Lucas Papademos: Economic performance, institutions, and human values

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I. Introduction

This conference focuses on a fundamental and broad topic of relevance to all fields of science and public policy: the importance of human values. The role of human values in shaping developments in different fields of science, in assessing the implications of scientific advances and in adopting appropriate policies is steadily becoming more widely recognised and better understood. This observation is also true for economic science and public policy.

Over the past half-century, economic science – both theoretical analysis and empirical research – underwent a profound transformation with the progressive and extensive adoption of mathematical analysis, statistical methodology and use of computing technology. The "dismal science" has become more of a true science. However, the vast majority of the significant advances in economic theory and empirical analysis has placed little emphasis on the role of values as well as institutions in influencing the behaviour of economic agents, the overall functioning of the economy and the orientation or conduct of economic policy. This fact may seem rather odd since in previous years the importance of institutions and underlying values was at the centre of economic and political thought.

The relative de-emphasis of institutions and values since the middle of the 20th century did not reflect a lack of recognition of their significance in affecting economic behaviour and public policy. I would argue that it was largely the result of various factors and assumptions: first, that for a given country institutions and values could be taken as given elements of the broader economic environment that evolved very gradually over time; second, that their effects on economic behaviour were indirect and relatively small, compared with the influence of other determining factors of demand and supply; and third, that their role in explaining market developments and economic relationships would be captured in terms of two key fundamental market determinants: "productive technology" and "preferences" of economic agents and authorities.

There are two key questions of scientific and policy relevance. First, what are the underlying factors and forces that shape preferences, drive scientific and technological advances, foster innovation and nurture an entrepreneurial spirit that ultimately are encapsulated in the economy's production processes and the functioning of markets? Second, to what extent does the observed economic performance of nations reflect these underlying factors and forces, which may be partly captured by economic institutions and prevailing economic cultures and social models? Since the late 1990s, increasing attention has been paid by economists and policy-makers to finding answers to these questions. Recent economic research – both analytical and empirical – is seeking to further explore how the economy's performance is influenced by institutions and values; and, more generally, how the economy's functioning may change if we relax some of the simplifying assumptions about (1) the behaviour of a seemingly "valueless", perfectly rational *homo oeconomicus*; and (2) the functioning of markets that are "perfect and complete", characterised by full information, rational expectations and largely unaffected by cultural and social values.

In my presentation, I will address some of these issues by examining how and to what extent institutions and values may be affecting the performance of the European economy. To this end, I will first sketch out a simple conceptual framework indicating how economic performance, the functioning of markets, institutions and human values relate to each other. Second, I will show how the growth performance of the European economy – compared to that of the United States – can be accounted for by differences in the trend growth rates of productivity, labour utilisation and population; and then I will discuss – on the basis of the empirical evidence available – the role of economic institutions, social preferences, values and attitudes in explaining, at least partly, these differences. A key issue of practical and policy relevance is whether European economic performance can, in fact, be improved without giving up values or preferences that are considered to be quintessentially European. But since there is no unique "European Social Model", I will then explore how differences in economic institutions, reflecting different cultural values and social models, may explain the divergence in the growth performance of European countries. Finally, I will focus on the other important dimension of

economic performance and a central policy objective: price stability. I will demonstrate the crucial role of the institutional frameworks for central banking and fiscal policy implementation in ensuring the preservation of price stability and the sustainability of economic growth.

II. Economic performance, markets, institutions and values: a simple conceptual framework

Before addressing the issues I have raised, it will be useful to define the various concepts more precisely and to specify a simple framework that describes their likely relationships and potential effects. Needless to say, the aim is not to formulate a comprehensive theory but to sketch out a conceptual structure that can help organise our thinking and analysis. This is illustrated in slide 3.

The economic performance of a country or economic area will be measured by its trend rate of economic growth and its ability to preserve price stability. These indicators of macroeconomic performance are the aggregate outcome of market mechanisms and forces and of the effects of economic and monetary policies. Economic institutions, as well as other types of institutions (e.g. legal) underpin the functioning of product, labour capital and money markets. They establish the "framework conditions" for the actions of economic agents, and also define the objectives and scope of public policies. The final – and fundamental – layer of this structure underlying both markets and institutions is the set of "human values" which potentially influences and interacts with both.

I will use the term "human values", or simply "values" in a broad sense: to include social and cultural values which are reflected in people's preferences and attitudes and which influence their behaviour, including their actions as economic agents and market participants. Edmund Phelps (2006), in a very recent paper, uses the term "economic culture" to describe the set of "cultural values, attitudes, morals and beliefs". His concept is similar to the one I have defined as "values" and it seems to relate more to cultural attributes than pertain closely to economic behaviour.

In principle, values can affect markets and economic performance both directly and indirectly, that is by shaping the features, objectives and functioning of institutions. There can also be interactions and feedback effects. The history of economic and political thought reminds us that great philosophers and economists, starting with Aristotle and including the Enlightenment thinkers like Adam Smith, David Hume, Immanuel Kant, and later on Max Weber (1905) and Joseph Schumpeter (1911), emphasised the role and influence of a society's values or culture for the functioning and performance of the economy. Karl Marx's (1867) work also centred on this relationship, but he stressed the reverse causation: the effect of the economy's structure and markets on society's values and culture.

In recent years, and after a prolonged period of neglect, the role of values or culture as an underlying determinant of market efficiency and overall economic performance has been emphasised and explored by, among others, Banfield (1958), Aghion and Howitt (1998, 2005), Eggertson (2005), Blanchard (2000, 2003, 2004), Layard (2003), Bruni and Porta (2005), Sapir (2004, 2005) and Edmund Phelps (1973, 2003, 2006), winner of the Nobel Prize in economics last year.

III. Economic growth in Europe and the United States: the contribution of productivity, labour utilisation and population

Let me now address these issues by examining the growth performance of the European economy. I will use as a benchmark for comparison and assessment the US economy, which is comparable in size and degree of development to Europe's and which has experienced high growth rates, especially since the mid-1990s. Economic growth in Europe over the past decade and a half, and especially since the mid-1990s, has been below our expectations and unsatisfactory in comparison with the United States. The average growth rate for the euro area in the period 1990-2005, was 2.0%, noticeably below the average growth of 2.3% recorded in the 1980s (1980-1989). Moreover, the gap in real GDP growth between the United States and the euro area widened over the period 1980-2005, as shown in Chart 1. During the 1980s, aggregate output growth in the euro area was on average about 0.5 percentage point lower than the US rate of growth. Since the early 1990s, this gap has widened. During the past decade (1996-2005), when the euro area economy expanded on average at a relatively robust pace of 2.3%, within the range of estimates of its potential growth rate, the US economy experienced an economic boom driven mainly by advances in information and communication technologies and grew by an average rate of 3.4%, that is about 1 percentage point higher than the euro area average rate of growth (see Chart 2). We are currently experiencing a

turnaround in the relative growth performance of the euro area and the US, which I will discuss later on. But I want first to focus on an examination of some key determinants of long-term growth of the European economy on the basis of its past performance.

The relative decline in Europe's trend growth since the mid-1990s does not imply that Europe has become a poorer continent: people's living standards, as measured by real GDP per capita, have risen significantly over the past decade, especially in some countries including Greece. The European economy has enjoyed macroeonomic stability; there have been no financial crisis or severe fiscal imbalances although budgetary policies in a number of countries faced serious challenges. Europe is home to competitive and globally successful companies; it enjoys comparably efficient and effective public services; it boasts world-class infrastructure; it maintains advanced education systems and generates internationally competitive top technology. And, at the same time, the contours of what may be called the European Social Model have remained intact: a well-developed welfare system provides a safety net for the needy; income inequality is relatively contained, especially when compared to other parts of the world.

Nevertheless, in a comparative perspective, in the light of the economic growth rates registered in the United States – not to speak of the spectacular growth dynamics in some emerging market economies – the performance of the euro area economy has been rather disappointing. What are the reasons? Taking a long-term perspective, and looking beyond the short-term fluctuations of the business cycle, we must examine the fundamental determinants of its potential or long-term economic growth: demographic trends, developments in labour utilisation and productivity and the variety of underlying factors that affect the ability of the European economy to achieve increased efficiency and to create more employment. In order to better understand and assess the relative contribution of these determining factors, it is useful to express, by employing a growth accounting framework, GDP growth in terms of the rates of change in productivity, labour utilisation and population.

Table 1 shows the extent to which the rates of change in these three variables have contributed to real GDP growth in the euro area and in the United States over the period 1996-2005. A number of interesting conclusions emerge from this decomposition of average economic growth. Since the mid-1990s, euro area real GDP growth has been driven mainly by labour productivity growth as measured by the rate of change in real GDP per hour worked. However, average productivity growth in the United States was significantly higher, by almost one percentage point. US output growth also benefited from faster population growth, which exceeded that of the euro area by 0.7 of a percentage point. The degree of labour utilisation improved in the euro area and had a positive effect on its growth. In the United States, by contrast, it remained unchanged on average and thus had no impact on growth.

The most important determinant of long-term or potential output growth in both the euro area and the United States is labour productivity. In the euro area, however, productivity growth has declined since the early 1980s, and it continued to decline further in the more recent period 1996-2005, when it fell, for the first time, below that of the United States.[1] Chart 3 shows the turnaround in the labour productivity growth performance between the euro area and the United States since the mid-1990s. In the period from 1996 to 2005, most of the real GDP growth gap (about 80%) between the United States and the euro area could be attributed to differences in labour productivity growth (measured by real GDP per hour worked), the remaining gap (about 20%) being explained by the joint effect of population growth and the rate of change in the degree of labour utilisation.

Labour utilisation, that is, the extent to which labour potentially available in the economy is effectively utilised, can be defined as hours worked per head of total population. This is the second important determinant of economic growth. It can be expressed as the sum of four components: average hours worked per employed person, the unemployment rate, the labour force participation rate and the share of the working age population in the total population. Let us look at these components one by one. The contribution to growth of the participation rate and hours worked has been much lower in the more recent past than in the 1960s and 1970s. The lower level of the participation rate and significant

[1] The decline in euro area productivity growth is manifest irrespective of the measure of labour input used. In Europe, however, productivity growth has generally been higher when it is measured per hour worked rather than by per person employed. Productivity comparisons across countries face various statistical or methodological problems. Nevertheless, it appears that productivity growth developments in the euro area and the United States are largely independent of the concepts used.

reductions in working hours per person employed in the euro area can certainly help explain the widening of the gap in the level of output per capita between the euro area and the United States.

Table 2 shows how the rate of change in labour utilisation can be decomposed into the rates of change of the four variables I referred to. The decomposition is useful because it helps to better understand the relative contribution of developments and factors affecting labour utilisation. Some of these factors can be influenced by policies and changes in economic institutions in a way that can contribute to improving the economy's growth performance. Since the mid-1990s, labour utilisation in the euro area has increased, also relative to the United States. This has contributed positively to euro area growth and to narrowing the growth gap with the United States. However, despite this improvement, the level of labour utilisation – as opposed to its rate of change – in the euro area remains much lower than in the United States. This fact reflects a lower labour force participation rate, a higher unemployment rate, and lower average working hours per person employed in the euro area.

The figures in Table 2 show how labour utilisation, and thus GDP growth, in the euro area have been supported by an increase in the share of the working age population that is employed (labour force participation has risen significantly and the unemployment rate has declined somewhat). At the same time, those employed are working, on average, fewer hours, and this has negatively affected labour utilisation. Moreover, despite the relative improvement in the unemployment and labour force participation rates over the past few years, the unemployment rate in the euro area is currently still around 3 percentage points higher, and the labour force participation rate around 6 percentage points lower, than the corresponding figures for the United States (see Chart 4). So although significant progress has been made in raising labour participation and in reducing the unemployment rate, there is still room for increasing the rate of utilisation of the labour force.

As I stated earlier, euro area growth has been adversely affected by a continued decline in average hours worked per person employed. Data for the business sector show that in 2005, Europeans worked, on average, 300 hours less per year than Americans, and less then they did in the early 1980s (see Chart 5). This gap between the United States and the euro area, which has been widening, reflects the shortening of statutory full-time working weeks and a rise in part-time employment in the euro area (see Blanchard, 2004).

Finally, the more dynamic demographic developments in the United States account for a substantial fraction of the real GDP growth gap over the past ten years. Since the mid-1990s, population growth has been on average about four times higher in the United States than in the euro area. This implies that living standards in the euro area, in terms of real GDP per capita, continued to improve and developed more favourably than indicated by relative real GDP growth rates. At the same time, what is worrisome is that the gap in population growth has been even larger with regard to growth in the working age population, which manifests that Europe has a more acute problem of population ageing.

IV. Economic growth in Europe: the role of institutions and values

IV.1. Market structures and economic institutions

Policy-makers in Europe have recognised the structural weaknesses of the European economy and have put together a range of reforms and policy measures seeking to remedy the deficiencies identified. The revised and refocused Lisbon strategy, which aims at making the EU "the most dynamic and competitive knowledge-based economy in the world" by 2010, outlines the main areas where policy action is needed (see European Community (2004) and Sapir et al. (2003)). There are five broad areas where reforms are urgently needed: first, reforms to improve education (and on-the-job training), boost research and development, enhance innovation and facilitate the diffusion of technological advances, so as to fully exploit the potential of an increasingly knowledge-based economy; second, reforms to increase competition in product and services markets; third, reforms in labour markets to increase flexibility and adaptability of the workforce; fourth, policies and institutions to create a more favourable business climate; and fifth, reforms to promote integration, enhance competition and foster innovation in European financial markets, with a special emphasis on venture capital.

Time constraints do not permit me to go into detail on the multitude of the necessary reforms that I mentioned. What I would like to do, in line with the topic of my presentation, is to examine and explain how and why the necessary adjustments to market structures should be accompanied by fundamental adaptations of the pertinent economic institutions and changes in social attitudes (which are much

harder to achieve), in order to improve the performance of the European economy.[2] To this end, I will now concentrate my remarks on the labour market. In other recent papers, I have examined the role of the financial sector and of education in fostering Europe's growth performance.

The importance of institutions for the functioning of labour markets in Europe can hardly be overstated. In fact, it has been estimated that one half of the dramatic increase in European unemployment from the golden days of full employment in the 1960s to the high and persistent unemployment levels of the mid-1990s can be explained by institutional factors (Nickell et al., 2002). Which "institutions" are particularly relevant? Let me mention three of them: first and foremost, employment protection legislation. Second, tax-benefit-systems, which determine the so-called tax wedge between workers' gross and net incomes, the transfers to the unemployed, and the tax burden on the employed. Third, wage bargaining structures and procedures and the role of trade unions. Let us consider employment protection legislation.

Workers can be protected against unemployment in various ways: either by strict regulations against layoffs, or through unemployment benefits, or a combination of both. The two are interrelated: in theory, employment protection legislation need not be very restrictive if an unemployed worker can rely on generous benefits, and vice versa. What does the empirical evidence tell us? Generous protection of "insiders", i.e. those who have a job, seems to have a negative impact on overall employment, since it affects the probability of employment of the "outsiders", especially women, the young and the long-term unemployed.[3] The validity of this proposition is illustrated in Chart 6 on the basis of the evidence from European countries. The lower job turnover and hiring also increases both the duration of unemployment and the proportion of long-term unemployed. The impact of employment protection legislation may be particularly adverse in industries that are subject to rapid technological change. In the context of increasing international economic integration, policies that constrain the reallocation of workers from uncompetitive industries to industries with a comparative advantage can adversely affect output and employment. To address the challenges of globalisation, institutions have to be in place to ensure that people are equipped with the right skills to safeguard their employability (Gordon 2004).

These arguments do not imply that workers cannot be protected against unemployment in an efficient manner. An alternative approach is "protect the worker, not the job". A less restrictive framework of employment protection would go hand in hand with better unemployment benefits. Such a combination of labour market institutions is at the core of the Danish so-called "flexicurity" model, which has recently received considerable attention. In Denmark, job turnover is also relatively efficient, possibly as a result of relatively long notification periods which allow displaced workers to search for their next job in good time, aided by active labour market measures (such a training, etc.). As a result, the rate of long term unemployment is low.

Another pertinent point, supported by the empirical evidence, is that rigidities in labour markets and restrictive product market regulations are also closely connected. Recent studies have shown a high correlation between employment protection legislation and restrictive product market regulations across OECD countries (Nicoletti and Scarpetta (2005)). This should not come as a surprise, since it is much easier to sustain a high level of employment protection in an industry if competitors are kept out of its market. Therefore, amendments to employment protection legislation should be considered in relation to the implementation of product market reforms to promote competition. Fostering, promoting competition in product markets will facilitate the implementation of labour market reforms.

These arguments suggest that the envisaged policy actions in line with the Lisbon strategy aimed at improving the functioning of labour and product markets – and the review of the institutions that determine their organisation which this reform agenda entails – can be expected to have mutually reinforcing beneficial effects on the performance of the economy. The improvement in labour utilisation in the euro area witnessed in recent years partly reflects the favourable effects of past labour market reforms. However, when looking at the levels of unemployment and labour force participation rates, it is clear that, despite the progress made, further improvements on both of these labour market fronts are possible and urgently needed.

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[2] See, inter alia, Nicoletti et al. (2000) and Nickell and Nunziata (2001).

[3] See Bassanini and Duval (2006).

IV.2. Values, preferences and economic culture

Institutions that are inappropriately designed are thus at least partly responsible for the unsatisfactory performance of the European economy. However, we should go one step further and look at the social values and preferences that influence the behaviour of economic agents who interact with, and are affected by, the economic institutions referred to earlier. After all, the various reforms envisaged in the Lisbon agenda will fail to produce tangible results if they run counter to what many Europeans perceive to be quintessentially European values, preferences and attitudes. As outlined in the simple conceptual framework introduced earlier, economic performance and the functioning of markets can be directly influenced by values and deeply held beliefs – such as self-realisation, fulfilment in life and other post-materialist values; the relative importance of work, achievement and success; freedom, competition and cooperation; tradition and religion; family and community; safety and protection, etc.

A number of economists have argued that lower labour force participation rates and shorter working hours in Europe relative to the US may reflect a preference on the part of Europeans for more leisure time over additional income.[4] In other words, that Europeans seem to place more value on extra leisure than having a few extra euros in their pockets, while Protestant work ethics and a more materialistic attitude to life drive Americans to work harder. Other examples of differences in values are that European women may prefer relatively more to stay at home to look after their children than pursuing their professional careers in parallel; that older people place greater value on enjoying the fruits of their working life through early retirement rather than continuing to seek gainful employment until – or even beyond – the official retirement age.

Nobel Laureate Edmund Phelps has recently investigated and sought to estimate empirically, by employing econometric techniques, the possible direct effects of deeply held values by people interviewed for the World Values Survey on some of the key determinants of economic performance that I discussed earlier: labour participation and productivity. He found, for example, that the lower number of Europeans, compared to Americans and other nationalities, stating that their job is most important in their lives is significant in explaining lower labour participation rates and lower employment in Europe (Phelps 2006). Furthermore, he found that the more people take pride in their work, the greater is their participation in the labour market, and the larger the reduction in unemployment. In other words, the evidence suggests that (1) Europeans are not as deeply involved in their jobs and place relatively lesser importance on work – compared to, say, Americans or Japanese – and (2) this fact can be directly linked to lower labour participation rates and higher unemployment rates, and thus to slower economic growth in Europe.

Similar direct effects could be identified in connection with productivity: Phelps found that "acceptance of competition" by the public has a strong impact on productivity, meaning that in countries where a majority of people state that competition is helpful rather than harmful, productivity in the economy is higher. Similarly, the more people value the opportunity to use initiative in their job, the better the productivity performance of the economy.

Although this is a partial analysis, these findings provide some striking evidence of direct linkages between values, institutions and economic performance. An understanding of deeply held values, attitudes and preferences may thus help in explaining some of the differences in productivity and labour utilisation between Europe and the United States. However, more work is needed to test the robustness of the empirical results and to better understand conceptually the linkages between values and the "intermediate" determinants of economic performance such as productivity and labour utilisation. Moreover, differences within Europe are significant and need to be taken into account.

V. Economic performance of European countries: the influence of social values and economic culture

Indeed, Europe is "united in diversity", as a suggested motto of the European Union states. A comparison of the growth performance of the US and European economies masks considerable diversity, on both sides of the Atlantic, but especially among European countries, as Chart 7 shows. A diversity of growth rates among the members of large monetary unions, such as the euro area and the US, is not unusual. In fact, the dispersion of growth and inflation rates within the euro area since the

[4] See Blanchard (2004) and Alesina and Giavazzi (2006).

introduction of the euro is very similar to that observed across regions and states in the US. What is characteristic of Europe, however, is the persistence of the observed dispersion in growth rates. This persistence may be attributed to a number of factors, such as the stimulative effects of historically low interest rates, which sustained dynamic growth over recent years, especially in Spain, Ireland and Greece. Another important factor, which has received increasing attention, is the potential longer-lasting influence of differences in economic institutions and social values, encapsulated in the so-called social models, of different European countries on their economic performance. As Sapir (2005) has observed, "the notion of a single "European Social Model" is largely misleading."

The prevailing social models in European countries can be meaningfully grouped into four types, as shown in Chart 8:

First, there is what could be called the Nordic model, which applies to Scandinavia, Finland and also includes the Netherlands: in this model, social protection benefits, universal welfare provision and active labour market policies are highly developed. Public sector employment is significant by any standards. The associated fiscal expenditures are large, necessitating comparatively high tax rates. Powerful labour unions ensure that wage disparities remain limited. This model has contributed to generating high employment rates, in combination of with a low risk of poverty and relative income equality.

Second, the Anglo-Saxon model, prevailing in the United Kingdom and Ireland: in this model, the welfare system provides a relatively limited safety net of social protection. Employment protection legislation is rather weak, recipients of benefits have to be actively searching for employment and flexibility in labour markets is considerable. Unionisation is low and there is a rather large dispersion in wages between very low pay and very high salaries. Overall, this model has a good record of generating growth and employment, but does not appear as equitable as other models.

Third, in Germany, France, Belgium, Luxembourg and Austria, the Continental model prevails. Here, the welfare state essentially consists of insurance-based unemployment benefit and pensions systems, meaning transfers are seen as unconditional entitlements, which influence the propensity to actively seek work. Trade unions, despite a general weakening over the past years, are still influential, and income disparity is relatively low. The Continental model seems to insure people relatively well against poverty but it may do so with less efficiency and unsustainably: low levels of labour utilisation (in terms of the number of people employed and hours worked) and a relatively large public sector have put pressure on public finances.

Fourth, the Mediterranean model, which can be identified in Greece, Italy, Portugal and Spain. Strict employment protection legislation and early retirement schemes keep employment levels below those of other models, because insiders are protected and incentives to take up work are not adequate. At the same time, a relatively low coverage of unemployment benefits means that the risk of poverty is comparably high. Rigid wage bargaining structures in the formal economy generate a highly compressed wage structure. Together with a large and inefficient public sector, the features of this model may render public finances increasingly unsustainable.

The differences in the institutional features of the four models and the related growth and employment performance clearly show the relationship between values, institutions and economic outcomes. While, in the first place, there might be differences in the importance which the various European nations attach to fundamental values such as protection from poverty, safety of employment or income equality, the resulting domestic institutions and regulations make a crucial difference. For example, whether countries choose to protect workers from unemployment through restrictive employment protection legislation or through generous unemployment benefits has an impact on the overall level of employment: stricter employment protection legislation in the Continental and Mediterranean models appears to a have an adverse impact on employment creation, whereas generous unemployment benefits seem to play only a secondary role.[5] Similarly, the probability of escaping poverty is greater in the Nordic and the Continental models, which is not only the result of a generous tax-benefit system, but also a consequence of higher human capital endowments (see Chart 8).

[5] See Sapir (2005), as well as recent work at the OECD, e.g. van den Noord et al (2006).

The differences in social models across European countries are likely to persist, precisely because the underlying values and preferences are different. What policy-makers can, and should, do is to learn from each other and from the different practices and experiences, assess what works and what does not, and then adapt the most promising ideas about economic institutions and regulations to the local conditions and the prevailing economic cultures. This is in fact a great advantage of the European Union's unique cooperative framework. It can make possible what is neatly encapsulated in the title of a paper by Tito Boeri (2002): "Let Social Policy Models Compete and Europe Will Win".

VI. Price stability: the role of the institutional framework for central banks and fiscal policy

As stated at the outset, a country's economic performance pertains to both economic growth and stability. Macroeconomic stability includes, inter alia, first and foremost price stability, which ensures that a currency keeps its purchasing power and retains the trust of the people. It also includes a stable financial system as well as prudent and sustainable fiscal policies. Also for this aspect of economic performance, the central proposition I have emphasised in the context of the presented conceptual framework remains intact: institutions matter and the social values of economic agents are embodied in appropriately designed institutions. A characteristic and important example is the set of institutions, fiscal rules and provisions enshrined in the Treaty on European Union which lay the foundation for the maintenance of price stability and the pursuit of sound fiscal policies.

The preservation of price stability in a modern economy with fiat money is the responsibility of central banks. Their monetary policy can ensure control of the price level over the medium and longer term. The effectiveness with which monetary policy can attain and maintain price stability depends on various factors pertaining to the way monetary policy is formulated and conducted. An essential condition for the effective conduct of monetary policy is the central bank's independence so that it can take decisions on the appropriate policy to achieve its objectives without being subject to any pressure or interference by the government and any other political authorities. There are strong theoretical arguments why the central bank should be independent. But the most convincing reason, which has led many governments to de-politicise monetary policy and grant independence to the central bank as an economic institution, is past experience and the empirical evidence.

Europe's "monetary constitution" builds on the experiences of a long historical process of trial-and-error, often with painful economic consequences, which led to the insight that in order to "safeguard the currency" (Bundesbank Act of 1957) and "defend the savings" of the people (Banca d'Italia mandate), the management of the currency should be entrusted to an independent central bank, with the primary objective of maintaining price stability, and which should not be allowed to directly finance the public sector. The extensive empirical evidence collected over many years and for a wide range of countries broadly and unambiguously confirms the beneficial effects of central bank autonomy for inflation performance.[6] Chart 9 clearly demonstrates that countries with more independent central banks have enjoyed lower average inflation without experiencing lower average economic growth (Blinder, 1998). Recent studies show that central banks in most countries (not only in advanced economies but also in emerging market and developing countries) have been granted higher degrees of autonomy over the past twenty years (Arnone, 2007). In addition, in the low-inflation environment currently prevailing in industrialised countries, those central banks endowed with a larger degree of independence are succeeding in maintaining price stability, as recent work at the ECB has demonstrated (Moutot et al., 2007).

The high degree of independence granted to the ECB and the national central banks of the euro area countries by the political authorities of the European Union is the outcome of past experience and their assessment that the autonomy of the central bank as an institution is essential for the effective achievement of its primary objective. Moreover, the ECB as an independent institution embodies the value which the people of Europe attach to price stability. And, if you allow me, with all due modesty I would like to point to the Eurosystem's successful performance over the past eight years in maintaining price stability and delivering a stable currency that can be trusted by 318 million Europeans. Moreover, the track-record of preserving price stability and the credibility of the ECB's monetary policy have contributed to fostering long-term growth and job creation in the euro area

[6] See for example, Alesina and Summers (1993), Fischer (1994), Eijffinger and De Haan (1996), Blinder (1998) and, more recently, Arnone et al., (2007) and Moutot et al (2007).

through various channels, including the solid anchoring of long-term inflation expectations to price stability.

Similarly, the history and experience – not least in this country – of persistent public sector deficits, and the resulting accumulation of crippling mountains of government debt led to the recognition that the "economic constitution" of Europe had to provide appropriate safeguards. In view of the harmful long-term effects of expansionary and stop-and-go fiscal policies, the degree of discretion of fiscal policy-makers had to be limited and clear yardsticks for responsible policy choices had to be provided (see Lucas, 1980). Europe's solution was the Stability and Growth Pact, a rules-based fiscal policy framework binding all Member States and which is essential for the orientation and coordination of national fiscal policies towards sound and sustainable public finances. However, the notion of "the law as the guardian of economic wisdom" (Herdegen, 1998) is widespread: the fiscal responsibility laws in New Zealand, the constitutional obligations to produce balanced budgets in all US Federal States (except Vermont), or the "Golden Rule" of the German Basic Law which prohibits the government from borrowing more than it spends on investment, are all based on this reasoning. It is the same reasoning that led Odysseus to have himself tied to the mast of his ship in order to achieve his long-term primary objective to return home and effectively avoid the temptations of the sirens songs and the potential short-term benefits but also long-term risks they entailed.

VII. Concluding remarks

I have covered a lot of ground and I should not further test your patience. But the topic of my presentation involved a variety of issues and policy dimensions. The relationships between economic performance, market structures, economic institutions and social values are complex and characterised by a multitude of direct and indirect interlinkages. Moreover, the attempt to examine and illustrate these relationships on the basis of the performance and the available empirical evidence for the European economy – in comparison with that of the US but also with the benefit of the different practices and experiences in European countries – did require some time for exposition; but, I believe, it has provided us with some useful conclusions of policy relevance.

Let me end on an optimistic note. The European economy is currently experiencing robust economic growth which is expected to continue, benefiting from the ongoing strength of global economic activity, despite the slowdown of the US economy, but primarily relying on internal sources of growth, with domestic demand projected to expand at a solid pace. There are, of course, uncertainties and several risks surrounding this central and likely scenario. But, at the same time, there are encouraging signs that the supply-side of the European economy is responding positively to the reforms in markets and institutions implemented over the past few years. Productivity growth is picking up, employment is rising and the unemployment rate is projected to further decline. If future developments and further analysis confirm the indications of supply-side improvements, we can look forward to a gradual increase in the European economy's potential for higher sustainable growth. The best way to secure this favourable prospect is to continue with the implementation of the necessary reforms in markets and institutions and with the adoption of best practices on the basis of a free exchange and competition of ideas and social values.

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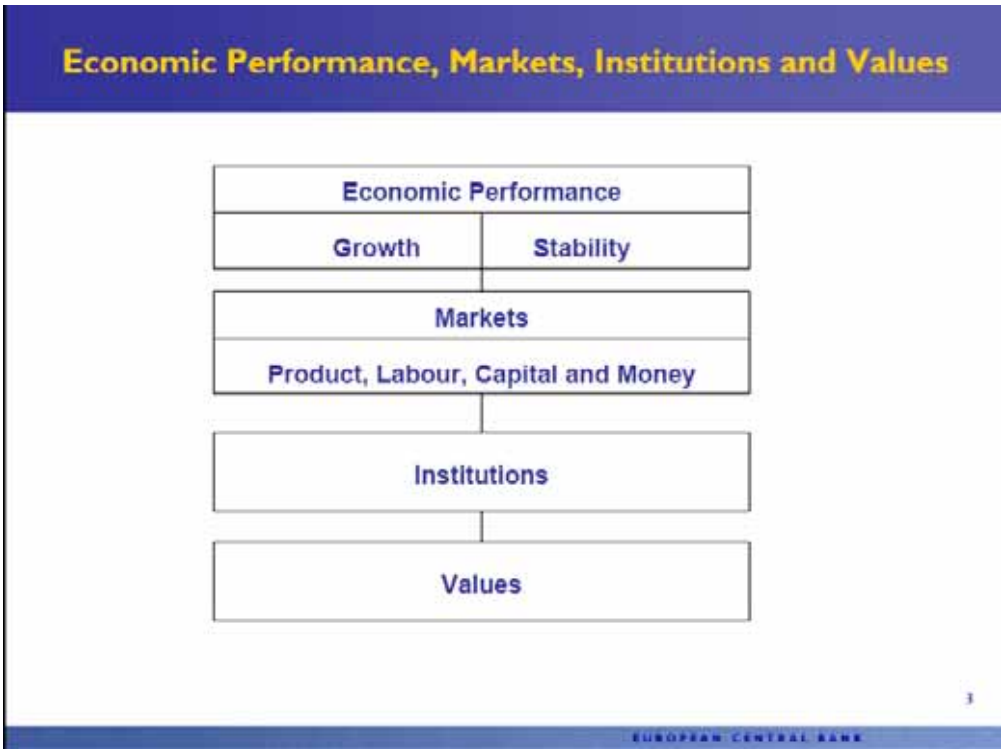
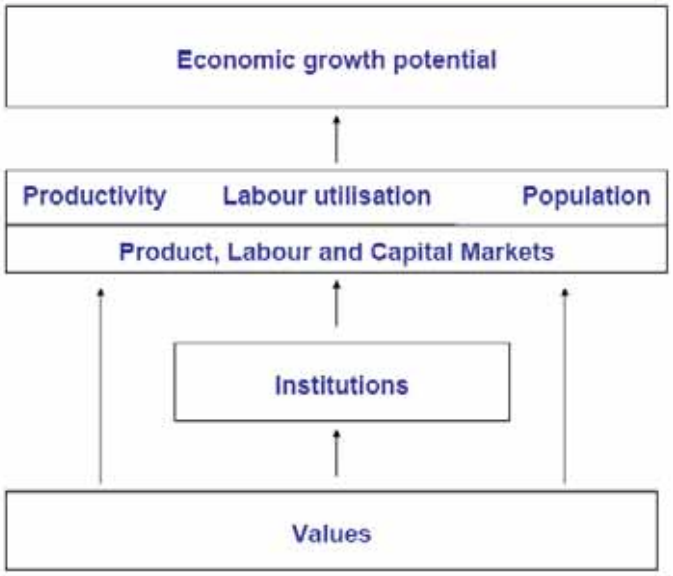


Economic Growth



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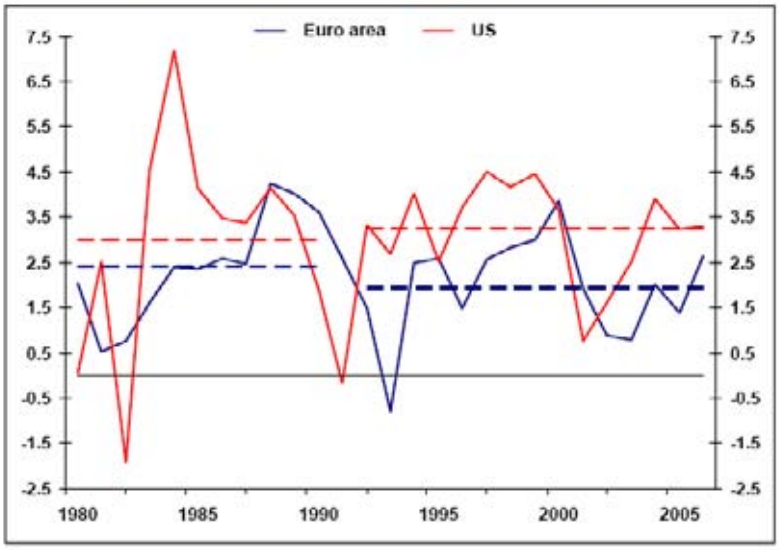
EUROPEAN CENTRAL BANK

Chart 1: The gap in real GDP growth between the United States and the euro area has widened



Source: European Commission (AMECO database).

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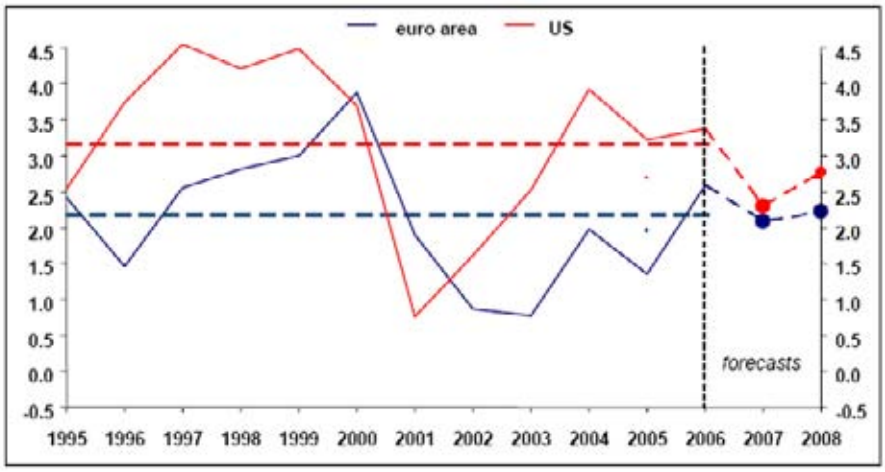
EUROPEAN CENTRAL BANK

Chart 2: The gap in real GDP growth over the past decade

real GDP at 1995 prices, annual percentage changes



Source: European Commission (AMECO database). Commission Forecasts Autumn 2006.

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EUROPEAN CENTRAL BANK

Table 1: Decomposition of real GDP growth in the euro area and the United States, 1996 – 2005

Percentage changes and percentage points per annum

	GDP	GDP per hour worked	Labour utilisation	Total Population
	sum (a) to (c)	(a)	(b)	(c)
(1) euro area	2.3	1.3	0.5	0.5
(2) United States	3.4	2.2	0	1.2
(2) - (1)	1.1	0.9	-0.5	0.7

Source: European Commission (AMECO database), OECD (Economic Outlook database) and ECB calculations.

Note: Figures may not add up due to rounding.

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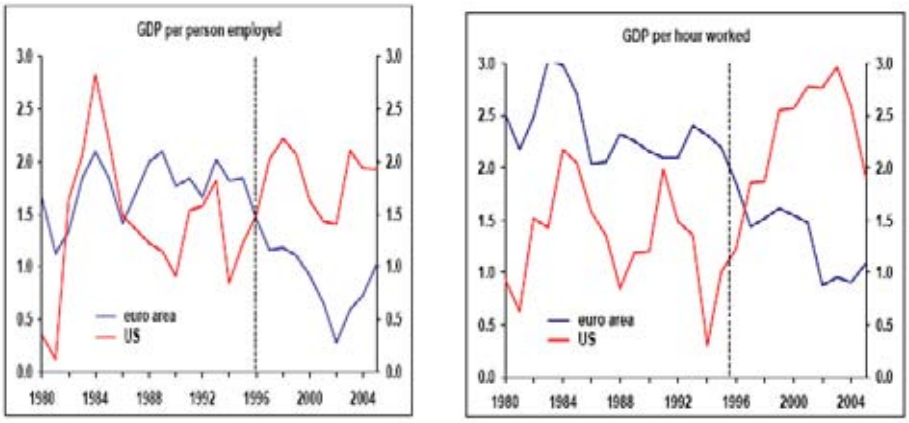
EUROPEAN CENTRAL BANK

Chart 3: Turnaround in labour productivity performance between the euro area and the US since the mid-1990s



Source: European Commission (AMECO database), and Groningen Growth and Development Centre Total Economy Database and ECB calculations. Data shown are three-year centred moving averages.

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EUROPEAN CENTRAL BANK

Table 2: Decomposition of labour utilisation growth in the euro area and the United States (1996 – 2005)

percentage changes and percentage points per annum

	Labour utilisation	Labour force participation rate	Unemployment rate	Average hours worked per person employed	Share of working age population in total population
	sum (a) to (d)	(a)	(b)	(c)	(c)
Euro area	0.5	0.7	0.3	-0.4	-0.1
United States	0.0	0.0	0.1	-0.3	0.2

Source: European Commission (AMECO database), OECD (Economic Outlook database) and ECB calculations.

Note: Figures may not add up due to rounding. Positive contributions from unemployment reflect a decline in unemployment rate.

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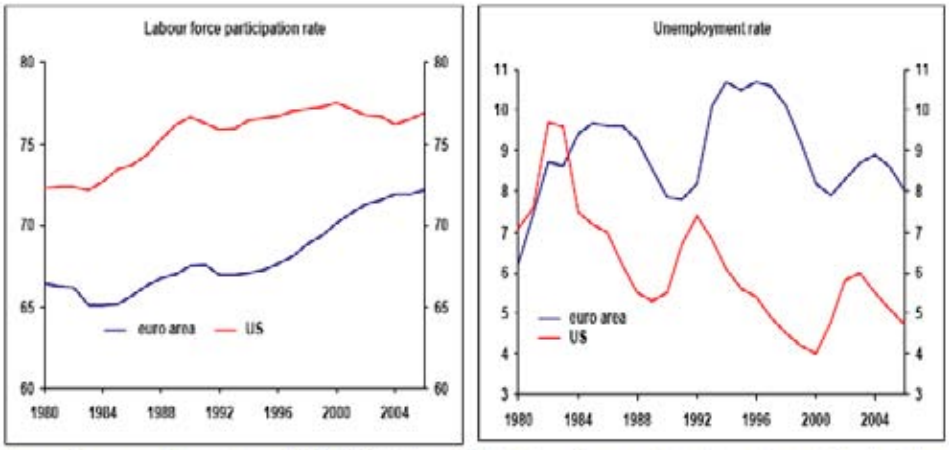
EUROPEAN CENTRAL BANK

Chart 4: Labour utilisation determinants (I): participation and unemployment rates (in % terms)



Source: European Commission (AMECO database). The labour force participation rate is defined as the ratio of the total labour force (employment and unemployment) to the working age population.

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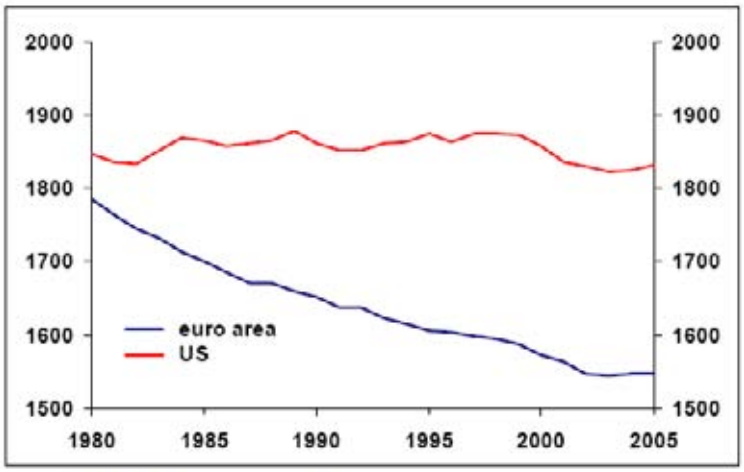
Chart 5: Labour utilisation determinants (II): average hours worked



Source: OECD Economic Outlook Database.

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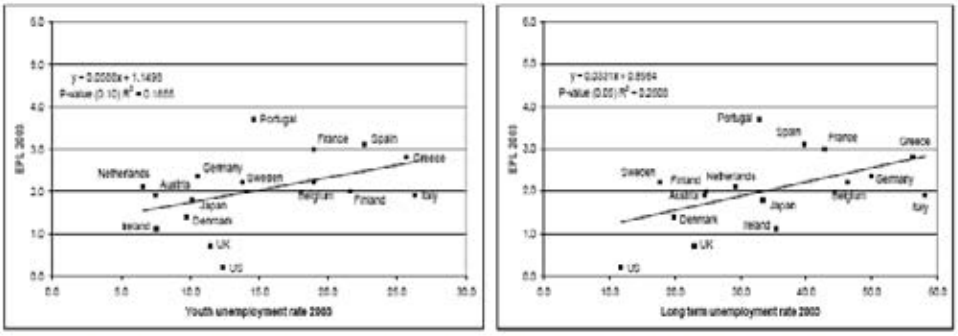
EUROPEAN CENTRAL BANK

Chart 6: The impact of labour market institutions: Employment protection legislation and labour market outcomes

Strictness of employment protection legislation (EPL)
(aggregate measure: value 0 to 6 = low to high EPL) and the rate of:

youth unemployment | **long-term unemployment**



Source: Source: OECD (2004, 2005) Employment Outlook, OECD (1994), The OECD Jobs Study

Note: The equations show the fit and significance (p-value) of the regression line

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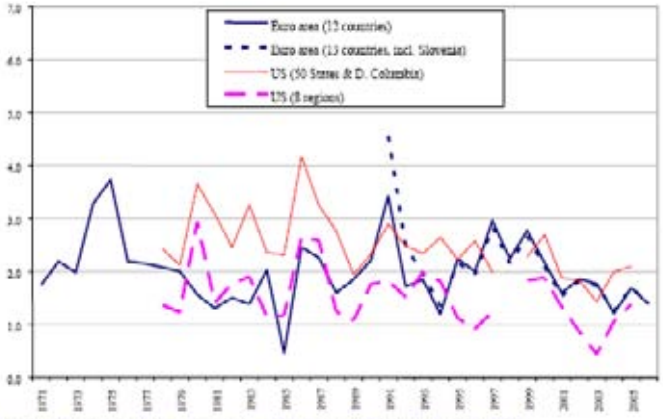
Chart 7: Dispersion of growth rates across euro area countries and the United States

*annual averages - unweighted standard deviation in percentage points *)*



Sources: European Commission (Ameco database) and US Bureau of Economic Analysis (BEA).

*) There is a statistical break in the US regional data in 1998. In the states and regions of the US, the data refer to Gross State Product (GSP). The 8 regions are defined by BEA covering the whole country. Data for Slovenia start in 1991.

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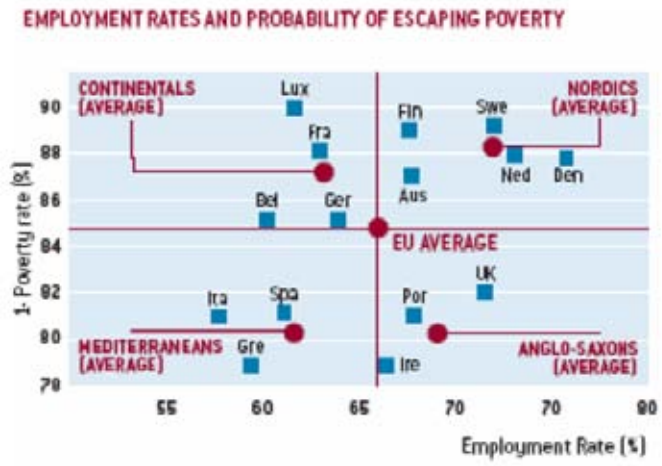
Chart 8: The four types of "Social Models" and their employment and poverty prevention performance



Source: Sapir (2005)

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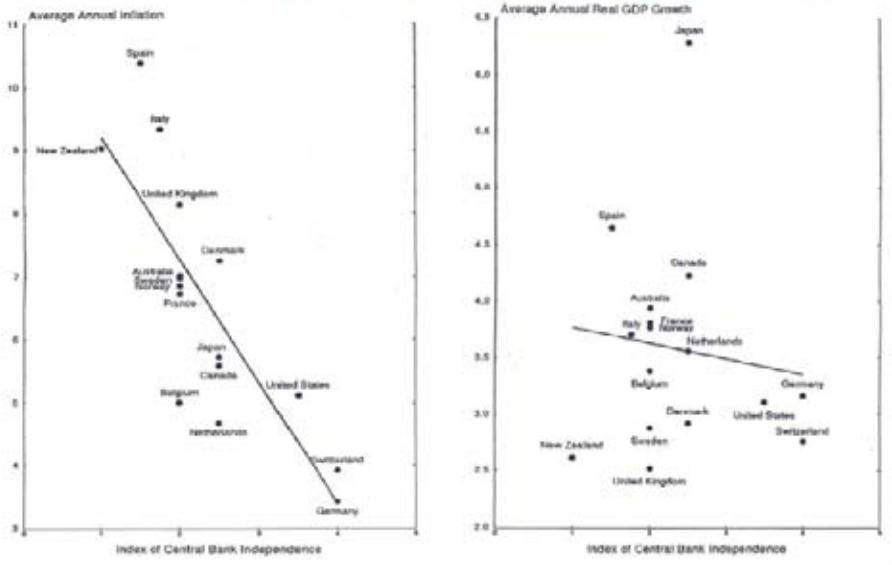
Chart 9: Central Bank independence and inflation and growth performance (1961 – 1990)



Source: Blinder (1998), "Central Banking in Theory and Practice", The MIT Press, Cambridge, Mass.

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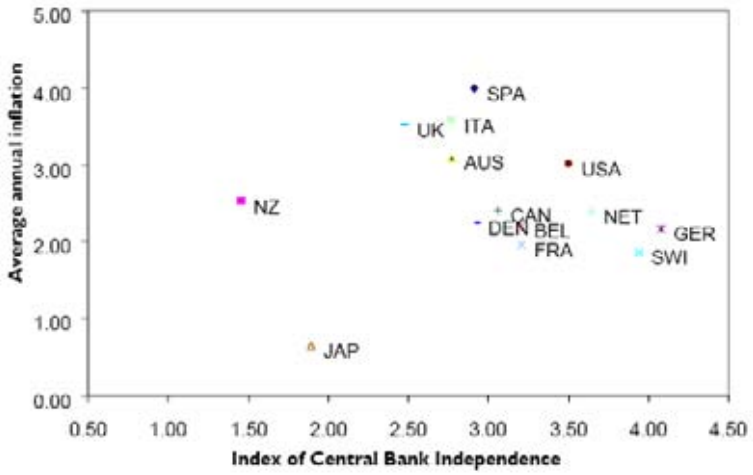
EUROPEAN CENTRAL BANK

Chart 10: Central Bank independence and inflation performance: recent evidence (1989 – 2006)



Source: ECB calculations for 1989-2006; based on Alesina and Summers (1993) – see P. Moutot, F. Mongelli, A. Jung, "The Eurosystem: Monetary Policy Preparation, Decision-Making, and Enlargement - Selected Issues", ECB Occasional Paper, forthcoming.

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