Jean-Claude Trichet: How can we increase growth potential in Europe?

Speech by Jean-Claude Trichet, President of the European Central Bank, at the Suomi Areena 2007, Pori, Finland, 20 July 2007.

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Dear Governor Liikanen,

I would first like to thank you very warmly for inviting me on the occasion of the "Suomi Areena 2007" event. It is a pleasure and a honour to be here today and to share with you my views on "How can we increase growth potential in Europe".

In light of the partly disappointing euro area economic performance in the past, it is a major policy issue. By contrast, the impressive performance of the Finnish economy, with output and productivity growth over the second half of the 1990s among the highest in the European countries, [Real GDP and hourly labour productivity grew on average by 3.8% and 2.7% respectively between 1996 and 2006], offers a good illustration of what could be done to increase growth potential in Europe. The transformation of the Finnish economy over the last decades represents one of the examples of the "knowledge based-economy" taking hold in Europe.

Against this background, I will first review the past economic growth performance of the euro area in comparison to the US and focus on some of the underlying factors of potential output growth. Then I will elaborate on the reforms which I consider essential to increase the potential growth rate of Europe.

The economic performance of the euro area since the mid-1990s

Since 1996, the annual growth rate for the euro area has averaged 2.1% per year compared to 3.3% in the US. What are the fundamental causes of this unsatisfactory low trend growth in the euro area? The answers can be found by looking at the factors that determine potential or long-term economic growth, namely[1]:

- The degree of labour utilisation,
- Productivity growth,
- And the demographic trends.

\- Over the period 1996-2006, the euro area witnessed a slight improvement in the utilisation of labour, which increased on average by 0.4% per year (compared with 0.1% in the US) when defined as the total annual hours worked divided by the total population. Labour utilisation reflects the extent to which the potential labour resources in an economy are actually utilised and therefore have a direct influence on output growth. This improvement in labour utilisation mainly reflects the significant rise in the euro area overall employment rate from 58% in 1996 to 64.4% in 2006, accompanied by a decline in the aggregate unemployment rate from 10.7% to 7.9%.

Although this is a very encouraging fact, which shows that the positive employment effect we witnessed over the last ten years has significantly helped us to partly counteract the growth differential to the US, one has to remain aware of the inferior starting position of euro area countries. Despite the important progress recorded, the overall employment rate in the euro area remains low by international standards (64.5% in the euro area compared with 72% in

[1] European Commission – AMECO database. Hours worked data from OECD.

the US in 2006) and the unemployment rate is still clearly too high (7.9% compared with 4.6% in the US on annual average in 2006 and 7.0 % to be compared to 4.5 % in May this year). It has to be noted that in 2006 the estimated number of annual hours worked in the euro area was 1604 compared to 1804[2] in the US.

Moreover, while the prime-age male employment rate in the euro area is comparable to that observed in the United States, the disparities remain important when we look at the youth, female and older worker employment rates. In 2006 the female employment rate was 56.5% in the euro area and 66% in the US, the older workers employment rate was 41.7% in the euro area and 61.8% in the US, and youth employment was 37.1% in the euro area and 54.2% in the US. These features appear to be consistent with an "insider-outsider" characterisation of the European labour market, where structural impediments prevent those groups "at the margin" from participating in the labour market.

The performance of the labour market in Finland has also been quite impressive these last years with the overall employment rate increasing from 62.4% in 1996 to 69.3% in 2006. However, some problems remain with regard to the institutional settings of the labour market, which may have to some extent inhibited the full realisation of employment gains from greater competition and innovation as illustrated by the still relatively high unemployment rate 7.7% in 2006[3].

All in all, the rise in employment did not cancel out structural weaknesses of labour markets and there is still considerable room to increase the level of labour resource utilisation in Europe.

- Productivity is the other major factor determining growth. Over the last decade, the diverging trend in hourly labour productivity growth has been the main reason explaining the growth differential between the euro area and the US. During the 1980's and the first half of the 1990s, hourly labour productivity in the euro area grew on average by 2.4%, then it decelerated to 1.3% between 1996 and 2006. By contrast, US hourly labour productivity growth rose from 1.3% to 2.1% over the same period.

At the sectoral level, the gap in labour productivity growth between the euro area and the US has been mainly driven by some market service sectors intensively using Information and Communication Technologies (ICTs) namely the wholesale and retail trade sectors as well as the financial sectors. In contrast to the US, in these two sectors, labour productivity growth significantly decelerated in the euro area over the last 15 years. In the wholesale and retail trade sectors, hourly labour productivity significantly accelerated in the US from 0.7% to 2.6% over the periods 1980-1995 and 1996-2004, while at the same time it decelerated in the euro area from 2.3% to 1.3%. In the financial sectors, over the same periods, hourly labour productivity growth has also accelerated in the US and has been roughly 4 times higher than the growth rate observed in the euro area over the period 1996-2004.

Several causes have been mentioned to explain this downward trend in the euro area. Specific policies aiming at increasing employment particularly in the unskilled segment of the labour market may have contributed to the observed slowdown in labour productivity growth. However, this apparent trade-off between labour utilisation and productivity is likely to be a temporary phenomenon that should progressively fade, when the economy reaches a higher "equilibrium" labour/output ratio.

There is another major reason that explains the big difference in the rate of labour productivity growth in Europe compared with the US, which in my view is a major policy issue, namely the fact that the European economy, being more inflexible, does not fully take

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[2] OECD Employment Outlook. Data for 2006 are partly estimates.

[3] There is in particular considerable scope to raise the employment rate of young people and further reform needs to be undertaken to achieve the more ambitious long-term objective of a 75% overall employment rate.

advantage of all the opportunities offered by new technologies, including ICT, and by the new division of labour initiated by globalisation. Restructuring of the productive sector and re-engineering of the production processes appear to be more difficult in a less flexible economy like the European one, implying a negative influence on productivity. The structural characteristics of the US economy – a more flexible labour market, a higher degree of competition in product markets and lower barriers to entry for new firms – were more conducive to exploiting the opportunities provided by new technologies.

It remains relatively easy to understand that the absence of sufficient flexibility in Europe and in the Euro area has not permitted us to take advantage of the new opportunities that were offered and therefore that Europe has not benefited from an increase in labour productivity (and in total factor productivity) like the United States. What remains hard to explain, is that not only labour productivity growth in Europe did not accelerate but that it slowed down significantly, by more than what would be accounted for by increasing employment in the unskilled segment of the labour market.

A conjecture that seems to me important to test is whether in periods of very rapid technological and structural transformations not only less flexible economies are not taking advantage of the situation but they might paradoxically behave less properly than in more "normal" times. That could be due to the fact that the degree of rigidity of the economy would augment in practice under the economic "stress" of the much more rapid changes of their environment. The fact that total factor productivity, which is one of the proxies for the pace of structural transformation over years has dropped from 0.7% before 1995 down to 0.3%[4] after 1995 seems to give some credit to this conjecture.

- Finally, let us not forget the demographic change occurring on both sides of the Atlantic. Indeed, Europe's long term growth performance has also been constrained by the low rate of population growth and the ageing of its society. Since the mid 1990's, population in the euro area has been growing at a yearly rate of just 0.4% compared to 1.1% in the US. However, what is worrisome is that at the same time, the gap in population growth has been even larger with regard to growth in the working age population the working age population grew on average by 0.3% per year in the euro area over the period 1996-2006 compared to 1.4% in the US , which manifests that Europe has a more acute problem of population ageing.

The need for further structural reforms in Europe

This brief assessment of the underlying causes of Europe's relatively disappointing longer-term growth performance provides a mixed picture of the European economy. The lack of structural reforms is, in my view, a major cause of the difference in the growth potential in Europe compared with the US and with some other advanced industrialized economies. The structural reforms identified in the Lisbon agenda have the potential to increase both labour productivity growth and labour utilisation, and therefore the long-term growth potential of the European economy. The experience of European countries which have undertaken some courageous and successful reforms show that it pays off. For instance, since the beginning of the EMU in 1999 the euro area has witnessed an increase of more than 12 million in the number of people employed, while from 1990 to 1998, the number of people employed only increased by around 3 millions.

It is clear that major structural reforms are not easy to achieve, but pursuing resolutely such reforms is especially needed in the current environment, where the European economy is facing a number of important challenges, including rapid technological change, accelerating globalisation as well as ageing populations. According to the European Commission's and

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4 Source EUKLEMS.

ECB projections, the impact of ageing populations alone could reduce on average potential output growth in Europe by nearly half by 2040, if structural reforms are not carried out[5].

There is today a unique opportunity for European governments to take advantage of the present favourable growth developments to push ahead with the structural reforms that have been already agreed upon but are still far from being achieved. Without aiming to be exhaustive, I should like to highlight some of the key priorities for reform in three main areas, namely:

- Getting more people into work,
- Increasing competition,
- And finally, supporting an innovative environment.

Getting more people into work

First of all, well-functioning labour markets are indispensable in fostering higher economic growth. The differences in labour market developments, especially with regard to the level of labour utilisation, between the US and Europe has prompted some economists to suggest the existence of a "European model" and a "US model", related to the trade-off between labour and leisure[6]. One view is that the lower levels of GDP per capita in Europe reflect a European preference for more leisure time. However, we should bear in mind that lower participation rates are not necessarily associated solely with personal preferences, but are also triggered by the legal and regulatory environment, tax systems and social institutions.

Necessary measures to increase labour utilisation or labour supply include the reform of tax and benefit systems in order to increase incentives to work. The use of flexible forms of work such as part-time and temporary work may also provide further working incentives[7].

High unemployment rates in the euro area and in particular unacceptable high youth unemployment rates clearly suggest the need to spur not only labour supply but also labour demand. There is a need to reduce labour market rigidities restricting wage differentiation and flexibility. Adjustments should be made to employment legislation where it impedes the hiring of younger and older workers in particular.

For instance, Denmark, Ireland and the Netherlands – which, by the way, are all three, de jure or de facto for Denmark, in the euro area – have achieved success in reducing unemployment and stimulating job creation, despite significantly different economic conditions[8]. In 2006 the unemployment rate in these countries stood below 4.5%, while their overall employment rate was above or close to the US level, namely 72 %. To achieve such remarkable success, these countries reformed their tax and benefit systems by reducing for example tax wedges on labour income and by carrying out a stricter enforcement of job search rules and a better surveillance of eligibility. They also increased, when and where needed, the flexibility of their labour market.

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[5] See "The economic costs of non-Lisbon: A survey of the literature on the economic impact of Lisbon-type reforms" by Directorate-General for Economic and Financial Affairs, European Commission Occasional papers No 16, March 2005 EC. See "Demographic change in the euro area: projections and consequences" ECB Monthly Bulletin October 2006.

[6] 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.

[7] 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.

[8] See Anthony Annett (2006) "Lessons from successful labour market reformers in Europe" IMF euro area policies: selected issues, August 2006.

Increasing competition

What all these countries also have in common is a significant reduction of product market regulation. This leads to the second prerequisite for higher medium to long-term growth: increasing competition towards establishing efficient and well-functioning product markets.

Most studies point to the potential that improving competition has to increase employment in the medium and long run, and to boost productivity trends by improving production efficiency and by enhancing the incentive to invest and innovate[9].

In the EU, some progress has been made in this regard. For example, several network industries, like telecommunications, are now fully or largely open to competition and the hourly labour productivity in this particular sector significantly accelerated from 4.9% to 8.4% over the periods 1980-1995 and 1996-2004 By comparison in the US, hourly labour productivity grew by 3.4% and 4.4% over the same periods in the telecommunication sectors.

A lot remains to be done, however: the extension and deepening of the EU internal market remains a priority in particular as regards further financial market integration, the pursuit of effective competition in the energy market and the implementation of the Services Directive. Member States have the primary responsibility for these tasks. Unfortunately, Member State's implementation record of Internal Market legislation is worsening and the number of Internal Market infringements remains stubbornly high in some European countries.

Let me also briefly mention labour mobility. Labour mobility is an essential element of the Internal Market and an important factor of adjustment mechanism in a context of monetary union. Evidence however suggests that, overall, cross-border labour mobility is still low in the euro area. And we still have formal barriers to labour mobility across the euro area. This is in clear contrast to the situation in the United States[10].

All in all, increasing product market competition and labour mobility – at the EU and national level, would enable more efficient production structures associated with a more competitive price setting. Following the principle of “an open market economy with free competition” is pivotal to fostering long-term economic growth.

Let me now focus more specifically on the financial sectors. Financial integration is indeed of key importance for the ECB, given the relevance for the conduct of the single monetary policy. The process of European financial integration is gradually taking place and considerable progress has been made for instance in capital markets and wholesale banking. However, the retail banking sector appears not yet to have reached its potential, and competition seems insufficient in this area leaving European consumers unable to take full advantage of the benefits of the EMU and the Single Market[11]. This seems also to have constrained to some extent the economic performance and the development of these sectors in the euro area as illustrated by their disappointing labour productivity growth performance.

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[9] See the ECB Occasional Paper Series No 44 “Competition, productivity and prices in the euro area services sector”, by the Task Force of the Monetary Policy Committee of the ESCB, April 2006.

[10] Although the data available refer mostly to the 15 earliest members of the European Union, the EU15, they are still illustrative of the situation in the euro area. In 2000 only 0.1% of the total EU15 population (or around 225,000 people) moved their official residence between two Member States. Furthermore, only a small proportion of individuals – 0.4% of the EU15 population – were known to commute across borders to work, and half of this amount was to a non EU15 country. In the United States, geographical labour mobility appears to be far higher. Evidence suggests that around 5.9% of the total US population moved their residence between US states in 1999. See F. F. Heinz and M. Ward-Warmedinger, “Cross-border labour mobility within an enlarged EU”, ECB Occasional Paper No 52, 2006. See also “Action plan for skills and mobility”, European Commission, 2002.

[11] See EIB “Financial integration in Europe” (2007).

More generally speaking, evidence indicates that the reallocation of capital from declining industries to industries with high investment opportunities and high productivity is faster in countries with developed financial markets[12]. These findings suggest that countries with more liquid capital markets and a developed banking system are growing faster on average[13].

Supporting an innovative environment

Finally, to fully exploit productivity potential, the labour and product market reforms I just mentioned need to be accompanied by policies that support innovation and technological changes. These include, inter alia, the unlocking of business potential by creating an entrepreneurial-friendly economic environment, measures to support innovation through higher investment in research and development (R&D) and policies aimed at improving human capital.

The performance of the Finnish economy illustrates all the benefits arising from developing a "knowledge based-economy" as targeted by the Lisbon agenda. Finland has been ranked by the World Bank among the top world and European countries regarding the ease of doing business. Moreover, Finland is ahead of most European countries when looking at venture capital and R&D investments as well as educational attainment.

First of all, Europe needs more new and thriving firms willing to reap the benefits of opening markets and to embark on creative or innovative ventures for commercial exploitation on a larger scale. It is increasingly new and smaller firms, rather than large ones, that are the major providers of new jobs[14]. The contribution from firm dynamic processes to aggregate labour productivity growth and innovation also plays a major role, in particular in high-tech industries. All in all, an entrepreneurial-friendly economic environment would imply less red tape for small and medium-sized enterprises to help them develop at home and across borders, as well as positive action to ease access to the finance they need. And Europe is significantly lagging behind in this field. For instance, venture capital financing in Europe remains only a fraction of what it is in the US relative to the size of their economies.

Second, promoting R&D investment is also a major issue. While many Member States expect to increase their R&D spending, Europe will fall short of the 2010 overall EU target of achieving 3% of GDP. In 2005 R&D investment relative to GDP was 1.9% in the euro area compared to 2.7% in the US. The efforts of European countries to increase R&D investment are still insufficient. Particular attention should be paid to increase public R&D spending efficiency and more attractive conditions for technology-intensive markets should be created. This includes for instance a better use of public procurement and a more innovation-friendly regulation. The European Commission estimated that an increase in the share of R&D expenditures in GDP from 1.9% in 2004 to 3% by 2010 would result in an increase of 1.7% in the level of GDP by 2010. It goes without saying that it is not only a quantitative issue and that at the same time the efficiency of research and development in terms of industrialisation

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[12] See P. Hartmann, F. Heider, E. Papaioannou and M. Lo Duca (2007), "The role of financial markets and innovation for productivity and growth in Europe", ECB Occasional Paper forthcoming.

[13] Some authors have calculated that if the average size of capital markets in the EU was bigger - in the US for instance this size is around 450% of GDP instead of 220% in the EU (based on an overall indicator measuring total financing in the economy by aggregating bank credit to the private sector, stock market capitalisation and the outstanding amount of domestic debt securities issued by the private sector) - then annual GDP per capita growth in the EU could be positively influenced (see G. Favara (2006), "An empirical reassessment of the relationship between finance and growth", mimeo).

[14] See the European Commission's Green Paper entitled "Entrepreneurship in Europe", 21.01.2003.

is crucial. In the longer term, GDP could be up by 4.2% in 2015 and 7.0% in 2020, equivalent to an additional growth rate of nearly 0.5% per year[15].

Finally, to make these measures most effective, they need to be accompanied by efforts to improve the labour force's level of education and expertise. Meeting the challenges of innovation and its diffusion as well as 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.

The last decades have already brought about an enormous increase in the level of educational attainment. However, so far investment in human capital in Europe is still clearly inadequate for a "knowledge-intensive" economy. In 2003, the US annual expenditure on higher education institutions represented 2.9% of GDP, while in the euro area it only represented 1.2%[16]. The gap is mainly a result of greater private funding. European universities should be allowed and encouraged for instance to seek complementary private sources of funding and legal, and other barriers to public-private partnerships between universities and businesses should be removed. A better and more effective education system, as estimated by some research of the European Commission, might add as much as 0.3 to 0.5 percentage points to the annual EU GDP growth rate[17].

Macroeconomic stability to support higher and sustainable growth

As mentioned earlier, the supply-side determinants of long-term growth that I have emphasised should not be understood as an exhaustive explanation for the growth performance of the European economy. We should also look beyond the microeconomics of the supply-side and ensure an appropriate macroeconomic framework in Europe.

First of all, sound national fiscal policies in Europe are of the essence because they ultimately are supporting growth and stability. Prudent fiscal policies for instance contribute to lower risk premia on long-term interest rates and thus to more favourable financing conditions, which in turn promotes investment and long-term growth. It is important that all governments comply with the provisions of the Stability and Growth Pact on fiscal consolidation in economic "good times" and that all the countries concerned honour the commitments they made at the Eurogroup meeting in Berlin on 20 April 2007. Taking advantage of the favourable cyclical conditions would enable most euro area countries to achieve their medium-term objectives in 2008 or 2009, and all of them should aim for 2010 at the latest.

Beyond that, the "quality" of public finances also matters for growth. It is essential to increase public spending efficiency in order to facilitate the reorientation of public expenditure towards productivity-enhancing physical and human capital accumulation. The ECB therefore welcomes the emphasis placed by the ECOFIN Council on measures to improve the quality and efficiency of public finances.

Monetary policy plays a key role in fostering sustainable economic growth in Europe through maintaining price stability. A central bank must avoid the negative effects of the uncertainty caused by high inflation on long-term growth as well as the adverse impact of uncertainty due to variable and unanticipated inflation. Variability of inflation increases uncertainty and exerts a major negative influence on investment and thus on potential output as well as on

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[15] 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.

[16] OECD Education at a Glance 2006.

[17] European Commission, 2003, "Chapter 3 - Education, training and growth", in: The EU Economy: 2003 Review

other components of aggregate demand. The environment of price stability, the credibility of the ECB in delivering price stability over time and therefore the solid anchoring of inflation expectations, are paving the way for sustainable economic activity.

Conclusions

Ladies and gentlemen, I would like to conclude by stressing a few points.

Monetary Union has been effective – and very successful – in supporting growth. In 2006, real GDP in the euro area grew by 2.9%, which is the highest rate since 2000. This positive development is very encouraging, but this is no time for complacency. Europe still has some way to go to fully benefit from globalization and meet the challenges of rapid technological changes and ageing population. We should also keep in mind that in a context of monetary union, not only fiscal policies, but also price competitiveness and unit labour cost developments across countries should be continuously and closely monitored.

That said, structural reforms are decisive to raise the long-term speed limit of the European growth. We have the tool in our hands to address the challenges I mentioned: the Lisbon strategy, as refocused and reaffirmed by the European Council. If all European countries summon up their strength and reinforce their push forward with structural reform, the improvement in economic activity presently observed in Europe will be broadened and made sustainable in the long run.

Thank you very much for your attention.