Mario Draghi: Competitiveness – the key to balanced growth in monetary union

Remarks by Mr Mario Draghi, President of the European Central Bank, at Treasury Talks "A European strategy for growth and integration with solidarity", a conference organised by the Directorate General of the Treasury, Ministry of Economy and Finance – Ministry for Foreign Trade, Paris, 30 November 2012.

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Ladies and gentlemen,

I am delighted to be here in Paris and to have the opportunity to discuss with you the challenges of restoring growth and job creation to the European economy.

We are doing so against the background of a relative stabilisation of market conditions, and more generally of improved confidence about the stability of the euro area. Fears that the euro could be reversible have been addressed. The recent announcement of the Outright Monetary Transactions (OMTs) can be taken as an example of how to address tail risks, with possible severe consequences for price stability over the medium term and how to bring confidence back to the euro area financial markets.

The confidence effect of the OMT announcement has been significant, and rightly so. Excessive government bond spreads have gone down, corporate bond and covered bond spreads have tightened, and a number of banks in stressed countries have been able to regain market access. These developments are very important for the prospective financing of the real economy.

The relative stabilisation that has occurred, however, does not rely solely on the determination that we have shown at the ECB. It also relies, crucially, on the determination of governments to validate two assumptions:

First is the collective commitment of all governments to reform the governance of the euro area. This means completing economic and monetary union along four key pillars:

- a financial union with a single supervisor at its heart, to re-unify the banking system;
- a fiscal union with enforceable rules to restore fiscal capacity;
- an economic union that fosters sustained growth and employment; and
- a political union, where the exercise of shared sovereignty is rooted in political legitimacy.

To borrow a turn of phrase from our late colleague Tommaso Padoa-Schioppa: these are not short-term matters. But they are urgent matters.

The second condition for lasting stabilisation is the individual commitment of each government to maintain or restore in their own country the conditions of competitiveness that are at the source of balanced growth and employment.

This is the aspect I would like to focus on now.

I welcome the consensus that now exists in France that competitiveness is a key policy concern. Indeed, it is a key concern in every country of the euro area. And it is of fundamental importance to the euro area as a whole.

Europe's future prosperity requires member countries to be competitive individually in order to be competitive jointly and thrive in an open, global economy.

External and internal competitiveness of the euro area

Let me begin by defining a competitive economy. In essence, it is one in which institutional and macroeconomic conditions allow productive firms to thrive. In turn, the development of these firms supports the expansion of employment, investment and trade.

Prices, costs and wages are important factors for firms to develop and maintain shares of the global market. But there are other factors that have become increasingly important in the past decade, especially for advanced economies. As low-cost competitors have emerged elsewhere in the world, specialisation in high-value products and innovative technologies, which are our comparative advantages at a global level, has become vital.

These are two areas in which the euro area performs well, exporting mid-tech and high-tech products to a wide range of advanced and emerging markets.

Reflecting the increased importance of emerging economies in the past decade, all major advanced economies have lost export market shares. But compared with the United States and Japan, the euro area has held up relatively well, largely by adjusting the range of products in which it specialises.

Since the launch of the euro, the concentration of exports in high-tech and research-intensive products has increased faster than in other sectors. This has been one factor explaining why the current account of the euro area as a whole has never deviated much from balance. Since the time the euro was launched, all the other main economic areas have either run large surpluses or large persistent deficits. China, for example, has run a surplus of up to 10% of GDP, while the US deficit has reached up to 6% of GDP.

But the balanced position for the euro area as a whole masks quite different positions among countries. The pattern of global imbalances, of large deficits and large surpluses, repeats itself within the euro area. For example, just before the crisis, some countries were running deficits close to 15%, while others posted surpluses close to 7%.

Moreover, the relatively resilient export performance of the euro area hides very uneven experiences at the country level. For example, German and Spanish exports have held up very well, only losing around 10% of their market share since 1999. Other countries, particularly large manufacturers such as Italy and France, have seen their share of world trade fall by between 30% and 40%, similarly to the United States and Japan.

The roots of these uneven performances lie not only in divergences in price and cost competitiveness that have emerged in the euro area, but also in different abilities to orient exports to the fastest growing products and partners.

The crisis has made one thing absolutely clear: large imbalances within the euro area can become a fundamental issue for the stability of economic and monetary union.

Why do I say this? Because it is inevitable that a union of sovereign states can become fragile if some states are permanent creditors and others are permanent debtors. This is particularly true if the imbalances are on a large scale.

Such a situation undermines mutual trust. It can then damage the overall functioning of the union, which will in turn spill over to all members. It can also make the conduct of monetary policy much more challenging.

This is the fundamental reason why improvements in competitiveness are so vital for all of our organisations and institutions, including the ECB. And it is the fundamental reason why reforms to strengthen national economies are so essential.

Reforms are not only in the individual interest of euro area countries: they are also in the collective interest of the union, because they will help to restore its stability and cohesion.

Recent progress in euro area convergence

So how can these severe divergences within the euro area be addressed? Certainly, there has been some recent progress in the convergence of relative costs and of internal and external imbalances.

This reflects to a large extent stronger policy action in the fields of fiscal consolidation and structural reforms as well as deleveraging in the private sector. Trade balances have also improved in most euro area countries, which had experienced excessive domestic demand and substantial losses in price and cost competitiveness before the crisis.

In most cases, this improvement has resulted from a combination of relatively strong export growth (particularly in Spain or Portugal) and very weak or negative import growth (notably in Greece).

The contraction of domestic demand continues to play a role in this adjustment. Part of this is cyclical, but it also reflects rebalancing away from previously unsustainable domestic demand growth. Demand has to be contained and supply has to increase, it is only that the supply adjustment takes more time.

There are also signs that competitiveness gains have contributed to recent improvements in current accounts. Exports have held up relatively well in view of the weakening of external demand. Exports of goods and services have increased by 22% in volume for Spain since 2009 – and by 15% for Ireland, 22% for Portugal and 19% for Italy.

More importantly, some countries that lost export shares before the crisis have since registered positive export performance, notably Spain and Portugal. This shows improvements in cost competitiveness and gains in export market shares in most of the countries where the need for adjustment is largest.

The downward adjustment of unit labour costs is proceeding in these countries.

The countries with the largest imbalances have notably recaptured some of the losses in competitiveness incurred previously. For example, the countries under full EU-IMF programmes have seen their unit labour costs improve by more than 10% since 2008, relative to the euro area average. Their current accounts have improved by around 8 percentage points of GDP since then.

This is welcome, but it would have been preferable if these adjustments had occurred before the EU-IMF programmes had to be put in place.

The gains in cost competitiveness respond not only to adjustments in relative wages. Productivity matters. In low-productivity sectors, labour shedding has increased aggregate productivity, particularly in Ireland and Spain, but also, to a lesser extent, in Greece and Portugal.

We expect, however, that progress in structural reforms, especially those that improve the functioning of labour markets, will help lower unemployment and facilitate new employment opportunities. The reform momentum has been particularly pronounced in some countries with relatively rigid labour markets, which in many cases coincide with those countries that face the largest adjustment.

Despite the adjustments in relative unit labour costs, the overall price adjustment has been much less pronounced. There is clear evidence that increasing profits contributed to a large extent to upward pressures on prices in some countries.

It is of paramount importance here to address the lack of competition in a number of areas with strong vested interests. This is imperative to ensure that the flexibility of wage costs translates into the necessary gains in price competitiveness. This is true in particular for the service sectors that have been most shielded from competition.

Policies for improved competitiveness

What more can be done to maintain the positive performance momentum and to integrate those parts of the euro area that are lagging behind?

Some euro area countries are not taking full advantage of their well-educated labour forces and of their potential in terms of innovation and global reach. They could greatly benefit from reorienting their productive structure towards more sophisticated products, upgrading their quality and redirecting their exports towards strongly growing markets.

Innovation is crucial in this respect. This means for a start that where profit margins are restored, they should serve to fund research and development to a higher extent. But innovation potential is not always translated into actual, marketable, employment-creating and growth-sustaining innovation.

What is key in translating potential into actual innovation and growth, is the regime of economic incentives. And it is indeed this system of economic incentives that the current wave of structural reforms in the euro area is addressing.

Another crucial element for a country's innovativeness and potential growth is education, the quality of a country's human capital. For this reason, in fiscal consolidation efforts, an eye must be kept on not only maintaining but also further improving the quality of education.

At the same time, research on innovation shows that to exploit fully the potential embedded in a country's labour force, the economic and institutional environment must be conducive for knowledge to be used effectively for economic development.

A central challenge for our economies is to set conditions so that the skills and capabilities of the labour force, especially of our young people, can be profitably employed in competitive firms, or in the new enterprises that they will go on to set up.

In this vein, removing rigidities in product and labour markets clearly raises the potential for growth and job creation. And the resumption of economic growth is fundamental for returning to a sustainable fiscal position.

Concretely, we must identify the bottlenecks that prevent the vast resources of the euro area from being used most fruitfully. This process is already under way: the World Bank's latest Doing Business report highlights Greece as one of ten countries that have most improved the ease of doing business, albeit from a rather unfavourable level. The momentum of reform is clearly going in the right direction, although much remains to be done.

Spain and Portugal were among the countries that made resolving insolvent firms easier, a crucial ingredient for efficiently restructuring the economy in this transition period, as resources must shift from unproductive to productive activities. It is the latter that create jobs.

This reallocation process, though sometimes painful in the short run, carries the seed of future prosperity: a growing body of knowledge shows that by increasing the ability of the economy to adjust, so that factors can be reallocated to the most competitive firms, aggregate labour productivity can increase substantially. Some studies indicate a gain of as much as 20–30%.

The current focus on competitiveness in France, leading towards an institutional and fiscal set-up that can support firms' investment and innovation, is therefore a welcome step in the right direction. It would be particularly welcome if this improved in particular the functioning of labour market for young people, so that they can find a job.

For the euro area, too, increased labour mobility across borders is crucial. We should see that the current institutional arrangements of the welfare state do not stand in the way of such mobility. The portability of entitlements across borders is a crucial pre-condition for such mobility and should be fostered.

Competitiveness and market integration

Another important aspect is the growth and competitiveness-enhancing potential of further market integration in Europe.

One example is a very recent study, which finds that applying the EU Patent would raise the gains for European firms from patenting inventions by 60%. Furthermore, if all countries also adopted best practices, those gains would more than double.

I quote this example to show that improving competitiveness in Europe does not imply a race between euro area countries, but rather the exploitation of their comparative advantages in the single market and a global economy that offer far greater growth possibilities than each economy on its own.

Improving competitiveness by setting the conditions for boosting productivity is not about ranking: it is about raising the bar for each country to enhance its potential and use it.

The policy challenge

Let me now conclude.

We at the ECB have responsibility to maintain price stability. As part of this mandate, we acted to remove unfounded doubts about the irreversibility of the euro. This is a necessary condition for price stability and will help restore the stability and prosperity of the euro area.

But it is not a sufficient condition: it is the responsibility of individual governments to adopt policies that ensure the full responsiveness of wages and prices, facilitating the efficient use of our large potential resources, thus revitalising growth.

Euro area governments have made significant progress, but their work is not yet complete.

What I see in France, and in many other parts of Europe, is a consensus that the erosion of competitiveness has to be reversed. This is meaningful.

What I also see in France, and in many other parts of Europe, is a growing debate on the best possible functioning of product and labour markets. This is essential.

Given that the full effect of many structural reforms will only emerge with a time lag, it is indeed of utmost importance that national policies continue to focus not only on fiscal measures but at the same time address key structural problems in labour and product markets.

This would – and, indeed, will – complement full compliance with the reinforced EU fiscal and governance framework, including rapid implementation of the fiscal compact. Full compliance is important to send a strong signal to markets and strengthen confidence in the soundness of public finances.

This would – and again I expect I can say it will – also complement the reform of governance of the euro area that I mentioned earlier.

The recent signs of stabilisation allow us all to face the medium-term challenges for the euro area with a degree of confidence. All policy-makers should take advantage of this situation to continue their reforms with determination. The challenge is substantial. But the prize – balanced growth, price stability, employment and social progress, is significantly larger.

Thank you for your attention.