Jean-Claude Trichet: How to elevate the potential growth rate of Europe

Speech by Mr Jean-Claude Trichet, President of the European Central Bank, at the Ludwig Erhard Lecture, Berlin, 16 October 2006.

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First of all, Dr Hans Tietmeyer is a pioneer of Economic and Monetary Union and the euro, and so, for obvious reasons, I feel close to him and responsible for ensuring that his work on the European project is continued. I particularly share his views on how to conduct monetary policy. Allow me to quote him to illustrate my point, "In the longer run, monetary stability has proved to be unequivocally beneficial for growth and employment. Moreover, it is the most social of all conceivable economic strategies."

Second, and on a more personal basis, I pride myself on being among his friends for more than 20 years.

Thanks to leaders like Hans, who shared the same vision for the future of Europe, in 1999, 11 European countries introduced the single currency, followed later by Greece. Slovenia will join the euro area next year. The introduction of the euro has been a remarkable success, acknowledged not only in Europe but in the whole world. However, to continue fully exploiting the benefits of the euro, Europe has to face important challenges that require major policy measures. Indeed, when comparing the euro area’s economic performance to that of the US in terms of growth, there is clear evidence of the fact that we have still a lot of progress to make. Since 1996, the annual growth rate in the euro area has averaged 2.1% per year compared with 3.4% in the US, reflecting a particularly mediocre euro area’s growth potential. As a result, while in 1996, the GDP per capita level in PPP in the euro area represented 84% of the US level, it represented only 76% in 2005.

Increasing potential output growth in Europe is today a priority for the euro area, as potential output growth is one of the major catalysts for improvement in living standards. It is also an important issue for the central bank, as potential output can be thought of as the maximum output an economy can sustain in the medium and long term without a rise in inflation.

I will first review the past economic growth performance of the euro area, focusing on some of the underlying factors of potential output growth, namely labour resource utilisation (or labour supply) and hourly labour productivity growth, in particular in comparison with the US and other advanced industrialized economies. Then I will elaborate on the kind of reforms which I consider essential to increase the potential growth rate and the prosperity of Europe in the future.

The economic performance of the euro area since the mid-1990s

Let me start with an assessment of the euro area’s economic performance by:

first recalling a few general facts,

then, analysing the euro area labour market and labour productivity performance in more detail.

As I already mentioned, over the period from 1996 to 2005, euro area output grew on average by about 1.3 percentage points less than in the US, and the gap appears to be persistent.\(^1\)

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1 The Ludwig Erhard Memorial Lecture on “Economic and Monetary Union: a German perspective” by Dr Hans Tietmeyer. Lecture held at the LSE on February 18, 1992.

2 Eurostat.

3 Since 2003, real GDP grew on average by 1.3% in the euro area compared with 3.5% in the US.
The main factor which explains these developments is the diverging trend in hourly labour productivity growth. Labour productivity growth is indeed typically the most important determinant of long-term potential output growth. During the 1980’s and the first half of the 1990s, hourly labour productivity in the euro area grew on average by 2.4%, decelerating to on average 1.3% between 1996 and 2005. By contrast, US hourly labour productivity growth rose from 1.3% to 2.2% over the same period.

At the same time, the euro area witnessed a slight improvement in the utilisation of labour, which increased on average by 0.3% between 1996 and 2005 \(^5\) compared with 0.1% in the US \(^6\) when defined as the total annual hours worked divided by the total population. Labour utilisation reflects the extent to which the potential labour resources in an economy are actually utilised and therefore has a direct influence on output growth. The slight improvement in labour utilisation mainly reflects the significant rise in the euro area employment rate from 58% in 1996 to 63.5% in 2005, accompanied by a decline in the aggregate unemployment rate from 10.7% to 8.6%. However, the increase in employment has been partly dampened by a fall in the average annual hours worked per person of 0.4% per annum over the same period \(\text{compared with a fall of 0.2% in the US}\). Let me now describe in more detail four features of the European labour market and labour productivity performance that will provide some useful insight on progress achieved by the euro area economy and its weaknesses.

First of all, despite the progress recorded on the labour market side, the overall employment rate in the euro area remains low by international standards \(63.5\% \text{ in the euro area compared with 71.5\% in the US in 2005}\) and the unemployment rate is clearly too high \(8.6\% \text{ compared with 5.1\% in the US in 2005}\). Moreover, in 2005 the number of annual hours worked in the euro area was 1603 compared to 1804 in the US. All in all, this clearly suggests that there is still considerable room for improvement as regards increasing the level of labour resource utilisation in Europe.

Second, while the prime-age male employment rate in the euro area is comparable to that observed in the United States, when we look at the youth, female and older worker employment rates, the disparities are considerable. The female employment rate was 55% in the euro area and 66% in the US, the older workers employment rate was 40% in the euro area and 60% in the US, the youth employment rate was 37% in the euro area and 54% in the US \(^6\). These figures appear to be consistent with an “insider-outsider” characterisation of the European labour market, where structural impediments prevent those groups “at the margin” of the labour market from entering and participating in the labour market.

The rise in the overall employment rate in the euro area over the last ten years has been mainly driven by an increase in the female and older workers employment rates, partly reflecting the progress made by structural reforms and wage moderation policy in some European countries. Nevertheless, and turning to my third point which relates more specifically to hourly labour productivity growth performance, specific policies aiming at increasing employment particularly in the unskilled segment of the labour market have certainly contributed to the observed slowdown in labour productivity growth. However, this apparent trade-off between labour utilisation and productivity is likely to be a temporary phenomenon that should fade when the economy reaches a higher “equilibrium” labour/output ratio.

However, it is worth mentioning that the US managed at the same time to increase both labour input and labour productivity. This leads to my final point. There is indeed another factor that explains the difference in the rate of labour productivity growth in Europe compared with the US, which in my view is a major policy concern, namely the fact that Europe is lagging behind in terms of innovation and more specifically the diffusion of information and communication technology (ICT). Several authors have already highlighted the major role of ICT in the revival of labour productivity growth in the US. \(^7\)

While the ICT sector is the single most important source of productivity growth, it represented only 40% of EU productivity growth compared with 60% in the US. In 2004, total R&D investment in the

\(^4\) Eurostat and OECD.
\(^5\) OECD.
\(^6\) Source: Eurostat and the OECD.
euro area accounted for 1.9% of GDP and the ICT sector represented as much as 20% of this amount, while in the US, 2.8% of GDP was spent on R&D and the ICT sector represented as much as 30% of this total.\(^8\) Even more important is the effect ICT diffusion has had on productivity in the US economy, particularly in the services sector, with a substantial impact on retail and wholesale business and on the financial services sector. ICT investment, which is a good indicator of ICT diffusion, represented 4% of GDP in the US over the period from 1996 to 2004 compared with only 2% in the euro area.\(^9\) The structural characteristics of the US economy — a more flexible labour market, a higher degree of competition in product markets and lower barriers to entry for new firms — were apparently more conducive to exploiting the opportunities provided by new technologies. By contrast, the productivity growth performance in Europe was characterised by a lack of technology diffusion across sectors, particularly in the services sector.

### The need for further structural reforms in Europe

Overall, this brief assessment of the underlying causes of Europe’s disappointing longer-term growth performance provides a mixed picture of the European economy. Of course, I focused on a specific set of supply-side determinants of economic growth. Economic growth is also influenced by other factors, including the macroeconomic policy framework. I will deal with some of these aspects, including the contribution of monetary policy to sustainable output growth, later on in my speech.

The lack of sufficient structural reform in Europe is, in my view, a major cause of the difference in the rate of economic growth in Europe compared with the US and with some other advanced industrialized economies, and of the fall in potential output growth in Europe. All in all, it appears that the overriding policy concern for Europe is how to simultaneously achieve solid employment and productivity growth. I will therefore now turn to those structural reforms that have the potential to increase both euro area labour productivity growth and labour utilisation, and therefore long-term growth potential. It is clear that embarking on the path of such major structural reforms is easier said than done, especially in the current environment, where the European economy is facing a number of important challenges, including rapid technological change, ageing populations as well as accelerating globalisation. For instance, ageing will not only put pressure on public finances by driving up ageing-related expenditure, but will most certainly also bring down the potential growth rate of Europe if no reforms take place. According to the European Commission’s projections, the impact of ageing populations alone could reduce potential output growth in Europe by nearly half by 2040, from the present rate of 2%-2.25% to around 1.25% if structural reforms are not carried out.\(^10\)

All in all, these challenges will require major efforts to increase the output growth and adjustment capacity of the euro area in general and the flexibility of workers in particular. European governments should take advantage of the recent favourable growth developments to push ahead with structural reform.

Without aiming to be exhaustive, I should like to highlight some of the key priorities for reform in four main areas, namely:

- Getting more people into work,
- Increasing competition,
- Unlocking business potential,
- And finally, supporting an innovative environment.

First of all, well-functioning labour markets are extremely important in fostering higher economic growth. The differences in labour market developments, especially with regard to the level of labour utilisation, between the US and Europe has prompted some economists to suggest the existence of a “European model” and a “US model”, related to the trade-off between labour and leisure.\(^11\) One view is

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\(^8\) Source: Groningen Growth and Development Centredatabase.

\(^9\) Source: Groningen Growth and Development Centredatabase.

\(^10\) See “The economic costs of non-Lisbon” March 2005 EC.

that the lower levels of GDP per capita in Europe reflect a European preference for more leisure time. However, we should bear in mind that lower participation rates are not necessarily associated solely 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 searching, early retirement schemes encourage early withdrawal from the labour market - employment rates for older workers aged from 55 to 64 stood at just 40% in the euro area in 2005\textsuperscript{12} and at around 60% in the US\textsuperscript{13} - and marginal tax rates that are too high discourage labour market entry and have a downward effect on average hours worked. Necessary measures to increase labour utilisation or labour supply 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 childcare, should also raise participation rates. Furthermore, the use of flexible forms of work such as part-time and temporary work may also provide further working incentives.\textsuperscript{14}

High unemployment rates in the euro area and in particular high youth unemployment rates, amounting to 17.8% in 2005 compared with 11.3% in the US\textsuperscript{15}, clearly suggest the need to spur not only labour supply but also labour demand. In this context, there is a need to promote wage flexibility and to address labour market rigidities. Adjustments should be made to employment legislation where it impedes the hiring of younger and older workers in particular.

And reform does pay off. Indeed, the European countries that did engage on the path of such reforms in particular Denmark, Ireland and the Netherlands have achieved success in reducing unemployment and stimulating job creation, despite significantly different economic conditions\textsuperscript{16}. In 2005 the unemployment rate in these countries stood below 5.0%, while their overall employment rate was above or close to the US level. To achieve such remarkable success, these countries reformed their tax and benefit systems by reducing for example tax wedges on labour income and by carrying out a stricter enforcement of job search rules and a better surveillance of eligibility\textsuperscript{17}. They also increased, when needed, the flexibility of their labour market by easing employment protection legislation (EPL), in particular as regards temporary workers.

What all these countries also have in common is a significant reduction of product market regulation (PMR). This leads to the second prerequisite for higher medium to long-term growth: increasing competition towards establishing efficient and well-functioning product markets.

Most studies point to the potential competitive pressure has to increase employment, at least in the long run, and to boost productivity trends by improving production efficiency and by enhancing the incentive to invest and innovate. The links between competition and productivity growth are now both theoretically and empirically well-established. The ECB and the Eurosystem as well as the Commission have been working in this domain of research.\textsuperscript{18}

In the EU, some progress has been made in this regard.\textsuperscript{19} For example, several network industries, like telecommunications, are now fully or largely open to competition. A lot remains to be done: the extension and deepening of the EU internal market remains a priority. With service-related activities representing around 70% of value added and employment in the euro area, more competition in the EU service markets is absolutely of the essence.

In this context, the adoption of the Services Directive by the European Parliament in February 2006 constitutes a step forward in the right direction even if it has been somewhat watered down which I regretted. Let us also stress that the mere adoption of Internal Market directives does not

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\textsuperscript{12} Eurostat data.
\textsuperscript{13} OECD Employment Outlook 2006.
\textsuperscript{15} Eurostat data.
\textsuperscript{16} See IMF (2006) paper “Lessons from successful labour market reformers in Europe”.
\textsuperscript{17} See Grubb (2000).
\textsuperscript{18} For further information on this topic, see European Commission (2004), “The link between product market reforms and productivity: direct and indirect impacts”, the EU Economy: 2004 Review.
\textsuperscript{19} See the ECB Occasional Paper Series No 44 “Competition, productivity and prices in the euro area services sector”, by the Task Force of the Monetary Policy Committee of the ESCB, April 2006.
automatically produce benefits. Once adopted, directives must be transposed into national law and enforced in order to produce benefits and Member States have the primary responsibility for these tasks.

The third prerequisite for higher growth in the euro area is the **unlocking of business potential** by creating an entrepreneurial-friendly economic environment. Europe needs more new and thriving firms willing to reap the benefits of opening markets and to embark on creative or innovative ventures for commercial exploitation on a larger scale. It is increasingly new and smaller firms, rather than large ones, that are the major providers of new jobs. The contribution from firm dynamic processes to aggregate labour productivity growth and innovation also plays a major role, in particular in high-tech industries. All in all, an entrepreneurial-friendly economic environment would imply less red tape for small and medium-sized enterprises (SMEs) to help them develop at home and across borders, as well as positive action to ease access to the finance they need. As regards risk capital markets, venture capital (VC) financing is also crucial. Without these funds, many new and innovative companies will simply not emerge. And Europe is significantly lagging behind in this field, as VC financing in Europe remains only a fraction of what it is in the US relative to the size of their economies. The immense importance of having an entrepreneurial-friendly economic environment is however increasingly appreciated by European governments, and several initiatives at national or EU level have started to implement actions for “better regulation”. For example, in March 2006, the European Council called for the establishment of “one-stop-shop” arrangements in each Member State by the end of 2007, which would enable a company to be set up in one week. Today, the number of days needed to set up a new business in the euro area ranges from eight days in France and Portugal to 47 and 38 days in Spain and Greece respectively, compared to only five days in the US.

Fourth, to fully exploit productivity potential, the labour and product market reforms I just mentioned need to be accompanied by policies that help to diffuse **innovation and technological change**. This includes, inter alia, measures to support innovation through higher investment in research and development (R&D). The immense importance of this issue, and the great opportunities provided by investment in research, are also increasingly appreciated by European governments and firms. Europe has set itself the target of achieving a share of 3% of GDP by 2010 and some progress seems to have been made in this regard. According to a recent EU pilot survey on R&D investment, European companies expect their global investment in research and development to grow by about 5% per year over the next three years, which represents a considerable improvement over recent years. At that growth rate, provided it would effectively materialize, European companies would be doing as well as their US counterparts in terms of R&D investment for the first time since a large number of years. The survey also found that European companies continue to prefer to locate R&D activities in their home country, with Germany, the United Kingdom and France topping their lists of favoured destinations.

To make these measures most effective, they need to be accompanied by 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. Policies aimed at improving human capital are usually considered to be of the utmost importance in this field. One possible explanation, commonly mentioned in literature, is that the diffusion of innovation and new technology is associated with a rapid decrease in learning costs over time triggered by the increasing number of users. More widespread knowledge about how to exploit new technology would obviously speed up the rate of diffusion and foster non linear effects as regards the benefits associated with it.

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22 Source, World Bank report “Doing business”. Other data are 10 days for the Netherlands, 13 for Italy, 14 for Finland, 19 for Ireland, 24 for Germany, 27 for Belgium, and 29 for Austria.

Better education and training also helps to reduce mismatches in the labour market and allows for a smoother reallocation of workers between sectors and firms.\textsuperscript{24}

All in all, meeting the challenges of technological progress 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.

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 from 25 to 34 had attained at least upper secondary education, compared to only 46% of persons aged from 55 to 64.\textsuperscript{25}

However, so far investment in human capital in Europe is still clearly inadequate for a “knowledge-intensive” economy. In 2005, the US annual expenditure on higher education institutions per student was 17,890 EUR, while in the euro area only about 7,402 EUR was spent. Furthermore, we need more high quality scientists and researchers. In the EU we have about 5.3 scientists and researchers per thousand workers, compared with the US’s nine per thousand.\textsuperscript{26}

The state of structural reform

If euro area countries 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 so-called Lisbon Strategy, which was put in place during a meeting of the European Council of Heads of State and Government in Lisbon in 2000. Over these first few years, progress has been made in some areas, as is also indicated by an increase in the euro area employment rate. Still, the reforms have not been far-reaching enough and their implementation, in particular, has been too slow, particularly as regards the urgency of these reforms and the opportunity costs associated with this slow motion.

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 to growth and employment. Also, a number of changes were made to the governance framework of the Lisbon Strategy in order to improve the implementation rate of structural reforms. One outcome of this process was that all EU countries had to prepare National Reform Programmes (NRPs) outlining steps for structural reform for the period from 2005 to 2008. Overall, the NRPs appear to reflect a stronger political commitment to the reform process in the context of the Lisbon Strategy, and all euro area governments acknowledge the need for further reforms and the benefits arising from implementing such reforms. It has also been acknowledged that a well-functioning and competitive Internal Market is particularly important for the euro area inasmuch as it will enhance its capacity to adjust smoothly to asymmetric shocks. This will help to more fully reap the substantial benefits of the single currency.

In this context, the NRPs appear to be an important step forward and these efforts are welcomed by the ECB. Indeed, the potential gains are very significant. A recent study finds that if Europe reaches the objectives set down in the Lisbon Strategy (in particular, full implementation of the internal market for services, a reduction of administrative burdens, improvements in human capital as well as the R&D and employment targets), EU GDP could be 12 to 23% higher than otherwise and employment increased by about 11% by 2025.\textsuperscript{27} These figures might look impressive. But these orders of magnitude are not out of reach. Fancy that if only we could go back to our labour productivity yearly progress level of the 80’s, namely 2.5%, we would gain each year around 1.2% of growth knowing that our present average yearly level is 1.3%... 


\textsuperscript{25} OECD (2005) “Education at a glance”.

\textsuperscript{26} OECD Indicators 2005, “Education at a glance”.

\textsuperscript{27} Netherlands Bureau for Economic Policy Analysis (2005) “Five Lisbon highlights: the economic impact of reaching these targets”. This study includes 20 EU countries, excluding Malta, Latvia, Lithuania, Estonia and Cyprus.
Macroeconomic stability to support higher and sustainable growth

As mentioned earlier, the supply-side determinants of long-term growth that I have emphasised should not be understood as an exhaustive explanation for the growth performance of the European economy. We should also look beyond the microeconomics of the supply-side and ensure an appropriate macroeconomic framework in Europe. I am referring now to the national fiscal policies and the single monetary policy.

First of all, sound fiscal policies in Europe are of the essence because they ultimately are supporting growth and stability. Through various channels, including favourable “ricardian” confidence effects, prudent fiscal policies contribute to lower risk premia on long-term interest rates and thus to more favourable financing conditions. This, in turn, promotes investment and long-term growth. It is, amongst others, for these reasons – to have a stable and sustainable fiscal framework for economic growth as well as to support a stability-oriented monetary policy – that the EU has adopted the Stability and Growth Pact.

Beyond that, the “quality” of public finances matters also enormously for growth. The level and composition of government taxes and expenditure has an impact on the way markets function, and they can hinder – or promote – growth. Reducing public spending inefficiency, would pave the way to financing tax cuts. And public expenditure directed towards productivity-enhancing physical and human capital accumulation rather than towards propping up failing enterprises or “sunset industries” is, of course, growth-promoting.

I do not need now to explain in detail why we at the ECB insist that the best contribution monetary policy can make to growth is to maintain price stability. I am in the presence of Hans about whom Time magazine wrote in 1997 “If the Romans had a god of central banking, he might look like Hans Tietmeyer”. Let me make a brief comment about the role of monetary policy in fostering sustainable economic growth in Europe.

What a central bank must do and can do is to avoid, to the extent possible, the negative effects on long-term growth of the uncertainty caused by high, variable and unanticipated inflation. The variability of inflation increases uncertainty and exerts a major negative influence on investment and thus on potential output as well as on other components of aggregate demand. The environment of price stability in line with our definition, the credibility of the ECB in delivering price stability over time and therefore the solid anchoring of inflation expectations, are paving the way for the favourable levels of medium and long term market rates, lending support to sustainable economic activity.

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Es war unser Versprechen, Hans. Das Versprechen, dass wir unseren Mitmenschen, den Haushalten, den Sparen und allen Wirtschaftsakteuren gegeben haben. Wir haben ihnen versprochen, dass die neue Währung mindestens so stabil und vertrauenswürdig sein wird wie ihre nationalen Währung vorher.


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Permettez-moi de dire, en conclusion, dans la langue de Molière après celle de Goethe, que je suis confiant dans l’avenir de l’Europe. L’Europe est une entreprise historique que l’on doit apprécier dans la durée. La signature du Traité de Rome a un demi-siècle, le discours de Robert Schumann sur la communauté du charbon et de l’acier plus d’un demi-siècle. Qui aurait pu penser en 1950 que nous aurions au tout début du siècle suivant une Union européenne de vingt cinq et bientôt vingt sept pays, un parlement élu au suffrage universel, une cour de justice établissant sa jurisprudence sur toute l’Union, un marché unique de 450 millions d’habitants et la même monnaie pour 12 pays et bientôt 13, regroupant 315 millions de concitoyens européens ?

Nous vivons aujourd’hui, sur le plan politique, après le double non néerlandais et français, un moment de doute, de trouble, un temps d’hésitation devant l’avenir. De tels épisodes nous en avons vécus plusieurs au cours des soixante dernières années. Nous les avons toujours dépassés et la construction européenne a repris son cours. Les raisons que nous avions hier de nous engager dans l’immense entreprise de l’Union européenne et d’approfondir cette union sont toujours valables ; sans doute même sont-elles encore plus fondées aujourd’hui qu’hier. C’est pourquoi je suis confiant dans notre capacité de surmonter à terme nos difficultés présentes : les rendez-vous historiques de l’Europe doivent s’apprécier dans la longue durée. Par ailleurs l’imprévisibilité du cours actuel de l’Union politique est la marque même de l’histoire qui se fait.

Jean Monnet, cet optimiste, dont les idées sont la source même de la construction européenne, écrit à la fin de ses Mémoires :

« Ceux qui ne veulent rien entreprendre parce qu’ils ne sont pas assurés que les choses iront comme ils l’ont arrêté par avance se condamnent à l’immobilité. Personne ne peut dire aujourd’hui la forme qu’aura l’Europe où nous vivrons demain, car le changement qui naîtra du changement est imprévisible ».

Je vous remercie de votre attention.