Willem F Duisenberg: Changing fortunes - financing world growth

Speech by Dr Willem F Duisenberg, President of the European Central Bank, at the 2003 Spruce Meadows Round Table, Calgary, 5 September 2003.

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It is a great pleasure for me to be part of this round table discussion today and I would like to thank the organisers for inviting me to share some thoughts with you on the topic of financing world growth. Since 2000, we have witnessed terrorism, war and declines in world equity markets, all of which contributed to increasing an already ongoing deterioration in confidence in most countries. Now with the end of the major hostilities in Iraq, the reduction in geopolitical uncertainties and lower oil prices, a gradual upturn in world economic activity is expected and it is important that policy-makers do all they can to support it.

Given the breadth of this topic and therefore the strong temptation to overrun on my time allocation, I will focus on just two points. First, I would like to say a few general words about the roles and, may I add, limitations of monetary and fiscal policy in reviving global demand, and the importance of microeconomic policies in this respect, in particular the role of structural reform in increasing potential growth. Second, with the help of regional-specific examples, I would like to present some future challenges with respect to microeconomic policies and structural reforms in the world.

Monetary and fiscal policy, and structural reform

The achievement and maintenance of strong growth implies a perspective that extends beyond shorter-term cyclical developments. Indeed, over the medium term, economic growth tends to be negatively affected by the considerable costs associated with inflation, and the prospect of stable prices is therefore a key factor of growth. By being strictly geared towards maintaining price stability in a credible and lasting manner, monetary policy makes an important contribution to achieving a high level of output and employment, and to sustaining growth. Confidence in lasting price stability removes the inflation risk premium on interest rates, ensuring low real interest rates, which in turn foster investment, growth and employment. Theoretical and empirical evidence clearly confirm that there is no long-term trade off between price stability and economic growth. Trying to use monetary policy to fine-tune economic activity or to gear it above a sustainable level will, in the long run, simply lead to rising inflation - not to faster economic growth.

Fiscal policy also plays a key role in contributing to macroeconomic stability. Stable, sustainable and efficient fiscal policies exert a favourable effect on long-term growth performance. They stimulate savings, capital formation, employment and innovation. And they facilitate the task of the monetary policy-maker in maintaining price stability. Sound public finances should rely on automatic stabilisers, rather than discretionary fine-tuning, to dampen the cyclical fluctuations of aggregate demand. Theory suggests that there are delays and risks associated with the latter - getting the timing wrong may result in pro-cyclical polices and make a monetary policy orientated towards price stability more difficult. In the medium term, fiscal policies can best contribute to sustaining non-inflationary growth by pressing ahead with fiscal consolidation.

Ultimately, over the economic cycles, growth will reflect conditions on the supply side of the economy. It is therefore microeconomic, and not macroeconomic, policies that can promote the supply of labour and capital and their efficient allocation, further innovation and the diffusion of new technologies, and as a result, mitigate problems such as structural unemployment.

Structural reforms in the labour and goods markets are a key element of any long-term strategy to improve investment, growth and employment prospects. First, more flexible markets increase the speed with which countries can adapt to economic shocks, thereby speeding up economic recovery. Second, increased competition in labour and product markets is conducive to a high level of innovation and the rapid spread of technological progress. This in turn supports long-term growth, without contributing to inflationary tendencies. Third, structural reform may facilitate the transmission of monetary policy. In more rigid economies, interest rate changes are transmitted to prices after a longer delay, and structural barriers can prevent the economic efficiency gains of the primary objective of monetary policy - price stability - from being fully realised.

It is important to mention here the close interplay between rigidities in capital, labour and product markets, which can strengthen one another. These interdependencies mean that structural reforms in any one of these markets will have an impact on the functioning of the others. It must be emphasised therefore that only a comprehensive reform programme can create the necessary conditions for stronger economic dynamism.

The need for structural reforms tends to become most urgent and evident to policy-makers during economic downturns. But don't forget that structural reforms do not provide short-term solutions to economic problems. Although they can have positive short-term confidence effects, it normally takes time for their benefits to unfold. Hence I cannot emphasise enough the need to speed up the pace of structural reforms in capital, labour and product markets.

Structural reforms in various regions of the world

Let me now turn to the issue of future challenges with respect to microeconomic policies and structural reforms in particular economic areas. I shall start with structural reforms in the euro area, and then move on to say a few words about structural reform in the EU Neighbouring Regions, the United States, Latin America and, finally, East Asia.

Euro area

Economic activity in the euro area remained subdued in the first half of 2003. However, there is increasing reason to expect that it will recover gradually in the second half of 2003 and strengthen further in 2004. Although the outlook for price stability is favourable, having allowed interest rates to fall to historically low levels, monetary policy cannot by itself generate lasting and sustainable growth and employment in the euro area. Part of the weakness in economic growth in the euro area may be linked to a lack of ambition in recent years in both fiscal and structural reforms to improve the conditions for investment and employment in the euro area.

The euro area needs structural reforms which increase the flexibility of labour, financial and product markets and effectively increase potential output growth, job creation and investment.

Although the extent and implementation of *labour market* reforms have been uneven across countries, the efforts made in the 1990s resulted in positive progress in two areas: first, in fostering employment growth across most sectors, which rose to 1.5% per year on average between 1997 and 2001, and second, in helping groups, such as women, the young and old and the least educated, to enter the labour market. Labour market reforms should now focus on reducing high structural unemployment and increasing participation and employment rates. Indeed, it is important that, alongside social considerations, the countries of the euro area give more weight to economic efficiency within labour markets.

Capital market reforms can also play a major role in making the euro area economy more flexible. Much has been achieved, not least due to the introduction of the euro, and the bulk of the Financial Services Action Plan has been implemented. However, the further integration of national capital markets towards a truly European financial market would be an important step towards safeguarding markets against country-specific shocks.

Finally, greater efforts must be made to remove existing barriers in *product markets*. Since the early 1990s state enterprises have undergone extensive privatisation, the use of state aid has fallen and market entry barriers have been lowered, although not evenly across all countries or sectors. In addition, there are still significant barriers to the further removal of price pressures, and these will need to be phased out.

EU Neighbouring Regions

The ten countries that are about to join the European Union have made considerable economic progress in recent years in terms of macroeconomic stabilisation and structural reforms. As a group and individually, these countries have achieved significant and sustained improvements in their economic fundamentals. In this regard, the perspective of EU accession has been an important anchor for policies. However, the process of catching-up in real incomes has been significantly slower than expected at the start of transition, and today, as they prepare to join the EU, there is still a significant GDP per capita gap with the current Member States. Improving the growth performance of acceding countries remains an issue of vital importance. While EU membership itself and the lagged effects of earlier reforms should foster the catching-up process, sustained policy action is needed to further improve the growth environment in the acceding countries. Reforms should, in particular, be conducive to capital accumulation and bring about tangible increases in total factor productivity.

In other EU neighbouring regions, efforts in structural reforms have varied considerably. Following a severe financial crisis in 2001, Turkey witnessed a strong rebound in 2002 and began an ambitious process to reduce inflation, while still struggling with some of its long-standing problems. This achievement was supported by structural - though still insufficient - reforms. In Russia, after a long delay in the early years of transition, a first package of structural reforms has been implemented in recent years, positively contributing to the strong recovery the country has been enjoying since the 1998 crisis.

United States

Turning to the United States, labour, product and capital markets have reached a high degree of flexibility. This reflects both the traditional market-oriented nature of the US economic system and reform efforts over the past 20 years, including a variety of deregulation measures in the 1980s. The flexible microeconomic structure of the US economy has helped to make it one of the strongest growth poles in the world, with GDP growth averaging 3.3% from 1983 to 2002 (compared with 2.4% in the euro area). At the same time, the US experience shows that no country can consider structural reforms as “completed”. In its latest Article IV report on the United States, the IMF identified a number of areas where further efforts would be desirable, including the budgetary framework, the social security system and the energy sector. Also, the series of corporate failures in 2001-02 revealed weaknesses in corporate governance practices, including accounting and audit rules, which are currently being addressed by the US authorities.

Latin America

Over the last two years, growth in most Latin American countries has been weak. This year, however, there are signs of a modest upturn, with confidence slowly returning. This has been due, in part, to the direction of the structural reform agendas of many countries in the region. To strengthen the foundations for growth, policy-makers must remain committed to implementing structural reforms. Countries that have made the greatest strides in reform are already reaping the benefits. Both Mexico and Chile, which are at the most advanced stage of reform in the region, have proven remarkably resilient to turmoil in regional economies and have weathered the period of weak global growth well, considering their exposure to sluggish mature economies. Other countries in the region have embarked on reform agendas and should be encouraged by the international community to see them through as swiftly as conditions allow.

East Asia

As for the crisis-hit countries in Asia, economic performance has been positively correlated with progress in reforms. Stronger average growth potential in countries such as Korea and Malaysia reflects partly the authorities' determination in pushing through corporate reforms, reforming the financial sector and strengthening insolvency laws. In China, the authorities have repeatedly emphasised that banking reform, if coupled with the restructuring and privatisation of state-owned enterprises, is key to strong growth and financial stability in the medium term.

The situation in the Japanese economy calls for urgent structural reforms. Authorities have made some progress in addressing the fundamental weaknesses and a reform strategy has been set out. First, banking sector reform has been appropriately focused on strengthening loan classification practices and accelerating the disposal of non-performing loans (NPLs). However, while progress has been made on the former issue, financial institutions still hold large amounts of NPLs in their portfolios and more progress would be desirable. Second, a strategy to promote deregulation in the product and labour markets has been set up. The successful implementation of structural measures in the Japanese product and labour markets would have the benefit of not only increasing potential output and employment, but also decreasing the vulnerability of the Japanese economy to economic shocks.

Concluding remarks

Let me conclude by first addressing the economic policy-makers in the euro area. I am convinced that economic activity in the euro area can only be lifted to a new, structurally higher, level by far-reaching and progressive structural reforms. In this respect, the major contribution that monetary and fiscal policy can make is to maintain a stable macroeconomic environment, entailing price stability and sound public finances. Moreover, as I have already argued, the effectiveness of both monetary and fiscal policy in bringing about macroeconomic stability hinges on the microeconomic functioning of the euro area economy, which can only be enhanced by embarking on structural reforms. I am pleased to observe that some countries in the euro area have already realised that the only solution to addressing the current economic slowdown lies in structural reforms to strengthen the functioning of the economy. I warmly welcome the efforts of the governments of these countries and sincerely hope that others will follow their example.

Second, as I have sketched out in my remarks to you today, while the need for structural reforms is pressing in the euro area, in all other regions of the world - albeit to different extents and to address somewhat different problems - there are benefits of structural reform to be won.

Thank you very much for your attention.