 2.8% of GDP on R&D.[19] Europe has set itself the target of achieving a share of 3% of GDP by 2010.

To make these measures most effective, they need to be accompanied by efforts to improve the labour force's level of education and expertise. The impact of education on growth may be related to innovation, as well as the adoption of new technologies. Additionally, better education and training help to reduce mismatches in the labour market and allow for a smoother reallocation of workers between sectors and firms.[20] The last decades have already brought about an enormous increase in the level of educational attainment, the so-called "catch-up effect in education". In the euro area, according to OECD data for 2003, an average of 73% of those aged 25-34 had attained at least upper secondary education, compared to only 46% of persons aged 55-64.[21] Nevertheless, meeting the challenges of technological progress and ensuring the labour force's employability and flexibility, requires that human capital is continuously adjusted to labour market needs through improved education and training as well as lifelong learning. In 2005, the US annual expenditure on higher education institutions per student was 22,234 USD, while in the euro area only about 9,200 USD was spent. Furthermore, we need more high quality scientists and researchers. In the EU we have about 5.3 scientists and researchers per 1000 workers, which compares to the US's 9 per 1000.[22]

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[16] Groningen database.

[17] See also ECB (2006) "Competition, productivity and prices in the euro area services sector", ECB Occasional Paper Series. No.44.

[18] See the World Bank web site www.doingbusiness.org.

[19] Eurostat data.

[20] See G. Schwerdt and J. Turunen (2005): "Growth in euro area labour quality", ECB Working Paper Series, No 575, January 2006.

[21] OECD (2005) "Education at a glance".

[22] OECD (2005) "Education at a glance".

The state of structural reforms

If euro area countries now summon up their strength and ambitiously push forward with structural reform, this will support and broaden the improvement in economic activity in the euro area. This is why the ECB has always encouraged the implementation of structural reform within the so-called Lisbon strategy, which was set in place by a meeting of the European Council of Heads of State and Government, in Lisbon in May 2000. Five years later, progress has been made in some areas - as also indicated by an increase in the euro area employment rate. Still, all in all the reforms have not been far-reaching enough.

Against this background, the mid-term review of the Lisbon strategy in 2005 led to a re-launch of the process by shifting the strategy's focus more strongly on growth and employment. As an outcome of this process, all EU countries have prepared so-called National Reform Programmes that outline structural reform steps for the years 2005-2008.

These efforts are welcomed by the ECB. The potential gains to be reaped are substantial. A recent study published by the Netherlands Bureau for Economic Policy Analysis finds that if Europe would reach the objectives set in the Lisbon strategy (for example, full implementation of the internal market for services, a reduction of administrative burdens, improvements in human capital as well as R&D and employment targets), EU GDP could be higher than otherwise by 12 to 23% and employment by about 11% by 2025.[23]

Other important findings relate to investment in the knowledge-based economy. Analyses made by the European Commission[24] show that if the effects of the increased knowledge investment foreseen within the Lisbon strategy were added in, the increase in annual EU potential output growth could reach up to three quarters of a percentage point. Over a ten year period, this would imply an increase in the GDP level of up to 7 or 8%. Of course, these are just crude calculations, which, however, give a notion of how large the welfare-enhancing potential of implementing structural reforms is.

Also the ECB's monetary policy has a role to play in supporting the implementation of structural reforms. A credible monetary policy aimed at maintaining price stability in the medium term and solidly anchoring medium and long term inflation expectations contributes decisively to a stable economic environment. In a stable macroeconomic context, it is not only easier to single out where reforms are needed, but the benefits of reforms are also made more visible and convincing, thus supporting their acceptance.

To **conclude**, the European Union and the Euro Area are in the process of reforming its economy so as to adapt it to future challenges. The economic strategy is on the right track, there is a consensus on the appropriate objectives and agreement on the right institutional setting to be set in place. It is now decisive that these plans are put into practice. *Implementation* is the key word today. The earlier this happens, the earlier economic activity, employment and innovation in the EU can be lifted to a higher level.

I am just coming back from Washington where I participated in the G7 and IMFC meetings. We have reaffirmed that the adjustment of global imbalances was a shared responsibility requiring participation by all regions in this global process. And with the help of the IMF we have listed the main areas where the global partners should concentrate their actions to do their "homework". US, Japan, emerging Asia – particularly China, oil producing countries have a lot of serious work to do. As far as Europe is concerned, I would say that all the reforms I have mentioned and called for, in our best European interest, are also full part of what we have agreed to do to contribute to the orderly adjustment of global imbalances. I said that '*implementation*' was now the key word. It is the key word at the European level as well as the key word at the global level. We all know what to do. We all know that each of us should do it in his/her own self interest. And we also know that a resolute and cooperative implementation by all partners would preserve more effectively and efficiently sustainable growth and job creation at a global level. We all count on the IMF to exert appropriate surveillance and remind all of us of the global superior interests that are at stake.

I thank you for your attention.

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[23] Netherlands Bureau for Economic Policy Analysis (2005) "Five Lisbon highlights: the economic impact of reaching these targets". This study includes 20 EU countries, excluding Malta, Latvia, Lithuania, Estonia and Cyprus.

[24] European Commission (2004) "A 3% R&D effort in Europe in 2010: an analysis of the consequences", study prepared by the Research Directorate General of the European Commission.