Jean-Claude Trichet: How to preserve and consolidate the remarkable success of the euro and the performance of the European economy?

Speech by Mr Jean-Claude Trichet, President of the European Central Bank, at the Brussels Economic Forum, Brussels, 16 May 2008.

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Ladies and gentlemen,

I would first like to thank the organisers very much for inviting me today to this "Economic and Monetary Union in Europe: 10 Years On" conference. It is a pleasure to be here, and to share with you my views on the remarkable success of the Euro and on how to preserve and consolidate that success by improving the performance of the European economy.

As the European Central Bank is close to completing its first decade of existence and the euro will soon be ten years old, I would like to take this opportunity to pay a tribute to all those who contributed to this great achievement. The introduction of the euro has been recognised as a remarkable success. Since 1999 the single currency has fully inherited the degree of credibility and confidence that was the privilege of the most credible national currencies before the euro. This has been in particular illustrated by the fact that the medium and long term euro market interest rates were at the same low level as the level observed for the most credible previous national currencies. In spite of a succession of very significant price shocks of oil and commodities, the average yearly inflation has been 2.1% from the 1st January 1999 up to the end of 2007. Since the setting up of the euro 15.7 million net new jobs were created, three times more than during the same number of years before the euro and around 2 million more than in the US during the same period. This success is even more remarkable if you refer to a large number of ex ante statements, some particularly blunt. I will not have the cruelty of quoting today those that had prophesised that the European single currency was impossible or that its introduction would be a complete failure, or that in any case it was impossible for it to be credible given the very nature of its construction.

Nonetheless, there is no place for complacency. Price stability in the medium term has to be permanently ensured. Credibility is not a given: any institution has to prove that it deserves it by its decisions and actions. Regarding the functioning of the euro area economy, the success obtained in terms of job creation needs to be complemented and consolidated by continuing to implement courageous structural reforms aiming at increasing the flexibility of all markets, at supporting innovative environments and therefore augmenting the growth potential of Europe and strengthening the resilience of our economy.

Achievements of Monetary Union

With the introduction of the euro, a completely new monetary policy framework was introduced in Europe, with the ECB conducting a single monetary policy for the entire euro area. Despite the uncertainty that surrounded the transition to this new regime, the ECB and the euro have enjoyed a high level of credibility since the very first days of Economic and Monetary Union, the level of credibility that was inherent to the most credible national central banks of the now euro area. This achievement owes much to the ECB's institutional framework, which gives a clear mandate to the ECB to safeguard price stability in the euro area, and grants it full independence in doing so.

Price stability is a necessary condition to sustainable economic growth, job creation and social cohesion. Empirical evidence shows there is a negative relationship between inflation and output growth, with a 100-basis-point permanent increase in inflation being associated with a 10 to 30 basis-point decrease in trend output growth.[1] And central bank independence is key for monetary policy to be credibly and effectively geared to price stability.

From the very beginning, the successful launch of the euro and the strong credibility of the newly created monetary authority led to a convergence of market interest rates at all maturities around the lowest interest rates prevailing prior to the euro. Monetary Union delivered a yield curve after the transition that was fully in line with the benchmark set by the most credible national currencies before EMU. As a result, in some euro area countries, medium and long-term market interest rates fell to unprecedented levels when the euro was introduced and have remained there since.

Of course, the ECB has to be credible in delivering price stability over time. And there is no better way to establish a reputation than for the public to see us behaving consistently, in a focused way. The ECB is a young institution, but our track record over the past ten years has been widely recognised as being more than satisfactory. Since the introduction of the euro, average annual HICP inflation rate has been slightly above 2%, despite a succession of significant shocks (commodity and food prices in particular). Actual inflation may *temporarily* drift away from the central bank's medium-term objective, notably due to significant commodity price shocks. What is important is that the monetary policy stance is permanently designed to deliver price stability in the medium term, taking into account the medium and long term risks assessed by the economic and monetary analysis. Overall, despite the different shocks the ECB had to cope with since its inception, prices have remained stable over this period, average inflation being moderate and inflation volatility being significantly lower in the euro area than it was before EMU.

This favourable track record has been acknowledged by financial markets and the public, with long-term inflation expectations derived from bond yields and surveys remaining successfully anchored at levels that are in line with the ECB's definition of price stability. I would like to stress that the stability of inflation expectations has been remarkable, considering the series of adverse economic disturbances which have hit the euro area since its inception. And let me add that the ECB has always taken firm and timely actions to pursue a monetary policy which best serves the ultimate objective of maintaining price stability.

The success of the ECB's monetary policy in delivering price stability and its determination to ensure a firm anchoring of inflation expectations has provided significant support for other European Community objectives, notably favourable financing conditions and macroeconomic stability, which in turn favour investment and sustainable economic expansion. Most euro area countries have benefited from significantly better financing conditions than in the 1990s, a situation which has supported fiscal consolidation.[2] For instance, in the run-up to Stage Three of EMU, fiscal deficits were considerably reduced, mainly due to falling interest payments, from an average of 5.2% of GDP between 1990 and 1998 to 3.4% between 1999 and 2007.

The euro also helps to strengthen trade and financial linkages across euro area countries. There is clear evidence that the introduction of the single currency and the associated increase in price and cost transparency have fostered both intra and extra-euro area trade in goods and services.[3]

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[1] See ECB Monthly Bulletin, May 2008.

[2] For instance, in the euro area in the nine years following the introduction of the euro, real gross capital formation grew on average by 3.0% per year, compared with only 1.7% during the nine-year period preceding the introduction of the euro.

[3] Exports and imports of goods and services within the euro area rose from about 31% of GDP in 1998 to around 37% of GDP in 2007. The completion of a single market for services will further facilitate trade in services. The rate of increase in extra-euro area exports and imports of goods and services even exceeded

In addition, the euro is acting as a catalyst for a single market in financial services and a gradual portfolio reallocation away from holdings of domestic financial instruments and towards holdings of financial instruments issued elsewhere within the euro area.

Performance of the economy of the euro area

Thanks in particular to these successes in macroeconomic stability and increased integration, the euro area has delivered an impressive performance in terms of job creation.

The significant rise in employment in the euro area over the past decade, reflects also the progress made on structural reforms and wage moderation policy. Since the start of EMU to the end of last year, the number of employed people has increased by 15.7 million, in the euro area, compared with an increase of approximately only 5 million in the nine preceding years, and the euro area unemployment rate has fallen to its lowest level since the early 1980s.

This remarkable labour market performance could even be improved. Europe is far from having exhausted its potential for further increases in participation rates and employment. The overall employment rate in the euro area remains modest by international standards (65.7% in the euro area compared with 72% in the United States), and the unemployment rate is still clearly too high.

More specifically, while the prime-age male employment rate in the euro area is comparable with that in the United States, considerable disparities remain when we look at youth, female and older worker employment rates. For instance, in 2007 the female employment rate was 58% in the euro area compared with 66% in the United States, the older workers' employment rate was 43.3% compared with 61.7% in the United States, and the youth employment rate was 38% compared with 54.2% in the United States.[4] These features of the euro area appear to be consistent with an "insider-outsider" characterisation of the European labour market, where structural impediments, resulting from the legal and regulatory environment, high taxes on labour and rigidities associated with wage regulations, may prevent those groups "at the margin" from actively participating in the labour market.

The figures I have just mentioned suggest that, overall, structural reforms in the labour market need to be high on the agenda. They appear even more appropriate if we consider that in the past Europe's growth performance has been, and will increasingly be, constrained (all other things being equal) by its relatively low population growth rate and population ageing. Since the early 1990s, the population of the euro area has been growing at a yearly rate of just 0.4% compared with 1.1% in the US.

Overall a comparison of the economic performance of the euro area with that of other industrialised economies over a longer-term perspective shows that Europe has room to develop its growth potential. Since the early 1990s, real GDP has grown on average by 2.1% in the euro area, compared with 2.8% in the United States. Since the start of EMU, the annual growth rate for the euro area has averaged 2.2% per year compared with 2.7% in the US.

One of the main reasons for the euro area's modest performance is the relatively low trend growth in labour productivity. During the 1980s, hourly labour productivity in the euro area

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that in intra-euro area trade, rising from about 31% of GDP in 1998 to almost 44% of GDP in 2007. Extra-euro area trade has, of course, also benefited from a period of strong external demand and increasing integration at global level. At the same time, this ratio increased from about 23.2% of GDP to 28.9% of GDP in the US. (Balance of payments definition, sources ECB and IMF for the euro area, Bureau of Economic Analysis for the US.)

[4] Data for the US refers to the year 2006.

grew on average by 2.3%, while in the 1990s it declined to 1.8% and further decreased to 1.2% between 1999 and 2007. By contrast, hourly labour productivity growth in the US accelerated from 1.2% to 1.6% and 2.1% over the same periods.[5]

What lies behind these labour productivity developments?

Specific policies aimed at increasing employment, particularly in the unskilled segment of the labour market, have certainly contributed to the slowdown in labour productivity growth. However, the developments in labour supply are only part of the story. To a large extent, the slowdown in labour productivity growth can be attributed to a significant slowdown in total factor productivity growth, or TFP growth, which is generally taken as a measure of technological progress and improvements in the organisation and overall efficiency of production. In the 1980s, TFP grew on average by 1.6%, before declining to 1.1% in the 1990s and to 0.7% between 1999 and 2007.[6] The countries that have managed to exploit the efficiency gains resulting, in particular, from new technology have enjoyed stronger labour productivity growth. For instance, in the last ten years, investment in information and communication technology in the United States was double that of the euro area.[7]

There are many factors behind the low level in total factor productivity growth in the euro area. Most prominently, the structural features of the economies in Europe do not incorporate appropriate incentives to invest in real and human capital, to innovate, and to increase the flexibility of firms to smoothly and quickly adjust to their new environment. It appears that the structural characteristics of the best-performing industrialised economies, namely more flexible labour markets, greater competition in product markets and lower barriers to entry for new firms have been more receptive to the opportunities provided by new technologies.

Need for further structural reform

These remaining structural rigidities are, in my view, the main reason for Europe's relatively modest growth performance compared with the most advanced industrialised economies. I should like to discuss some of the key priorities for reform in three main areas, namely (i) getting more people into work; (ii) increasing competition; and (iii) supporting an innovative environment. These topics are clearly reflected in the Integrated Guidelines for the new phase of the Lisbon Strategy and the recommendations for the euro area. I firmly believe that the Lisbon Strategy, as refocused and reaffirmed by the European Council, is the tool in our hands to push forward ambitiously with structural reforms and improve the euro area's economic performance, and therefore consolidate the remarkable success of the euro.

(i) Getting more people into work

First of all, well-functioning labour markets are indispensable in fostering higher economic growth in the euro area. Despite an impressive success in job creation, the still relatively high unemployment rates in the euro area clearly suggest that there is a need to spur not only labour supply but also labour demand.

As regards labour demand, there is a need to reduce labour market rigidities, for they restrict wage differentiation and flexibility, and thus tend to discourage the hiring of younger and older workers in particular. At a time of rapid technological change, a flexible labour market is essential to facilitate the adjustment of human capital to labour market needs. Too rigid

[5] Source AMECO database. Data on hours worked per worker for the euro area for 2007 are assumed to be constant. Data on hours worked per worker for the US are estimated using the OECD data for 2006 and 2007.

[6] Source: European Commission.

[7] ICT investment represented 4% of GDP in the United States compared with 2% in the euro area over the period 1995-2004 (source Groningen database).

employment protection legislation has a very 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. Progress towards greater contractual flexibility remains slow in several euro area countries.

Moreover, in those European countries and regions where competitiveness has declined and/or the unemployment rate remains high, it is important that wage increases do not fully exhaust productivity gains in order to provide incentives for firms to create additional jobs. In this context, the Governing Council considers that features that enforce wage rigidity and lead to non-optimal wage-setting, in particular, and indexation of nominal wages to the consumer price index, should be avoided. This is particularly relevant today with the risk of second-round effects stemming from the impact of higher energy and food prices on wage. Avoiding these practices is essential to preserve price stability in the medium term and, in turn, the purchasing power of all euro area citizens. The Governing Council is paying particularly close attention to wage negotiations in the euro area.

Finally, as regards labour supply, further reforms in income tax and benefit systems would help to increase people's incentives to work. In particular those people with weaker ties to the labour market, such as women and older workers.

(ii) Increasing competition and deepening European integration

Increasing competition by establishing efficient and well-functioning product markets is equally fundamental. Many studies point to the potential of competition to boost productivity trends in particular by enhancing the incentive to invest and innovate. This gives already a key role to competition policies, since "little else than productivity growth matters in the long-run", as Bob Solow[8] once put it. But beyond that, relaxing the regulatory regime supports further employment creation. At the same time, it helps to reduce inflation persistence and contains upward price pressures, thereby improving the adjustment capacity of countries.

In the European Union, significant progress has been made in strengthening competition and increasing economic integration over the past two decades. The Single Market has already yielded major benefits for the European economy.[9] The extension and deepening of the internal market remains a priority as regards further financial market integration, the pursuit of effective competition in the energy market and the implementation of the Services Directive. The growing role of services in modern economies suggests that rising living standards and competitiveness in Europe will very much depend on improvements in this area.

Let me now focus more specifically on the financial sectors. For the ECB, financial integration is essential, given its relevance to the conduct of the single monetary policy. European financial integration is taking place gradually, with considerable progress having already been made. The degree of integration, however, varies across market segments, and integration is generally more advanced in those market segments which are closer to the single monetary policy. While the euro area banking markets for wholesale and capital market-related activities have shown clear signs of increasing integration since the introduction of the euro, the retail banking segment has remained more fragmented, leaving European firms and consumers unable to take full advantage of EMU and the Single Market.

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8 See the introductory article of the special issue on the slowdown in productivity growth in The Journal of Economic Perspectives 1988, Vol. 2, No 4.

9 The European Commission recently estimated that the Single Market has brought about an increase of 2.75 million extra jobs and an extra increase in welfare of €518 per head in 2006, corresponding to a 2.15% increase of the EU's GDP over the period 1992-2006 (see European Commission, "The single market: review of achievements", November 2007).

(iii) Supporting an innovative environment

Finally, to fully exploit productivity potential, the labour and product market reforms I have mentioned need to be accompanied by policies that support innovation and technological change. These include in particular measures to support innovation through higher investment in research and development, and policies aimed at improving human capital.

First of all, Europe needs more new and dynamic firms willing to reap the benefits of opening markets and to pursue creative or innovative ventures with a view to large-scale commercial exploitation. Notably, it is new and smaller firms, rather than large ones, that are the job creators. An entrepreneur-friendly economic environment would imply less red tape for small and medium-sized enterprises, and help them to develop at home and abroad, as well as positive action to ease access to the finance they need. Europe is significantly lagging behind in this field; its venture capital financing, for instance, remains only a fraction of that in the US, relative to the size of its economy.

Finally, research and development as well as human capital make valuable contributions to TFP growth – a fact that has been known for some time. In 2006, R&D investment relative to GDP was only 1.9% in the euro area, compared with 2.7% in the US. While many Member States expect to increase their R&D spending, the EU will fall short of its overall target of spending 3% of GDP on R&D by 2010. Increasing R&D investment is not of course an objective in itself. If we want to see an impact on growth, it is also the return on that R&D that matters. In this context, particular attention should be paid to raising public R&D spending efficiency and intensifying cooperation between public research institutes and industry.

Moreover, meeting the challenges of innovation and its dissemination as well as ensuring the labour force's employability and flexibility requires human capital to be continuously adjusted to labour market needs through improved education and training, as well as lifelong learning. However, investment in human capital in Europe is still clearly inadequate for a "knowledge-intensive" economy. There is still a need in Europe to enhance the quality and efficiency of our schools and universities as well as to increase incentives for all relevant parties, including firms, to invest in human capital.

Conclusion

Ladies and gentlemen, if I had to list the necessary conditions, "the building blocks" to preserve and consolidate the remarkable success of the euro and to reinforce the strength and performances of the euro area economy, I would stress four in particular:

- As far as the first building block is concerned, you will not be surprised that I mention first the quality of the monetary policy of the ECB. From that standpoint, the clarity of our primary mandate – enshrined in the Treaty – to deliver price stability in the medium term, the full independence of the ECB, the transparency of our definition of price stability and our two pillar strategy, our track record, and the credibility acquired by the ECB and the Eurosystem are our major assets.
- I will also seize this occasion to underline once more, as a second building block, the importance of the Growth and Stability Pact. The fiscal pillar of the EMU is key for the cohesion of the euro area. The ECB takes care of the M in EMU. The Growth and Stability Pact is a fundamental component of the E, taking into account that we are running a single currency for 15 countries that all have their own national fiscal policies.
- The third building block through which we will consolidate our success deals with structural reforms. As I said today, I trust that the firm and courageous implementation of the Lisbon Strategy as refocused and reinforced by the European Council is of the essence to augment our growth potential, consolidate sustainable prosperity and job creation as well as strengthening the resilience of our economy.

- The fourth building block is the attentive monitoring of cost competitiveness indicators and, in particular, unit labour costs at the level of each national economy. The smooth functioning of the euro area, taking into account the relative importance of the public sector and of the non tradable sector in a number of economies, calls for not relying exclusively on the working of the competitiveness channel amongst tradable goods and services to engineer corrections of deviations of relative cost competitiveness inside the euro area. Appropriate handling of the unit labour costs in the civil service and public sector, appropriate recommendations to social partners given in a timely manner would avoid in certain cases painful national corrections through the competitive channel.

Thank you very much for your attention.