Jean-Claude Trichet: The creation of economic and corporate wealth in a dynamic economy

Contribution to the panel discussion by Mr Jean-Claude Trichet, President of the European Central Bank, at the conference organised by the European Central Bank, the Bank of France and The Conference Board, Frankfurt am Main, 17 January 2008.

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Dear guests, dear colleagues,

I would like to focus my remarks today on the role of macroeconomic policy for long-term economic growth.

Before talking about the role of policy, I will briefly look back at the economic growth performance of the euro area in the past decade and focus on some of the factors underlying the rate of growth of potential output. I will then look in more detail at how macroeconomic policies can help to increase Europe's trend growth rate.

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

Between 1996 and 2006 the annual growth rate in the euro area averaged 2.1% per year,[1] which was below the growth rates observed in a number of other industrialised economies, including the United States, where the average growth rate of real GDP was 3.1%. What are the fundamental causes of this unsatisfactory trend growth in the euro area, especially this 1 percentage point difference with the US ? The answers can be found by looking at the factors that determine long-term economic growth, namely:

- the degree of labour utilisation;
- demographic trends; and
- productivity growth.

Over the period 1996-2006 the euro area witnessed an improvement in labour utilisation, which increased by an average of 0.4% per year[2] compared with almost no growth in the United States when defined as total annual hours worked divided by the working age population. Labour utilisation therefore accounts for 0.4 percentage point of the euro area-US growth differential, "in favour" of the euro area. This improvement in labour utilisation in the euro area mainly reflects the significant increase observed in the euro area's 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%.[3] This is a very encouraging fact, which shows that labour market reforms and immigration may have helped to overcome some of the constraints on growth on the supply side of the euro area economy. However, it should be noted that, despite this progress, we are still a long way from having exhausted the potential for further increases in participation rates and employment. And this appears even more urgent if we consider that, over the same period, Europe's growth performance has been constrained by its low rate of population growth and the ageing of its society.

As regards demographic trends, the working age population of the euro area grew by an average of 0.4% per year over the period 1996-2006, compared with 1.3% in the United

[1] European Commission – AMECO database.

[2] European Commission – AMECO database.

[3] Eurostat.

States.[4] These demographic trends therefore account for 0.9 percentage point of the euro area-US growth differential, "in favour" of the US. Taken together, labour utilisation and demographic trends can explain 0.5 percentage point of the difference between the growth rates of the United States and the euro area, "in favour" of the US.

On the basis of a 1.1 percentage point difference in annual average growth between the US and the euro area over the period 1996-2006, the remaining differential of 0.6% for real GDP growth indeed stems from annual average labour productivity growth of 1.3% in the euro area and 1.9% in the United States.

It is true that the positive labour supply shock over the past decade might have contributed to the disappointing productivity growth seen in the euro area. However, standard growth accounting analyses show that developments in labour supply are only part of the story. The slowdown in labour productivity growth can be attributed to a large extent to a marked deceleration in total factor productivity. Those countries that have tended to compensate for the positive labour supply shock by increasing investment growth and/or exploiting the potential efficiency gains offered by new technology in particular have enjoyed stronger labour productivity growth. For instance, over the period 1996-2005 the direct contribution of ICT to labour productivity growth, as measured by the contribution of ICT capital services, has in the United States been roughly double that observed in the euro area (0.63 percentage point in the United States, compared with 0.37 percentage point in the euro area). Similarly, hourly labour productivity growth in ICT manufacturing and service sectors[5] grew by an average of 12.6% and 6.5% in the United States and the euro area respectively over that period.[6]

There could, of course, be many reasons for this decline in total factor productivity growth rates, and this conference has been useful in shedding light on some explanatory factors. Among the most prominent causes are those structural features of the European economies that are undermining investment incentives and impeding the efficient allocation of resources. There is, for example, some empirical evidence of a negative correlation between anti-competitive regulation and the contribution made to productivity growth by services using ICT.[7] The impact of structural features determining the "viscosity" of economies may of course change over time. In my view, rapid technological changes and the globalisation of economies, both of which require the restructuring of economies, have made the remaining rigidities and the "viscosity" of European economies more costly in terms of productivity and growth performance over the past decade. In this respect, I would agree with the findings of the paper on market structures and productivity presented at this conference by Mr Scarpetta and Mr Nicoletti.

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4 The demographic trend combines population growth, which was 0.4% on average for the euro area and 1.0% for the United States, as well as changes in the age structure, defined as the working age population as a share of the total population, which remained constant in the euro area while increasing by 0.2% on average in the United States.

5 Electrical machinery, post and communication services.

6 Source: EU KLEMS. Note that these figures are calculated as averages of the growth rates observed over the period in question.

7 See, for example, A. Alesina, S. Ardagna, G. Nicoletti and F. Schiantarelli (2005), "Regulation and investment", Journal of the European Economic Association 3, pp. 791-825, in which the authors find that regulatory reforms have had a significant positive impact on capital accumulation in the transport, communication and utilities sectors, especially in the long run. In G. Nicoletti and S. Scarpetta (2003), "Regulation, productivity and growth", Economic Policy, April, the authors find that various anti-competitive product market regulations significantly reduce total factor productivity growth at the industry level. In their contribution to this conference, J. Albert, G. Nicoletti and S. Scarpetta provide a broad survey of the relevant literature and some additional evidence.

On the basis of this diagnosis, the best contribution that macroeconomic policy can make to long-term growth is to provide an environment conducive to employment, investment and increases in our economies' capacity to adjust in response to technological and economic change. I should like to highlight two key priorities, namely:

- increasing the flexibility of labour and product markets and furthering economic integration; and
- implementing a stable macroeconomic framework.

This is, of course, not an exhaustive list. But I think that these are the key elements for macroeconomic policy, and I will focus on these here today.

Increasing the flexibility of labour and product markets and furthering economic integration

Well-functioning, integrated markets are required in order to meet the challenges posed by greater innovation and increase the adjustment capacity of an economy. For this to happen, labour markets need to be flexible. In the context of rapid technological change, it is essential to ensure that the labour force is employable and flexible by facilitating the adjustment of human capital in line with labour market needs. A high level of employment protection legislation may have a particularly strong negative impact on industries experiencing rapid technological change, since it may prevent the efficient matching of workers to jobs in view of new job requirements. Unfortunately, progress in increasing contractual flexibility, particularly for permanent contracts, has been disappointingly slow in several euro area countries. Wage flexibility also has an important role to play in the smooth functioning of markets. Structural rigidities in wage setting, by not allowing firms and sectors to remain competitive and not sufficiently reflecting existing levels of unemployment, reduce market opportunities for firms and thereby limit labour demand, investment and long-term growth.

In addition, an economic environment comprising well-integrated goods markets and financial systems provides a level playing field allowing productive forces to thrive. Some progress has been made in the EU in strengthening competition and increasing economic integration over the last two decades. The single market initiative has already brought about considerable benefits for the EU economy. The European Commission recently estimated that the single market had resulted in 2.75 million extra jobs over the period 1992-2006, corresponding to an increase in welfare of €518 per head by 2006.[8] However, much remains to be done, particularly in some service sectors. The extension and deepening of the EU's internal market clearly remains a priority as regards further financial market integration and the implementation of the Services Directive. The economic importance of services suggests that improvements in European living standards will crucially depend on productivity improvements in this area.

ECB studies, including work presented at this conference, have shown the key importance of financial integration and modernisation for the efficient operation of the economy.[9] The process of European financial integration is gradually taking place, with considerable progress being made, for instance, in capital markets and wholesale banking. However, it appears that the retail banking sector has not yet fulfilled its potential, and competition and integration in this market segment still appear insufficient.

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[8] European Commission, "The single market: review of achievements", November 2007.

[9] See P. Hartmann, F. Heider, E. Papaioannou and M. Lo Duca (2007), "The role of financial markets and innovation in productivity and growth in Europe", ECB Occasional Paper Series, September, as well as ECB (2007) "Financial integration in Europe", Frankfurt am Main.

Finally, allow me also to briefly mention labour migration. In my view, labour migration is an important adjustment mechanism in the context of monetary union. However, evidence suggests that cross-border labour mobility is limited within the euro area. Although this can be attributed in part to differences in culture and language, efforts should at least be made to remove the remaining formal institutional barriers to labour mobility across the euro area. At the same time, well-designed immigration policies should benefit the European Union by supporting the allocative efficiency of markets.

Let me also stress the fact that flexible and integrated labour and product markets are prerequisites for the smooth functioning of a monetary union such as the euro area. Regional monetary and exchange rate policies are no longer possible, and so well-designed structural policies that enhance flexibility in product and labour markets are crucial in order to ensure the continued competitiveness of European companies.

Macroeconomic stability with a view to supporting stronger, sustainable growth

This brings me to my second point, namely the contribution that fiscal and monetary policy can make to long-term sustainable economic growth.

First of all, sound national fiscal policies are of the essence in Europe because they support growth and stability. Prudent fiscal policies help, for instance, to avoid unnecessarily abrupt adjustments, as well as contributing to lower risk premia on long-term interest rates and thereby giving rise 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 as regards fiscal consolidation. In particular, countries need to make use of economic "good times" in order to accelerate fiscal consolidation. All of the countries concerned need to honour the commitments they made at the Eurogroup meeting in Berlin on 20 April 2007, namely to achieve their medium-term fiscal objectives by 2008 or 2009 – or 2010 at the latest.

Beyond that, the "quality" of public finances is very important for growth. It is essential to increase the efficiency of public spending in order to facilitate the redirection of public expenditure towards physical and human capital accumulation with a view to enhancing productivity. Indeed, evidence for the EU shows that there is room for improvement in public sector performance and efficiency, with gains possible with a public sector of the same size or even smaller.[10] Moreover, inefficiently high levels of public spending imply high taxes and are likely to inhibit potential growth. The ECB therefore welcomes the emphasis placed by the ECOFIN Council on measures to improve the quality and efficiency of public finances and on the importance of modernising public administrations in order to achieve better "value for money", provide the public with better services, increase control over government expenditure and enhance competitiveness.

Let me now turn to the contribution made by monetary policy. Can monetary policy help to create conditions conducive to strong, sustainable growth? Before attempting to answer this question, one should always remind oneself of what monetary policy can – and cannot – do. In practice, monetary policy amounts to temporary purchases of marketable assets from commercial banks in exchange for monetary base. No sophisticated economic theories are necessary to understand that our monetary policy instrument is unable to directly prop up innovation and the underlying rate of productivity growth in the economy.

This is not to say, however, that productivity growth is unrelated to monetary policy. In fact, theory suggests that, ceteris paribus, a permanent productivity slowdown will tend to

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[10] See A. Afonso, L. Schuknecht and V. Tanzi (2005), "Public Sector Efficiency: An International Comparison", Public Choice, 123 (3-4), pp. 321-347, and A. Afonso, L. Schuknecht and V. Tanzi (2006), "Public Sector Efficiency: Evidence for New EU Member States and Emerging Markets", ECB Working Paper No 581.

increase inflation once the economy reaches its new, long-term equilibrium. In order to prevent this outcome and ensure that price stability is maintained, the long-term rate of growth of money will have to be reduced.

The negative effects of a productivity slowdown can be greatly exacerbated if an environment of stable prices is not maintained. Some scholars have, for example, linked the “Great Inflation” seen in the 1970s to policy-makers’ misinterpretation of changes in the economy’s rate of productivity growth. In their view, after years of strong growth in the 1960s, policy-makers considered the slowdown to be a temporary phenomenon, while it later became evident that the deceleration in productivity was more persistent. According to this analysis, given the difficulties in recognising the nature of the slowdown in real time, monetary policy did not prevent a build up of inflation, which became entrenched in expectations and eventually led to stagflation, with relatively low growth and double-digit inflation. A painful disinflationary process was necessary in order to restore macroeconomic stability.

This confirms that the best contribution that monetary policy can make in order to foster sustainable economic growth and job creation is to maintain price stability. This is generally true, not just in response to productivity developments. A monetary policy that is credible in pursuing price stability and ensuring that inflation expectations remain well anchored will help to create a stable macroeconomic environment. This, in turn, will ensure the economy functions smoothly, facilitate firms’ long-term planning and stimulate investment. For these reasons, maintaining price stability is an explicit and overriding monetary policy objective in the euro area, as enshrined in the Treaty establishing the European Community. At the same time, price stability and well-anchored inflation expectations ensure that, if and when inflationary shocks do materialise, they are less costly to correct in terms of macroeconomic disruption and do not, therefore, undermine sustainable long-term growth and job creation.

So far, I have emphasised the importance of maintaining price stability and referred to the inflationary experience of the 1970s, but I would not wish to suggest that the appropriate response to negative productivity developments is always the tightening of monetary policy, or that, conversely, the response to increases in productivity should always be the loosening of monetary policy. On the contrary, in fact, the real rate should move in the opposite direction in the long run. Even in the short run, part of the difficulty in gauging the correct monetary policy response lies in determining whether a demand or supply effect is dominant.[11]

In addition, it is also important to bear in mind that changes in the rate of growth of productivity do not occur in a vacuum, but instead typically take place at the same time as other unforeseeable events. In the euro area, the first few years of the new millennium have not been notable only for a slowdown in productivity growth and, potentially, its more recent stabilisation. We have also witnessed very significant volatility in exchange rates, successive dramatic upswings in oil prices and, last but not least, turmoil in financial and money markets. These other shocks may obviously counteract the impact that productivity developments have on inflation.

I believe that the ECB’s monetary policy strategy is well equipped to cope with the uncertainty related to possible changes in productivity growth because it does not commit the ECB to react mechanically to specific indicators or forecasts. Thus far the ECB has always remained prudent. It has not interpreted the temporary increases seen in productivity since the start of EMU – namely in 2000 and 2006 – as more permanent changes to trend

[11] On the one hand, the fall in productivity will tend to limit potential output growth, thereby generating, ceteris paribus, excess aggregate demand and inflationary pressure. On the other hand, aggregate demand will be curbed by the reduction in profitable investment opportunities and individuals’ permanent income. All other things being equal, a fall in aggregate demand will tend to exert downward pressure on prices.

developments. By allowing us to make use of information from various types of analysis and by focusing in detail on the nature of shocks affecting the economy, the ECB's strategy is likely to continue to serve it well in an environment of pervasive uncertainty regarding future productivity developments.

Conclusion

On this note, let me conclude by saying that macroeconomic policies contribute to long-term growth essentially by establishing the right framework conditions for the flexible and efficient functioning of the economy and by contributing to macroeconomic stability. In this respect, the ECB has contributed to Europe's growth prospects and job creation and will continue to do so. The Lisbon strategy and the Stability and Growth Pact are valuable elements of the European governance structure which support such advances also in the area of fiscal policy and policies for product and labour markets.