Jean-Claude Trichet: Economic reform in Europe

Contribution by Mr Jean-Claude Trichet, President of the European Central Bank, at the Panel on EU/US cooperation at the Advancing Enterprise Conference, London, 26 January 2004.

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Mr Chancellor, Ministers members of the Ecofin, Ladies and Gentlemen,

The European Central Bank (ECB) very much welcomes and supports the economic reform process in Europe and it is a great pleasure and honour for me to participate in this very distinguished panel. Well-designed structural reforms in capital, labour and product markets will increase the flexibility of the euro area economy, enhance its resilience against economic shocks and ultimately result in a higher long-term growth rate potential which should be our first priority in Europe.

1. The ECB contribution to long term sustainable growth

The ECB provides important contributions to the economic reform process by helping to ensure a stable macroeconomic environment in the euro area. In particular the ECB maintains price stability in the euro area and helps to ensure financial stability. Maintaining **price stability** contributes to an economic environment favouring growth and job creation. Four main reasons can be mentioned in this respect. First, it preserves and bolsters consumers' purchasing power and enhances the efficiency of the market at allocating resources. Second, price stability paves the way for lower uncertainty and risk premia in financial markets: this ultimately implies lower medium and long-term interest rates. Third, price stability provides markets with an indispensable nominal anchor for adjusting changes in wages consistently with productivity growth, thereby contributing to preserve competitiveness. And fourth and not the least, price stability prevents the economically and politically undesirable arbitrary redistribution of wealth and income that arises in inflationary as well as deflationary environments.

Ensuring price stability and ensuring the credibility of price stability over the long term is the most important contribution of the ECB and the Eurosystem to growth and job creation in Europe. The ECB makes also an important contribution to safeguarding **financial stability** in the euro area. This should not be underestimated, given that a well-developed and stable financial system improves the efficiency of financing decisions and ultimately fosters economic growth.

Over the last five years, the ECB's stability-oriented monetary policy has resulted in low and stable inflation and has ensured that medium and long-run inflation expectations have been well anchored. Furthermore, the euro area has enjoyed a high degree of financial stability. However, a monetary authority such as the ECB and the Eurosystem provides a necessary condition for growth but is not responsible for the other conditions that are equally necessary to ensure higher long-term growth and prosperity. This requires in particular sound fiscal policy and bold structural reforms.

2. The need for sound public finances

Sound public finances support a stable macroeconomic framework. In particular, a fiscal policy that is set according to rules, and is lived up to, adds to macroeconomic stability by providing economic agents with expectations of a predictable economic environment. This reduces uncertainty and promotes longer-term decision-making, notably investment decisions, and economic growth. Furthermore, it is important to keep in mind that fiscal policy can also promote growth and employment via appropriate adjustments of the level and composition of government taxes and expenditures. Reducing inefficient public spending can for example help to finance tax cuts. Furthermore, public expenditures can be redirected towards productivity-enhancing physical and human capital accumulation rather than, for example, the provision of subsidies for declining industries.

As regards the Stability and Growth Pact most recent events, I would only say that the Governing Council shared the concerns of the Commission on the ECOFIN Council conclusions of 25 November 2003 and made it public. The Commission is the guardian of the Treaty and the Governing Council of the ECB respects the recent Commission's decision to seek legal clarity.

The Governing Council does not see a need for changes in the Treaty, and the Stability and Growth Pact in its current form is appropriate in its view. The Governing Council is in agreement with the

Commission that the implementation of the Stability and Growth Pact could be further improved, in particular as regards the analysis of structural balances and strengthening the incentives for sound fiscal policies in good times. Clarity and enforceability of the fiscal framework should also be enhanced.

3. The need for structural reforms

Turning to the aim of a **higher long-term sustainable growth rate** in the euro area more generally which, as I said, should be our major strategic goal, what we need is both higher productivity growth and higher employment creation. What is needed for these objectives to be achieved are economic reforms that ensure that capital, labour and product market rigidities will be *substantially* lowered. Structural reforms in capital, labour and product markets and in social security systems are needed to allow an allocation of capital and human resources which would be much closer to the optimum, enhancing the euro area's growth potential and facilitating the adjustment to economic shocks.

The reform priorities in the euro area's capital, labour and product markets are overarching and very broad. In many cases they need to be translated into concrete policy measures at the European and/or the national level.

Starting with **capital markets**, the pace of reform in this field has been impressive over the last years in anticipation and since the introduction of the euro. This includes policy-induced reform, such as the Financial Services Action Plan (FSAP) or the development of national legal frameworks governing the issuance of mortgage bonds. Reform covers also market-led initiatives, such as the development of electronic trading platforms or consolidation in the clearing and settlement infrastructure.

Despite the past achievements the need for continuation and completion of the reforms remains. This relates first to the completion and implementation of the FSAP and its follow up. The FSAP should give rise to genuine common financial legislation and regulation for market players. The so-called Lamfalussy framework, which allows for flexible technical rules at the EU level complemented by enhanced co-operation as regards national implementation and enforcement, has for good reasons been extended from the securities field to banking, insurance and financial conglomerates.

A second area of structural reform in capital markets is the further consolidation and integration of market infrastructure and the further harmonisation of the standards and conventions routinely used by market participants. There is a large variety of remaining obstacles to a fully integrated and efficient euro area market which still needs to be addressed by the relevant actors. A simple but telling example of the benefits that collective action can bring in this regard is the development of the EONIA overnight interest rate index by market participants organised within a trade association. This index has become the generally accepted reference in the euro overnight interest rate swap market, leading in turn to the impressive development of this particular market segment.

Turning to **labour markets**, a number of structural reforms have been undertaken in recent years and efforts are still on-going in several Member States. Although unevenly implemented across countries, the positive impact of past reforms in the labour market has become visible. Output growth became more job intensive towards the end of the 1990s and the estimates of the natural rate of unemployment (NAIRU) in the euro zone tend to show a decline in structural unemployment from the mid-1990s. However, the high level of average unemployment and the relatively low average employment rate in the euro area, which in 2002 was still around 62%, compared for example to the United States with almost 75%, indicate that much more needs to be done. More specifically, policies should aim at:

- Increasing incentives towards employment. Policies should aim towards reducing labour taxes and non-wage labour costs and increasing the incentive compatibility of benefit systems.
- Allowing for a sufficient degree of wage differentiation to ensure that wages reflect divergent productivity growth and regional/sectoral developments.
- Increasing the efficiency of matching potential workers with job vacancies. This requires continuous investment in education, training and life long learning as well as improved efficiency of public and private employment services.
- Increasing other aspects of labour market flexibility such as labour mobility (across occupations, sectors and regions) and encouraging the increased use of more atypical forms

of employment such as flexitime, part-time and self-employment in particular, which should play a much more important role in job creation in continental Europe.

The need for further labour market reforms should also be seen against the background of population ageing. Demographic developments will, inter alia, make it particularly challenging to achieve and maintain sustainable fiscal balances in the period ahead.

As regards **product markets**, a number of studies have shown that the potential gains from creating truly integrated and competitive European markets could be very large. On the one hand this would require further progress with regulatory reforms at the national level in order to intensify domestic competition. On the other hand it needs the full EU-wide integration of markets. Regarding the latter much progress has been achieved in integrating EU goods markets, largely driven by the completion of the Single Market. The integration of services markets however has been more limited due to a large number of obstacles, whether legal, cultural or inherent to the nature of some segments of the service sector. Specific areas for further reform efforts include:

- The full implementation and enforcement of the existing Internal Market legislation. The extension of the Single Market to areas, which were so far not or only partially covered, for example many service sectors. Furthermore, the integration and reform of a number of network industries (e.g. energy, transport and postal sectors) needs to be continued.
- Ensuring effective competition within and across Member States. This requires a continuous review of the powers of regulatory and competition authorities at both Member State and Community level.
- The legislative and regulatory framework of the European economies should be reviewed at all levels of government in order to create a more business-friendly environment.

To conclude I would like to stress more particularly five points.

First, on the economic underpinnings, the main strategic goal of the Eurozone as well as of the European Union as a whole should be to increase substantially our growth potential. This is crucial and calls upon increasing very significantly in particular our rate of employment, our labour productivity progress and our technological and scientific basis.

Second, as regards methodology, it is clear that we have to work out an appropriate concept for the actual, precise, to the point implementation of the reforms. The Lisbon agenda is excellent in terms of diagnosis. It is not associated with a precise and efficient decision making process, with a powerful delivery concept, which is absolutely indispensable. I was very encouraged to hear clearly Mr Mc Creevy stressing to the Governing Council of the ECB that the Irish Presidency will put the Lisbon agenda implementation on top of its priorities. The ECB will very warmly back initiatives of the Presidency in that domain. It is urgent.

Third, as regards prioritization of structural reforms, I would personally particularly mention four points which seem to me of utmost importance in the Eurozone: Youth unemployment which is attaining unacceptable levels in some economies; unsatisfactory functioning of the Single Market in the service sector; insufficient labour productivity progress in the economy as a whole; and, lastly, consequences to be drawn from ageing in the management of the social protection schemes.

Fourth, as regards public opinion, I trust that we have all to exert maximum efforts to improve explanations, pedagogy, communication with the public at large. We are living in very vivid and exemplary national democracies and in a European Union where the ultimate judge is the people. We have to convince our public opinion at large that each individual would be better off - with more growth and more jobs - if we could deliver the reforms of the Lisbon agenda . The ECB will do all what it can to help improving pedagogy in this respect.

And five, I confirm here that we, in the Governing Council of the ECB, know that structural reforms are not easy to work out, that it needs much courage and determination from Governments, Parliaments and social partners. We will back in the future as we have in the past this courage and this determination.