

Jean-Claude Trichet: Structural reforms in Europe

Speech by Mr Jean-Claude Trichet, President of the European Central Bank, at the OECD Forum, Paris, 22 May 2006.

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It's a pleasure for me to be here at the OECD Forum to share with you my views on structural reforms in Europe. I am particularly honoured to take part in this Forum given the leading role played by the OECD in shaping global discussions on economic, financial and, especially, structural issues, which are the topic of my intervention today. I wish also to pay my tribute to the outgoing Secretary General Donald Johnston for his outstanding leadership and, if he permits me to say that, for his deep friendship. Let me also welcome the new Secretary General Angel Gurría for whom I have esteem and confidence since 25 years!

Economic performance of the euro area

I would like first to start with a brief assessment of the euro area's economic performance by recalling a few facts. Over the last years the euro area witnessed a slight improvement in the utilisation of labour, which increased on average by 0.2% per year between 2000 and 2004.¹ This mainly reflects the rise in the euro area employment rate from 61.5% in 2000 to 63.6% in 2005² which corresponds to the creation of more than 11 millions new jobs over the same period and to a decline in the aggregate unemployment rate from 10.5% to 8.6%. Remarkably, employment growth in the euro area showed resilience to the economic slowdown at the beginning of this decade, with employment growing on average by 1.1% over the period 2000-2005, compared to 0.9% in the US.

However, the employment rate in the euro area remains low by international standards: for example, the employment rate was 71.2% in the US in 2004³ and the unemployment rate clearly too high compared with, for example, the unemployment rate of about 5.0% in the US in 2005⁴. Furthermore, since the launch in 2000 of the Lisbon strategy, the annual growth rate for the euro area has averaged 1.8% per year (compared to 2.8% in the US), thus remaining behind its main competitor. When comparing the euro area's economic performance to the US, there is evidence of increasing disparities in growth. Since the beginning of the 1990s, the gap in per capita income growth between the US and the euro area has continuously widened - by 0.8% on average per year during the 1990s, increasing to 1.3% per year from 2002 onward.

The main explanatory factor behind these developments is the diverging trend in hourly labour productivity growth between the euro area and the US. During the 1980s, hourly labour productivity in the euro area grew on average by 2.4% compared to 1.3% in the US. In the 1990s, hourly labour productivity in the euro area increased on average by 1.8%, decelerating to 1.2% in 2000-2004. By contrast, US hourly labour productivity growth rose from 1.5% to 2.8% over the same periods.

Over a period of 20 years we have been the witnesses of a very significant structural change across the Atlantic. From the eighties to the first years of the twenty first century the growth of labour productivity per hour has been multiplied by more than two in the US when it has been divided by two in Europe. Overall in this respect the relative position of the US and of Europe has changed by a factor 4 to the detriment of Europe!

It seems to be relatively easy to understand why the US has improved its own productivity. Technological progress in the I.T productive sector in particular has contributed significantly. But even more important has been the effect on productivity of the diffusion of I.T and of innovation in general in all the sectors of the US economy particularly the services sector, with a substantial impact on retail business and on the financial services sector. This is now well documented and research has

¹ Groningen Growth & Development Centre database (GGDC) of Groningen University, Netherlands.

² Second quarter 2005 Eurostat LFS data.

³ OECD (2006) Factbook. Figures for 2005 not yet available.

⁴ Bureau of Labor Statistics.

considerably improved our understanding of what has happened in the mid nineties with the end of what has been called the Solow paradox...

On this side of the Atlantic one can understand why we did not observe the same jump in labour productivity: on the one hand the share of I.T production in the GDP is significantly lower and, on the other hand, the absence of sufficient flexibility in the economy in general does not permit to benefit from the rapid diffusion of innovation in general and of I.T in particular in the other sectors of the economy. To sum it up Europe would still be in the Solow paradox.

But there is a second paradox in the case of Europe or perhaps more than a paradox: a conundrum. Why is it that not only we did not improve our productivity when the US did it – around the mid eighties – but that we observed on the contrary a very significant diminishing of our productivity? This phenomenon seems to me only half understood through traditional explanations: the impact of specific policies aiming at drawing back to work a significant number of previously unemployed unskilled workers – with a low level of productivity – that have been launched in several European economies; and a degree of under-investment hampering the stock of capital allocated to each employee. But it explains only around half of the diminishing of the labour productivity growth. The other half seems to be explained by a significant diminishing of total factor productivity which is extremely surprising because it occurs precisely at the moment of powerful historical surge in science and technology.

There we are at the heart of the conundrum. The conjecture I would propose is that, under certain circumstances, in a period of very rapid technological and structural changes, the more an economy is inflexible, the more it resists to these changes, to the extent that far from taking advantages of the acceleration in progress in technology its “Total factor productivity” growth diminishes in comparison with what it was in the period preceding the surge of technology. In other words it seems that there is not only an “opportunity cost” for being inflexible in a period of very rapid technological change – i.e not seizing the new opportunities offered by the acceleration of changes - but also a “direct cost”, coming perhaps – and there lies the conjecture - from the fact that under the stress of accelerating changes the economy becomes even more inflexible and hostile to technological progress than in more “normal times”.

The evolution of the “Total factor productivity” growth in Europe seems to confirm that phenomenon. From an average level of 1.3 % in the 80's it diminished to an annual average of 1.1 % during the 90's and 0.7 % between 2000 and 2004. These observations are calling urgently for structural reforms, in particular all the reforms that would augment the flexibility of all markets – labour, goods and services and financial – in the euro area economy.

The need for structural reforms

Understanding the reasons of these developments is very important. As also stressed by the OECD⁵, the lack of sufficient structural reform in Europe is a major cause of the gap in economic growth between Europe and the US. I will therefore now turn to structural reforms that have the potential to increase both euro area labour productivity growth and labour utilisation and therefore the long run growth potential.

The euro area economy is facing a number of important challenges, including rapid technological change, ageing populations as well as accelerating globalisation. Moreover, the long-term sustainability of public finances in the euro area should be improved pursuing pension as well as health care reforms. These challenges will require major efforts to increase the adjustment capacity of the euro area in general and of workers in particular. The adverse consequences arising from an ageing population could only be solved by an extension of the working life and/or substantial inward migration. Other challenges, such as globalisation and increased competition, are also accompanied by increased opportunities: globalisation provides incentives for firms and workers to excel in what they do best while outsourcing some goods and services at lower costs on a global scale, providing consumers with substantial benefits⁶.

⁵ See OECD (2005) and (2006) “Going for Growth” and OECD (2005) “Economic Surveys: Euro Area”.

⁶ See Economic Policy Committee of the EU (2005), “Responding to the challenges of globalization”, Brussels.

Without aiming to be exhaustive, I should like to highlight some of the key priorities for reform in four main areas, namely getting people into work, increasing competition, unlocking business potential and supporting an innovative environment.

First of all, well-functioning labour markets are extremely important in fostering high economic growth. The divergent pattern displayed by growth and labour utilisation in the US and in Europe has prompted some economists to suggest the existence of a 'European model' and a 'US model', related to the trade-off between labour use and productivity.⁷ One view is that the lower levels of GDP per capita in Europe reflect European preferences for more leisure. However, we should bear in mind that lower participation rates are not necessarily solely associated with personal preferences, but are also triggered by the legal and regulatory environment, tax systems and social institutions. Benefit systems that are too generous discourage job search, early retirement schemes encourage early withdrawal from the labour market - employment rates for older workers aged 55-64 stood at just 40.2% in the euro area in 2005 and, according to the OECD, at around 60% in the US - and marginal tax rates that are too high discourage labour market entry and have a downward effect on average hours worked. To increase labour utilisation and get people into work, necessary labour supply side measures include the reform of tax and benefit systems to address these problems and increase incentives to work. Measures aimed at reconciling motherhood with professional life, such as the provision of child care, may raise participation rates. Furthermore, the use of flexible forms of work such as part-time and temporary work may also provide further working incentives.⁸

High unemployment rates in the euro area and in particular high youth unemployment rates, amounting to 17.8% in 2005, clearly suggest the need to spur labour demand. In this context, there is a need to promote wage flexibility and to address labour market rigidities. Furthermore, adjustments to the level of employment protection legislation are needed where they impede the hiring of younger and older workers in particular.

Regarding the second priority area for reforms that I would like to mention, increasing competition and establishing efficient and well-functioning product markets is another prerequisite for higher medium to long-term growth.⁹ The economic literature generally leads to the conclusion that competition is an important factor explaining both productivity and price developments¹⁰.

A lack of competition harms productivity trends by limiting production efficiency and by reducing the incentive to innovate. Moreover, increased competition is generally associated with a lower price level brought about by a reduction in the mark-ups of firms, for given marginal costs. Stronger competition stimulates a more efficient use and allocation of resources thereby increasing allocative efficiency, exerting downward pressure on costs and triggering price reductions.

The extension and deepening of the EU internal market is among the policies that are needed to further improve the functioning of product markets. With service-related activities representing around 70% of value added and employment in the euro area (against almost 80% in the US), more competition in EU service markets is required. The gap between the euro area and the United States in labour productivity has widened considerably since the 1990s and some services sector, such as retail and wholesale trade, account indeed for a large part of this gap: labour productivity growth per person employed was 0.7% in the euro area in 1996-2002 compared to 5.5% in the US in 1996-2001.

The euro area should step up measures to boost services market competition in order to increase economic efficiency and economies of scale. This would support a higher level and growth rate of labour productivity in the services sector and promote a more dynamic economy. Moreover, measures aimed at increasing services market competition may have a dampening impact on relative price

⁷ See Blanchard, O. (2004): "The economic future of Europe", *The Journal of Economic Perspectives*, vol. 18, pp. 3-26; and also Gordon, R. J. (2004): "Two centuries of economic growth: Europe chasing the American frontier", CEPR Discussion Paper, No. 4415.

⁸ See, for example, Genre, V., R. Gomez-Salvador and A. Lamo (2005): "European Women: Why do(n't) they work", ECB Working Paper Series, No 454, March 2005.

⁹ For a further extension of this topic see European Commission (2004), "The link between product market reforms and productivity: direct and indirect impacts", the EU Economy: 2004 Review.

¹⁰ See for example G. Nicoletti and S. Scarpetta (2003): "Regulation, Productivity and Growth: OECD Evidence", OECD Economics Department Working Paper No 347, P. Cavelaars (2003), "Does Competition Enhancement Have Permanent Inflation Effects?", *Kyklos*, 56 (1) and M. Przybyła and M. Roma (2005), "Does product market competition reduce inflation? Evidence from EU countries and sectors", ECB Working Paper No 453.

changes in some services sectors and thus temporarily on aggregate inflation. Overall, a higher level of competition in the services sector would tend to support more efficient and flexible services markets, facilitate adjustment processes and increase the resilience of the euro area to economic shocks¹¹.

In this context, an internal market for services and the adoption of the Services Directive would constitute an important step forward. It would remove barriers to cross-border provision of services and make it easier to set up services businesses in other Member States.

In the EU, some progress has already been made in improving the functioning of product markets. For example, several network industries, like telecommunications and air transport, are now fully or largely open to competition. And the reforms do pay off: the remarkable labour productivity growth performance in some network industries in Europe over the last ten years provides a perfect example of the positive impact on labour productivity growth of easing regulations and fostering competition. For example, in the telecommunication sector which was largely liberated in the course of the 1990s, hourly labour productivity grew on average by 8.5% in the euro area over the period 1996-2003 compared to 6.9% in the US. The euro area HICP index for telecommunications fell by 35% relative to the overall euro area HICP index in the period 1998-2005.

The third prerequisite for higher growth in the euro area is the unlocking of business potential by creating an entrepreneurial-friendly economic environment. This includes lowering costs imposed by public sector administrations for existing firms and business start-ups. Let me illustrate this with some figures. According to the World Bank, in 2004, the average cost of starting a business with up to 50 employees in the euro area (excluding Luxembourg) is estimated to have been around ten times larger than in the US¹². The policy implication of lowering business regulation is that EU countries can help to raise economic growth by avoiding an excessively restrictive regulatory environment for firms. The immense importance of this issue is increasingly appreciated by European governments and several initiatives at national or EU level have started to implement actions for a "better regulation". In March 2006, the European Council called for the establishment of "one stop" arrangements in each Member which would allow the setting up of company in one week by end 2007. Today it takes on average 27 days to set-up a new business in the euro area compared to 5 days in the US.¹³

Fourth, to fully exploit productivity potential, the labour and product market reforms just mentioned need to be accompanied by policies that help to diffuse innovation and technological change.

This includes, inter alia, measures to support innovation by higher investment in research and development (R&D). In 2004, roughly 1.9% of euro area GDP was spent on R&D compared to 2.8% in the US. Europe has set itself the target of achieving a share of 3% of GDP by 2010. Analyses made by the European Commission¹⁴ show that if the effects of the increased knowledge investment foreseen within the Lisbon strategy were added in, the increase in annual EU potential output growth could reach up to three quarters of a percentage point. Of course, these are just crude calculations, which can certainly be challenged, but they give a notion of how large the welfare-enhancing potential of implementing structural reforms is.

Of crucial importance in this strategy are the efforts to improve the labour force's level of education and expertise. The impact of education on growth may be related to innovation, as well as the adoption of new technologies. Additionally, better education and training help to reduce mismatches in the labour market and allow for a smoother reallocation of workers between sectors and firms.¹⁵ The last decades have already brought about an enormous increase in the level of educational attainment, the so-called "catch-up effect in education". In the euro area, according to OECD data for 2003, an average of 73% of those aged 25-34 had attained at least upper secondary education, compared to only 46% of persons aged 55-64.¹⁶ Nevertheless, meeting the challenges of technological progress

¹¹ See also ECB (2006), *ibid.*

¹² See the World Bank web site www.doingbusiness.org.

¹³ See the World Bank web site www.doingbusiness.org.

¹⁴ European Commission (2004) "A 3% R&D effort in Europe in 2010: an analysis of the consequences", study prepared by the Research Directorate General of the European Commission.

¹⁵ See G. Schwerdt and J. Turunen (2005): "Growth in euro area labour quality", ECB Working Paper Series, No 575, January 2006.

¹⁶ OECD (2005) "Education at a glance".

and ensuring the labour force's employability and flexibility, requires that human capital is continuously adjusted to labour market needs through improved education and training as well as lifelong learning. In 2005, the US annual expenditure on higher education institutions per student was 22,234 USD, while in the euro area the equivalent of only about 9,200 USD was spent. Furthermore, we need more high quality scientists and researchers. In the EU we have about 5.3 scientists and researchers per 1000 workers, which compares to the US figure of 9 per 1000.¹⁷

In addition, ICT investment, which is an indicator of the diffusion of innovation, represented 6% of GDP in the US over the period 2000-2004 compared to only 3% in the euro area. ICT diffusion appears to be particularly relevant in the services sector given the higher potential for employment creation in that sector combined with the evidence that there is no apparent trade-off in the medium term between labour productivity and employment growth at the level of the sector as a whole. As a result, the key issue for the larger euro area countries is how to increase their future capacity to promote the diffusion of innovation and, in particular, technological changes in the service sectors, a field in which the Nordic EU countries have performed particularly well¹⁸.

The state of structural reforms

If euro area countries would now summon up their strength and ambitiously push forward with structural reform, this will support and broaden the improvement in economic activity in the euro area. This is why the ECB has always encouraged the implementation of structural reform within the Lisbon strategy. Five years later, progress has been made in some areas - as also indicated by an increase in the euro area employment rate. Still, all in all the reforms have not been far-reaching enough¹⁹.

Against this background, the mid-term review of the Lisbon strategy in 2005 led to a re-launch of the process by shifting the strategy's focus more strongly on growth and employment. As an outcome of this process, all EU countries have prepared so-called National Reform Programmes that outline structural reform steps for the years 2005-2008²⁰. These measures are designed to, among other things, enhance the sustainability and quality of public finances, promote flexible labour and product markets, support a favourable business environment, and ensure a fully operational EU internal market, including the markets for energy and services. Applying comprehensive structural reforms is of particular importance for the euro area countries, in order to increase wage and price flexibility and the resilience to shocks, facilitate structural adjustment, raise potential output growth and job creation, and reduce price pressures, thereby facilitating the task of the single monetary policy.

Also the ECB's monetary policy has a role to play in supporting the implementation of structural reforms. A credible monetary policy aimed at maintaining price stability in the medium term contributes to a stable economic environment. In a stable macroeconomic context, it is not only easier to single out where reforms are needed, but the benefits of reforms are also made more visible, thus supporting their acceptance.

In turn, structural reforms can also have important consequences for the transmission of a monetary policy which is committed to price stability. In more rigid economies interest-rate changes are transmitted to prices after a longer delay and structural impediments can prevent the economic efficiency gains sought through the stability-oriented objective of monetary policy from being fully realised.

To **conclude**, the European Union is undergoing an important process of reforms of its socio-economic model so as to adapt it to future challenges. The economic strategy is on the right track, there is a consensus on the appropriate objectives and agreement on the right institutional setting to be set in place. The next decisive step is now to accelerate the putting into practice of these plans. The earlier this happens, the earlier economic activity, employment and innovation in Europe can be lifted to a higher level and standard. I trust that this acceleration of reforms will not only be in the

¹⁷ OECD (2005) "Education at a glance".

¹⁸ See A. Annenkov and C. Madaschi (2005), "Labour productivity in the Nordic EU countries. A comparative overview and explanatory factors 1980-2004", ECB Occasional Paper No. 39, October.

¹⁹ See the article entitled "The Lisbon strategy – Five years on" in the July 2005 issue of the ECB Monthly Bulletin.

²⁰ See the Box entitled "The 2005-2008 Lisbon National Reform Programmes of the euro area countries" in the January 2006 issue of the ECB Monthly Bulletin.

interest of Europeans, but eventually in the interest of the whole global economy as an economically stronger Europe will also raise our contribution to economic prosperity elsewhere in the world.

Thank you very much for your attention.