Jean-Claude Trichet: Structural reforms in the euro area

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Introduction

The conclusions at the recent European council regarding the implementation of the Lisbon agenda in EU countries have been both encouraging. While some modest progress has been made in the first years, the pace of reform needs to be very significantly stepped up if the targets are to be achieved. And it is encouraging that the European Council is therefore committed to a more forceful implementation.

The implementation of the Lisbon agenda is all the more pressing as some countries have shown how an ambitious reform agenda can bear the expected fruits for long-term employment and output growth. In the Netherlands, for instance, reforms in social security and the development of part-time and flex-time employment have contributed to a substantial increase of the employment rate and the integration of an increasing number of women in the labour market.

Several countries have now started to implement reform agendas. This has led observers to conclude that European countries are likely to get back on a more dynamic track over the medium run. While these advancements should be acknowledged, there are still important areas of economic reforms that have been barely touched upon but that are of vivid importance shall the euro area find again a more vigorous economic growth path.

Part of the problems in introducing and carrying these structural reforms may lie with the lack of communication of the importance of an ambitious reform agenda. In particular, the introduction of the euro has constituted a major change for euro area economies and can rightly be considered a structural reform itself that should trigger further changes and a more forceful removal of rigidities on labour and product markets.

Structural reforms in the euro area

Importance of structural reforms for output and employment growth

Let me, first of all, stress again the importance structural reforms have for output and employment growth. While the objective of higher potential growth rates and the importance of the intermediate targets, namely productivity growth and employment creation are by and large consensual view, there still remains some misunderstanding as to how these objectives can be reached.

As the ECB has stressed, 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.

Structural reforms, on the one hand, are playing an important role in the determination of long term potential growth of the euro area, which is mainly determined by the efficiency of microeconomic relations. A high rate of innovation and technological diffusion in all parts of the economy supports long-term growth without fuelling into inflationary pressures.

Moreover, a flexible economy increases the speed of adjustment of the euro area to permanent shocks and its resilience to temporary ones. While a rigid economy has the tendency to react to external influences only with a substantial lag, and more so with respect to negative shocks than to positive ones, a more flexible economy reacts more rapidly and with less costs - such as an increase in unemployment or loss of output growth.

Finally, one should not forget that the development of employment is to a substantial amount determined by the competitive conditions on labour and product markets: an increased competition on these markets decreases the pricing power for firms and the rents they are able to earn, and lowers pressure on wage increases. This is particularly important for employment growth in the services sectors, which are less exposed to international competition. In this area, structural reforms can yield further reduction in price pressures and at the same time create conditions for moderate wage developments that could enhance more pronounced employment creation.

The structural environment for monetary policy

Structural reforms can therefore help to improve the environment in which monetary policy is conducted, by increasing the potential output and productivity growth at low inflation rates. However, they can also contribute more directly to support a stability-oriented monetary policy by affecting the mechanism through which monetary policy decisions are transmitted to prices.

On the one hand, structural characteristics of labour and product markets will have an impact on the wage-price dynamics through the effects they may have on the price- and wage-setting behaviour of firms and trade unions. With imperfectly competitive product and labour markets, firms and employees can affect - at least partially - the price and wage dynamics on a local scale, resulting in stronger inflationary pressure and structurally grounded inflation dynamics that have to be met with more restrictive monetary policy.

On the other hand, the transmission mechanism of monetary policy can be impaired by overly rigid economies, preventing monetary policy decisions to be properly reflected in price developments. In particular, structural rigidities may imply that monetary policy decisions affect prices and inflation rates only with a substantial lag. Consequently, policies have to be longer in place in rigid economies than in more flexible ones in order to ensure price stability. This not only lengthens the reaction time but will also increase the sacrifice ratio.

Where does the euro area stand today?

Since the introduction of the Single Market in 1992, euro area and EU countries have undertaken important reforms regarding the functioning of the capital, labour and product markets. Nevertheless, substantial impediments remain to be removed in order to guarantee more flexibility on these markets. I would like to stress that these reforms should not only aim at an increasing flexibility on markets within each country but also across countries where substantial obstacles hamper a more pronounced integration of EU countries.

Regarding the labour markets, the ECB repeatedly pointed to the speed of reforms that has to be substantially increased, shall the current imbalances - such as high unemployment and low employment rates - be resolved. In order to prevent a further persistence of these imbalances these reforms should receive high priority.

The reform agenda regarding labour markets should comprise a large array of rigidities that dampen both labour demand and supply and reduces the equilibrium growth rate of employment. Here, should be mentioned the overly burdensome tax and social security systems that still characterises many euro area countries. On the one hand, these systems substantially lower incentives for labour supply, in particular from low-wage earners. On the other hand, they substantially add to gross wages employers have to pay, reducing consequently their labour demand. Demographic change adds, moreover, further stress to the existing systems by increasingly putting the financial burden on a diminishing number of people in the labour market. Some EU countries have started to tackle these problems and all must be done to encourage them and others to pursue their efforts in this domain.

Rigidities on the labour market also arise through overly burdensome employment protection legislation and the centralisation of wage bargaining systems in some euro area countries that further hinder a flexible reaction of the labour market to shocks. In addition, the wide-spread use of undifferentiated minimum wages and the administrative extension of wage agreements do not allow an appropriate differentiation to account for regional asymmetries.

In addition to labour market reforms, a further flexibilisation and integration of capital markets across EU countries can also give a substantial contribution to strengthening the productive capacity of

European economies. Moreover, a deeply integrated euro area-wide capital market would help to insure against country-specific shocks. In addition, reducing market entry barriers and regulation and a sound corporate governance framework improves the availability of venture capital, which constitutes the backbone of highly innovative enterprises, and would overall reduce capital costs and strengthen investment.

Let me also mention that, despite much progress in this area, additional effort should be undertaken to reduce and eliminate still existing entry barriers and market regulations on product markets. While substantial progress has been made, notably in some of the very important network industries such as telecommunications, but recently also on the electricity market where some countries already benefited from substantial price decreases, some areas are still characterised by dominant market incumbents, public ownership and market entry regulation. Moreover, still persisting state-aid for particular sectors or on an ad-hoc basis do not create the necessary environment for dynamic product markets with rapid firm entry and exit that is vital for sustained productivity and output growth.

These efforts to push through a further product market reform agenda should be complemented by investments in the technological capabilities of euro area countries. In particular in comparison with the US, it becomes clear that the euro area countries display a substantial gap in the introduction and use of ICT. There is an urgent need to reduce the gap that has opened up in this area.

Finally, more energy has to be invested in order to reduce the stubbornly high impediments for cross-country trade, in particular in the services sectors, which are very important for employment creation. Here, we are still far from the Single Market ideal, which would allow resources to flow freely from one country to another. This requires a further reduction in bureaucratic obstacles and - where necessary – the harmonisation of regulations across countries.

The creation of the euro as a structural reform

Integration of the Single Market and EMU as a catalyst of further reforms

These impediments and obstacles notwithstanding, the introduction of the euro has been a structural reform by itself that is likely to contribute to further economic integration of the economies belonging to the Economic and Monetary Union and to foster the continuous development of the Single Market. For instance, countries with the same currency tend to trade more with each other than they would with countries with different currencies. By increasing price transparency, reducing transaction costs and fostering competition, the euro acts as a powerful catalyst to the economic integration process in the euro area. Consequently, trade of goods and services among euro area countries will continue to grow at a sustained rate, thereby contributing to increased competitive pressure on product markets that would otherwise only have been achieved through reforms on the level of each individual member country.

This further integration will put pressure on euro area member countries to provide the most appropriate framework for employment and enterprise creation and the development of the productive forces and therefore to adjust also their labour and capital markets to the new reality of the single currency.

In this context fiscal policy can make an important contribution. First, it can contribute 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 or be redirected towards productivity-enhancing physical and human capital accumulation.

Changes in the monetary policy regime and changes in price and wage setting

The creation of a single currency and the introduction of the euro not only raises pressure to speed up the structural reform process but will also change profoundly the behaviour of the euro area economies and in particular the way prices and wages are set.

I have already mentioned the increasing integration and growing intra-euro area trade resulting from the introduction of the euro. In addition, the commitment of the ECB to price stability creates the conditions for low inflation across the euro area. Both will increase competition among European producers, limiting their pricing power and helping to keep inflationary pressures confined. Additionally, with increasing competitive pressure and reduced scope for pricing power, enterprises are led to look for alternative ways to increase their resilience and to enhance their competitiveness. This will provide an additional boost for productivity growth and raising potential output growth.

Similarly, the introduction of the euro has an important impact on the dynamics of wages, helping to keep them in line with productivity developments. On the one hand, increased competitive pressure among European firms reduces any rents they may have been able to earn in the past and increases their labour demand elasticity. This will tend to increase real wage flexibility. On the other hand, the low-inflation commitment of the ECB provides a stable anchor for low inflation expectations and a lower inflationary bias on the side of labour. Moreover, the absence of specific monetary policy reaction with respect to country-specific shocks will tend to reduce the contractual length for wage accords, helping to reduce nominal and real wage inertia.

Overall, therefore, the introduction of the euro in supporting efforts to increase the flexibility of product and labour markets and to make prices and wages reflect more rapidly a change in the economic environment of the euro area. This should improve incentives to invest in new technologies to boost productivity and output growth and to speed up the transformation of the euro area towards a "dynamic, knowledge-based economy".

The way forward

The Lisbon agenda

In order to proceed with the necessary structural reforms in the euro area, the Lisbon agenda continues to provide an important benchmark against which to measure progress with reforms. The Lisbon agenda has been put together in order to formulate a strategic goal for the European Union, bringing together the different strands of reform policies on product, labour and capital markets that are already undertaken for some time. Moreover, in order to facilitate monitoring of progress with reforms, quantitative goals have been fixed to measure progress in particular on the labour market in achieving for instance a higher employment rate or increasing labour market participation of women.

The goal that has been fixed at the time - to become the most competitive and dynamic knowledge-based economy by 2010 - seems increasingly difficult to reach. In addition to efforts that have to be undertaken on the individual country level, it seems to me necessary to strengthen the European framework through which reforms are monitored and accompanied in order to improve incentives for more rapid transposition of reforms. Let me first briefly summarise the main points of the Lisbon agenda before turning to the question of how the benchmarking and monitoring process could be strengthened. In particular, the Lisbon agenda stresses the following reforms necessary for an increased flexibility on product, labour and capital markets:

- A further integration of capital markets should be pursued. Here, the implementation of the Action Plan for Financial Services by the end of 2005 will help to improve access for venture capital by reducing intra-EU barriers to capital transfers. This implies to integrate the market for government bonds, to harmonise accounting standards and to enhance co-operation between financial services regulators in different EU countries.
- On product markets, the Lisbon agenda stresses a further strengthening of the competition intensity, and in particular a further opening of electricity and gas markets across EU countries. Let us observe that in order to measure the speed at which EU directives are transposed into national law, a transposition rate has been defined at set at 98.5% of existing directives, which euro area countries have great difficulty to meet. Moreover, the Lisbon agenda stresses the importance of a supportive environment for innovative activity, including closer ties between universities and firms and a strengthening of the education systems in EU countries.
- Regarding the reforms on labour markets, the Lisbon agenda points to an increasing use of flexible arrangements for labour contracts, such as the increased use of part- and flex-time work, as well as to improvements in the wage bargaining process to better take into account

regional and firm-level disparities. Moreover, the agenda proposes changes in the institutional framework to improve the functioning of both active and passive labour market policies. Once introduced, these reforms should help EU countries to reach the target of an employment rate of 70% that has been fixed by the agenda.

Strengthening of European monitoring structures

This leads me to my last point: How to improve the framework on the European level to better monitor and implement much needed structural reforms. As has been stressed at the recent European Council, monitoring and implementation of the Lisbon agenda are the key to proceed with structural reforms in the EU.

In particular, two approaches that have been used in the past and that could be further developed to provide powerful tools in this area. One concerns the process of benchmarking to be used as a tool to determine best practices across the euro area - and eventually industrialised countries more generally. The other regards the existing European structures of monitoring and peer pressure to proceed with structural reforms in the EU.

After two decades of structural reforms across developed economies, much experience has been gained as to what policies have performed well compared to the status quo. Some of this experience has been used to form important reform agendas both on the EU level and the level of individual countries. I have just mentioned two of the most important ones: the Single Market Initiative and the Lisbon agenda. In particular, recent propositions by the ECOFIN council regarding benchmarking Member States' performances in terms of progress towards the Lisbon goals and a specific mid-term review of the Lisbon strategy would be very welcome to complement existing efforts in this area.

But there are other experiences - also outside the euro area - that could be fruitfully reviewed and used to inform our views on particular issues. For instance, the recent corporate governance problems, both in the US and the euro area, show that there is still much to be learned for further structural reforms in this area. Moreover, policy makers and international organisations have started to analyse more thoroughly different aspects of structural reforms to stress their importance for improved macroeconomic performance. This expertise should be funnelled more directly into our definition of benchmarks and be used more actively to inform our communication practices.

Nevertheless, communication alone will not be sufficient to move on with reforms. It will also require to strengthen the European framework through which these reforms are monitored. Currently, this framework relies largely on a peer pressure mechanism, mainly depending on good will of governments in individual EU countries. In light of the current stance of structural reforms in the EU, this does not seem to be sufficiently powerful and more active measures to push forward with reforms - similar to the Single Market Initiative - should be sought. In particular, the ECB welcomes the call made by the recent European Council to build national Reform Partnerships, involving social partners, civil society and the public authorities in order to improve the implementation of necessary reforms.

In this process, the ECB will continue to monitor and analyse structural reforms and provide additional insights. This takes place in co-operation between ECB and NCBs and a continuous exchange of views with other international organisations such as the European Commission, the OECD or the IMF.

Conclusion

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

First, on the economic underpinnings, the main strategic goal of the euro area 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 has however not been associated with a with a powerful implementation, which is absolutely indispensable.

Third, as regards prioritization of structural reforms, I would personally particularly mention four points which seem to me of utmost importance in the euro area: 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.