Guy Quaden: Structural reforms in Europe – harmonisation or decentralisation?

Exposé by Mr Guy Quaden, Governor of the National Bank of Belgium, at the Central Bank of Luxembourg, Luxembourg, 12 January 2007.

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I would like to thank my colleague Governor Mersch for giving me the opportunity to address this assembly, where I recognise a good many Luxembourg, Belgian and fellow European friends. They immediately bring to mind the close relations between our two countries, including close links on the monetary front for more than 80 years. I am pleased to see that these links have not been broken down within the wider European monetary union, which Luxembourg and Belgium have belonged to since 1999 and which expanded to 13 countries just a few days ago.

The theme of our discussion is obviously something that is at the heart of my preoccupations, and for several reasons.

Firstly, as an economist, understanding how the economy works and proposing ways of improving it, through structural reform, is almost a *raison d'être*.

Then, as a central banker, along with my colleagues in the ECB Governing Council, I put out a reminder of the need for structural reform each month, in the explanation of our monetary policy decisions. What might sound like the monetary authorities singing the same old song to politicians at little cost does in fact reflect the importance of the two-way interaction between monetary policy and structural reform.

On the one hand, by ensuring price stability in the medium term and making sure that inflation expectations are well anchored, monetary policy helps foster a macroeconomic environment that is more stable and therefore conducive to more growth and employment. The current low level of long-term interest rates is without a doubt largely attributable to the credibility earned through monetary policy. This achievement needs to be preserved; not least because it helps make structural reforms easier to implement.

On the other side of the coin, by improving the economy's capacity to adapt and raising the growth potential, structural reforms facilitate monetary policy-making. Therefore, my colleagues and I welcome the efforts that have already been made in areas where the benefits are only reaped in the long term, while political considerations tend to be rather short-term.

And lastly, as both a Belgian and European citizen, it seems quite legitimate to aspire to a society organised in such a way that everyone can put their talents to good use, be rewarded for their efforts, but also give and take a sufficient dose of solidarity, and live in a quality environment. Indeed, the overall objective of structural reform must be to raise the standard of living in a sustainable way for each of us today, and for generations to come.

I believe that the diagnosis for the European economy is already well known. Labour force mobilisation is relatively weak in Europe - and this has certainly proved to be the case in Belgium - while productivity gains have slowed down, despite remarkable scientific and technological progress. In the light of these observations, there has been a consensus for several years now - under the influence of work carried out notably by the IMF, the OECD and the European Commission - on the need to stimulate labour market participation, reinforce the quality of the labour force, improve the functioning of markets in goods and services, including financial services, and step up the innovation effort. This strategy was endorsed by the governments of the European Union Member States at the March 2000 European Council in Lisbon.

I think we have to acknowledge that progress has been made, albeit at varying speeds from one country to another, but that there is also still a long way to go. European economies today are faced with many challenges. I am of course thinking of globalisation of the economy, demographic shifts and climate change. The current improvement in the economic climate must not be used as an excuse for postponing reforms; on the contrary, it should be seen as an opportunity to put them into practice with even greater resolve.

My exposé will obviously not cover the whole issue of structural reform. Owing to time constraints, I will not go into nonetheless important topics like education and innovation. In line with what has been suggested, I would like to illustrate the subject of reform with some concrete examples drawn from my country's experience and pointing up encouraging progress, even though it is often still not enough.

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First and foremost, in Belgium's case, reforms were carried out in areas where they were deemed most urgent. Significant progress has been made towards improving the country's public finance situation, which had become unsustainable in the 1980s, and with wage-setting, taking account of the need to remain sufficiently competitive, because Belgium has such an open economy. Apart from these characteristics that are peculiar to the Belgian economy, reforms have also been started in the field of pensions and employment of the older age bands of the population.

1. On the public finance front, the results so far are quite satisfactory. Belgium brought down its budget deficit from 8 p.c. of GDP in 1992 to less than 3 p.c. in 1997, which was one of the conditions for joining the monetary union. With the exception of 2005, a year for which Eurostat considers that the government's takeover of a public enterprise's debt should be accounted for as non-recurring expenditure, public sector accounts have been in balance since the year 2000.

   Of course, a central banker must never let complacency creep in. So I make no secret of the fact that these results have been helped along a little by low interest rates, one-off revenues and, more recently, a favourable economic situation. On the other hand, I urge even greater ambition. For, in order to meet the cost to the budget of population ageing in the coming decades (healthcare, pensions, etc.), it is structural surpluses we should be showing as soon as possible.

   Even if it is advisable to further speed up the trend, the debt ratio, which reached a peak of 133.5 p.c. of GDP in 1993, has nonetheless been on a continual downward path since then and dropped below the 90 p.c. mark in 2006.

   The return to a sustainable long-term budgetary policy has been made possible thanks to credible commitments, based on the opinions of independent institutions.

   EU constraints and peer pressure have certainly served as an incentive, especially in the form of the multilateral surveillance system laid down by the Maastricht Treaty and then by the Stability and Growth Pact. European budgetary standards have been a powerful disciplinary tool in preparing for Economic and Monetary Union membership. They remain effective in that respect. They have also played a big part in persuading the public to accept the need for the adjustment process.

   To prepare the ground for its work on the budget, the Belgian government draws widely on the expertise and advice of independent national bodies. On the one hand, it has entrusted the National Accounts Institute with the task of preparing the macroeconomic forecasts which, in principle, serve as the basis for drawing up public budgets. On some occasions, the government has chosen to add a safety margin to these forecasts. Conversely, credibility factors effectively prevent it from taking into consideration a more favourable macroeconomic scenario than that published by the National Accounts Institute.

   In addition, and again acting independently, the High Council of Finance, in whose work the National Bank is involved, draws up recommendations for the course of the public sector borrowing requirement. These targets – certainly ambitious, but realistic all the same - have formed the basis for successive governments' budget plans. These recommendations go even further than strict respect for EU rules, since they take into account future requirements stemming from the ageing population. Moreover, the High Council of Finance, which also comprises experts appointed by the Communities and Regions, contributes to ensuring the necessary coordination between the various levels of power that make up the country's system of government. It effectively transposes the general objectives for all the public authorities into specific recommendations for each entity. These are given a formal setting in cooperation agreements between the federal government and the communities and regions, a sort of internal stability pact.

   We could look at it as an example of good practice. Besides, the beneficial role of the NAI and the High Council of Finance in preparing the ground for consolidation of public finances is acknowledged in recent IMF and EC publications.

2. Unlike the budgetary procedures, the automatic wage-indexation mechanism used in Belgium meets with almost unanimous disapproval by the international institutions, because of the nominal rigidities it risks causing. Along with Luxembourg, Belgium is certainly in good company here, but we are quite isolated among the European countries, even if several of them have partial indexation systems. Are Belgium and Luxembourg right to go it alone or not ? In my view, in the Belgian case the question calls for a carefully weighed-up response.

The wage-indexation mechanism has been around for a long time in Belgium. The first collective agreements on the subject were concluded as early as 1920, notably in the mining industry, and, after a wage freeze during the second world war, they were widely reinstated at the end of it. The wage-indexation mechanism has become an essential element of a wide social consensus, but at one time, it also risked undermining business competitiveness. Index-linking was also temporarily suspended following the devaluation of the Belgian franc in 1982.

The need to keep a competitive edge led to a thorough reform in 1994. The government laid down a new requirement for the so-called health index to be used as a reference for indexation rather than the general consumer price index. A number of products like tobacco, alcoholic drinks, petrol and diesel are not taken into account in calculating the health index. In this way, any increase in taxes and excise duties on these products, especially tobacco and petrol, is no longer passed onto wages and prices and, on the other hand, second-round effects on wages from a sharp rise in oil prices are limited. This goes a long way towards explaining why, unlike what happened during the 1973 and 1979 oil crises, nominal wages have not been caught up in an inflationary spiral in recent years.

No doubt driven on by the same desire for competitiveness, but also by the need to rein in public finances and inflation, I understand that the Luxembourg government also decided in spring 2006, after negotiating with the social partners in the tripartite coordination committee, to adjust the automatic indexation mechanism until 2009, by delaying the point in time when wages are indexed. And it decided to neutralise certain taxes, excise duties, fees and other contributions in the reference index for index-linking.

While the indexation system, after being thoroughly reformed, remains an acquired right for both employees and for recipients of social benefits, the total development in private-sector wages has also been controlled since 1996 by the wage norm-another distinctive feature of the Belgian system. This indicative norm is set every two years by the social partners (employers and trade unions) in line with the expected evolution of hourly labour costs in the three main neighbouring countries (Germany, France and the Netherlands). It builds into the wage-formation process an explicit reference to the external situation and thus the competitiveness of the economy. It is a strong coordinating tool for negotiations at sectoral level. Among these sectors, the so-called "all-in" agreements, introducing a corrective mechanism in the event of higher indexation than anticipated during the negotiations, have mushroomed.

All in all, I would say that if we didn't have wage indexation, we wouldn't have to invent it. But, taking account of the built-in control features, now keeping it within limits, indexation in Belgium is not - or to be more precise, is no longer - the bugbear still decried by so many international institutions.

3. On the other hand, I wholeheartedly share these same international institutions' opinion on the need to raise the rate of employment in Belgium. At just 61 p.c. of the population aged between 15 and 64, Belgium's employment rate is still noticeably lower than the average in Europe, not to mention other parts of the world. The boost it needs concerns, in particular, those groups that are under-represented on the labour market – young people, women, people of foreign origin and especially the relatively older groups of the potentially-working population.

Raising the rate of employment among the over-55s is essential both to guarantee the financial viability of the legal pension system and to reinforce the economy's medium- and long-term growth potential. Quite paradoxically, the low rate of employment can be regarded as a pool of unused potential. However, tapping this potential is proving particularly difficult because the reforms we need to implement in this field frequently come up against strong resistance, from workers and employers alike.

Action along these lines has already been taken in Belgium.

As early as 1996, the federal government got down to tackling a major reform of the pensions regime for employees and the self-employed, by gradually raising the statutory retirement age for women, from 60 years at the beginning of 1997 to 65 on 1 January 2009. By then, it will be the same as the legal retirement age for men, which is helping to bring down the cost of population ageing. More women staying on in the labour force has also helped push up the employment rate among 55 to 64 year-olds, a rate which rose from 26 p.c. in 2000 to 32 p.c. in 2005, even though this is still very low.

The exemption from seeking work granted to older unemployed people provided an important opening for early retirement from the labour market. The age limit for this exemption, which was set at 50 years until 2002, has been raised gradually to reach 58 in mid-2004.

In 2005, the government launched another big reform whose main objective is to raise the employment rate among older people, above all by boosting the labour supply. It is known as the Solidarity Pact between the generations.

The most significant measures concerned early retirement. This scheme has been used a lot from the end of the 1970s onwards, initially along with business restructuring efforts, but it quickly became widespread. At one time, the early retirement age was brought down to 55, and even to 50 in companies in difficulty or undergoing restructuring.

These conditions have become unsustainable now that people are living longer and the population is ageing. The Pact brings the statutory early retirement age up to 60 years from 2008 onwards, with a seniority condition which will be gradually raised to 35 years. Various measures have also been taken to limit the use of early retirement schemes in the event of mass redundancies, notably by giving priority to active employment policies through outplacement and training. An employment cell must now be systematically set up in such cases.

Moreover, the Pact has also established a framework to encourage people reaching the end of their career to keep their job or return to work. Financial incentives have therefore been introduced, including a new bonus system granting a pension supplement for people continuing to work after the age of 62. This should push up the actual retirement age itself.

The Pact bears witness to an awareness and brings in an indispensable change of trend. According to the work done by the Study Group on Ageing set up within the High Council of Finance, it is a significant stage in the process, but still not enough in itself to bring the employment rate in Belgium up to a satisfactory level.

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Before summing up, I just have to say a few words about the question posed by the organisers of this debate to each of the contributors, namely, which is the best method: harmonisation or decentralisation? Do these few selected examples of measures taken in Belgium enable us to draw some lessons about the best strategy for continuing and speeding up implementation of the structural reform so badly needed by European economies ?

First of all, I would point out that this reform applies to existing situations which differ radically from one country to another, even from one region to another. These specific characteristics, which can range from the institutional set-up to the labour relations and social security system, the structure of the economy or even the preferences of the various parties involved, must be taken into account when drawing up appropriate measures, likely to get sufficient backing from society at large.

Faced with these arguments in favour of decentralisation, we should not overlook the importance of the common approach developed at European level, in the context of the Lisbon strategy. Its contribution has been primordial in making structural reform a subject of national debate. The use of benchmarking and promoting "best practice" also come into this awareness-raising effort at national level. Furthermore, the European dimension helps reap the benefits of positive externalites factors stemming from close coordination of reform measures between countries, and helps keep the risk of possible "beggar-my-neighbour” policies to a minimum.

In the updated Lisbon strategy that they endorsed in 2005, the Member States and the EU authorities have put together a useful combination of a common and decentralised approach. The broad lines are drawn up at European level while the Member States are now given more responsibility in implementing reform measures.

Individual Member States mainly have their say by adopting National Reform Programmes, setting out government action in the fields of public finance, employment, the functioning of product and labour markets and promoting innovation. This joint process enables the European Union to take advantage of the positive interaction between structural policies. In the EU countries, notably in Belgium, drawing up these National Reform Programmes and implementing the reforms effectively requires close cooperation between the different levels of government (regional, national, European), as well as between public authorities and other stakeholders, and here I'm thinking particularly of the social partners, the academic world and society at large.

Within this framework, the national central banks also have a key role to play. One the one hand, they must back up the political decision-makers and the social partners by providing their macroeconomic and financial expertise. On the other hand, they have to keep the public informed of the grounds for and the need for the structural reforms.

Ladies and gentlemen,

The structural economic reform train in Europe is certainly on track. It now just needs a strong push, so that every citizen can enjoy a higher level of employment and well-being tomorrow.