Jean-Claude Trichet: Structural reforms for the European economy

Speech by Mr Jean-Claude Trichet, President of the European Central Bank, at the Forum ABC, Madrid, 15 February 2008.

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Ladies and gentlemen,

I would first like to thank very warmly the organisers for inviting me to speak here today in the context of the series of conferences organised by the "Forum ABC". In my intervention I would like to share with you my views on "Structural reforms for the European economy" and on the importance such reforms have for job creation and productivity growth. This is indeed a major policy issue and, I believe, a topic of great interest to everyone here too. After all, high employment and high productivity levels are the key preconditions for a high level of real income and living standards in our societies.

If we look back over the last decade, employment growth has been strong in the euro area and even more so in Spain. However, over the same period, labour productivity growth decelerated significantly in the euro area and in Spain in particular. A key challenge therefore is how to simultaneously achieve solid employment and productivity growth.

It is well-established in the economic literature that structural reforms and institutions are among the main factors that explain the different performance of per capita income growth across countries over the medium to long term. By structural reforms and institutions I am here referring not only to the effective functioning of labour, product and financial markets, but also to the general framework configuring the environment in which economic agents make decisions regarding their investment in businesses, education, innovation, etc.

Experience shows that, it is not easy to carry through some structural reforms at least. However, it is particularly important to resolutely pursue such reforms in the current environment, which includes a number of important challenges, such as rapid technological change, accelerating globalisation and ageing populations. This applies to the Spanish economy as well as to all other economies members of the euro area.

I will first compare the economic growth performance of the euro area with that of the United States, focusing on some of the underlying factors of potential output growth. Then I will elaborate on the structural reforms, which I consider to be most essential to increase the potential growth rate of the European economies.

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

Since 1995, the annual growth rate of the euro area has averaged 2.2% per year compared with 3.1% in the United States. What are the fundamental causes of this lower trend growth in the euro area? The answers can be found by looking at the factors determining the trend in economic growth, namely employment growth, which in turn is related to labour utilisation and, demographic trends; and productivity growth.[1]

As regards labour utilisation, defined as the total number of annual hours worked divided by total population, the euro area outperformed the United States. Over the period 1995-2007 it increased by 0.5% per year on average in the euro area compared with 0.2% in the United States. With a rise in labour utilisation of 2.0% on average per year over the same period, the Spain's performance was even more impressive.

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1 Source European Commission, AMECO database and OECD for hours worked for the US. Moreover, data for 2007 are partly estimates. The last update of the AMECO database was November 2007.

In the euro area, the improvement in labour utilisation mainly reflects the significant rise in the euro area overall employment rate from 58% in 1995 to 65.6% in 2007,[2] which has been accompanied by a decline in the aggregate unemployment rate from 10.4% in 1995 to 7.2% in December 2007.[3] The latest number is the lowest on record since the early 1990s.

In fact, since the beginning of EMU in 1999 the euro area has witnessed an increase of more than 15 million in the number of people employed, while from 1990 to 1998, this number only increased by around 3 million.

Spain's performance, with an increase of more than 5 million in the number of people employed over the period 1999-2007, has been simply remarkable.

These are encouraging developments, which show that past labour market reforms, immigration and wage moderation have helped to overcome some of the constraints on growth stemming from rigid and over-regulated labour markets. However, despite this progress, we are still a long way from having exhausted the potential for further increases in participation rates and employment. The overall employment rate in the euro area remains low by international standards [65.6% in the euro area compared with 72% in the United States,[4] and the unemployment rate is still clearly too high [7.2% compared with 5.0% in the United States at the end of 2007].[5] More specifically, while the prime-age male employment rate in the euro area is comparable to that observed in the United States, considerable disparities remain when we look at youth, female and older worker employment rates. [For instance, in 2007 the female employment rate was 57.9% in the euro area compared with 66.1% in the United States, the older workers employment rate was 43.6% compared with 61.8% in the United States, and the youth employment rate was 38% as compared with 54.2% in the United States]. These features of the euro area, which incidentally – are broadly shared by the Spanish labour market, appear to be consistent with an "insider-outsider" characterisation of the European labour market, where structural impediments, triggered by the legal and regulatory environment, high taxes on labour and rigidities associated with wage regulations may prevent those groups "at the margin" from actively participating in the labour market.

The figures I have just mentioned suggest that, overall, structural reforms in the labour market still need to be high on the agenda. This appears even more urgent if we consider that in the past Europe's growth performance has been, and will be in the future (all else equal), increasingly constrained by its low population growth rate and population ageing. Indeed, since the mid 1990's, population in the euro area has been growing at a yearly rate of just 0.4% compared to 1.1% in the US. However, what is worrisome is that at the same time, the gap in population growth has been even larger with regard to growth in the working age population. The working age population grew on average by 0.3% per year in the euro area over the period 1995-2007 compared to 1.2% in the US (1.1% in Spain).

Finally, turning to labour productivity, while during the 1980s and the first half of the 1990s, hourly labour productivity in the euro area grew on average by 2.3%, it slowed down to 1.3% between 1995 and 2007. Similarly, over the same period hourly labour productivity growth in Spain decelerated very significantly from 2.5% to 0.5%. By contrast, US hourly labour productivity growth rose from 1.4% to 1.8%.

The positive labour supply shock, reflected by the increase of employment particularly in the unskilled segment of the labour market experienced in the euro area as well as in Spain has,

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2 Average to 2007Q3.

3 Source Eurostat.

4 Data related to employment rates for the euro are available to 2007Q3 and 2006 for the United States.

5 Data refer to December 2007.

to a certain extent, contributed to the disappointing productivity growth. However, this slowdown in labour productivity growth can be largely attributed to a marked deceleration of total factor productivity growth. Indeed, in the euro area and Spain, TFP growth decelerated from 1.4% over the period from 1980 to 1995 to 0.7% and 0.1% respectively between 1995 and 2007.

There are many potential factors explaining the decline in total factor productivity growth. Among the most prominent causes are those structural features of the European economies that are undermining incentives, including innovations, to invest in real and human capital and that reduce the flexibility of firms to smoothly and quickly adjust to their new environment. Some empirical evidence has shown that 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 more conducive to exploiting the opportunities provided by the new technologies.[6] The gap in labour productivity growth between the euro area and the United States has been driven mainly by market services sectors namely the “wholesale and retail trade” and the “financial” sectors, intensively using Information and Communication Technologies (ICTs),[7] reflecting to some extent, the lack of competition in these particular sectors in Europe and the need to further deepen and extend the EU internal market.

II. The need for further structural reforms in Europe

Long-standing structural rigidities are, in my view, the major cause of the difference in the growth potential in Europe compared with the United States and with some other advanced industrialised economies. The experience of European countries, which have undertaken some courageous and successful structural reforms as well as increased the degree of openness of their economies, is encouraging. In Spain for instance, several specific factors may have contributed to the positive labour market development, I mentioned before. The substantial migration flows registered over that period, coupled with some elements of flexibility provided by short-term contracts, have supported job creation and allowed potential bottlenecks in a number of fast-growing segments of the labour market (in particular construction, tourism and services for households) to be contained.

Coming back to the euro area, without aiming to be exhaustive, I should like to highlight some of the key priorities for reform in three main areas, namely (i) getting more people into work; (ii) increasing competition; and (iii) supporting an innovative environment.

Getting more people into work

First of all, well-functioning labour markets are indispensable in fostering higher economic growth in the euro area. The still relatively high unemployment rates in the euro area clearly suggest that there is a need to spur not only labour supply but also labour demand.

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6 See, for example, A. Alesina, S. Ardagna, G. Nicoletti and F. Schiantarelli (2005), “Regulation and investment”, Journal of the European Economic Association 3, pp. 791-825, in which the authors find that regulatory reforms have had a significant positive impact on capital accumulation in the transport, communication and utilities sectors, especially in the long run. In G. Nicoletti and S. Scarpetta (2003), “Regulation, productivity and growth”, Economic Policy, April, the authors find that various anti-competitive product market regulations significantly reduce total factor productivity growth at the industry level. J. Albert, G. Nicoletti and S. Scarpetta in their contribution to the conference provide a broad survey of the respective literature and some additional evidence.

7 Over the period 1995-2005, hourly labour productivity in the euro area grew on average by 1.6% and 2.5%, in the “wholesale and retail” and “financial” sectors respectively, compared with 3.6% and 3.4% in the United States. Source EUKLEMS database.

As regards labour demand, there is a need to reduce labour market rigidities that currently restrict wage differentiation and flexibility and thus tend to hinder the hiring of younger and older workers in particular. Moreover, in those European countries and regions where competitiveness has been lost in the past and/or the unemployment rate remains too high, it is important that wage increases do not fully exhaust productivity gains in order to provide incentives for firms to create additional jobs. In this respect, sufficient wage differentiation is also required to improve the employment opportunities for less skilled-workers where there is high unemployment for this category of employees.

The extent to which an increase in nominal wage growth leads to upward pressure on inflation depends crucially on trend labour productivity growth. Under normal circumstances, stronger labour productivity growth would justify an increase in nominal wage growth, thus allowing wage earners to participate in economic growth without adding to inflationary pressures. But, for the same reason, without sustained improvements in labour productivity, higher nominal wages would not lead to improvements in real purchasing power, but undermine job creation and fuel inflationary pressures. Against this background, the ECB's Governing Council considers that, features enforcing wage rigidities and leading to non-optimal wage setting – in particular indexation of nominal wages to the consumer price index – should be avoided. This is particularly accurate in this period where the euro area economy is currently in a juncture which is dominated by exogenous price shocks and uncertainty about the outlook of the real economy. Headline inflation which has been pushed up by external pressures on energy and food prices, is today significantly above 2% in the euro area and even higher in Spain. We must absolutely avoid the second round effects, namely that these price developments lead to futures increases of prices and wages and thereby prolong the period of high inflation and disanchor inflation expectations.

Finally, as regards labour supply, further reforms in income tax and benefit systems would help to increase people's incentives to work. Reducing disincentives to work, such as high marginal tax rates, high unemployment benefits, and encouraging people to work longer as it has been done in Spain,[8] can stimulate the labour supply and employment of all workers, but particularly those with a generally more tenuous attachment to the labour market, such as women and older workers. Furthermore, facilitating the use of flexible forms of work, such as part-time and temporary arrangements, may also contribute to the incorporation of certain segments (e.g. the young, females) into the labour market, hence increasing labour supply.[9]

In this respect, the experience of some EU Member States is telling. For instance, Ireland and the Netherlands – both euro area countries – as well as Denmark, whose currency has been pegged to the euro within the ERM since the beginning – have achieved success in reducing unemployment and stimulating job creation, despite significantly different economic conditions.[10] In December 2007 the unemployment rate in these countries was close or below 4.5%, while their overall employment rate was well above the euro area average. To achieve such remarkable success, these countries reformed their tax and benefit systems by reducing, for example, the tax wedge on labour income and by enforcing job search rules more strictly and a better monitoring of eligibility for unemployment benefits. They also increased the flexibility of their labour markets.

What all these countries also have also in common is that they have significantly reduced product market regulation. This leads to the second prerequisite for higher potential growth: increasing competition in order to establish efficient and well-functioning product markets.

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8 Work beyond 65 years of age is being encouraged through a 2% increase per annum in the final pension.

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

10 See A. Annett (2006) "Lessons from successful labour market reformers in Europe" IMF euro area policies: selected issues, August 2006.

Increasing competition

Many studies point to the potential that increasing competition has to increase employment and to boost productivity trends by improving production efficiency and by enhancing the incentive to invest and innovate.[11]

In the European Union, significant progress has been made in strengthening competition and increasing economic integration over the last two decades. The initiative of the single market has brought sizable benefits for the EU's economy. The European Commission recently estimated that the single market has brought about an increase of 2.75 million extra jobs and an extra increase in welfare of €518 per head in 2006, corresponding to a 2.15% increase of the EU's GDP over the period 1992-2006.[12]

However, much remains to be done, in particular in some market services sectors. The extension and deepening of the EU internal market remains clearly a priority as regards further financial market integration, the pursuit of effective competition in the energy market and the implementation of the Services Directive. The growing economic importance of services[13] suggests that improvements in European living standards are likely to depend especially on a high degree of competition and on productivity improvements in the services sector.

Let me now focus more specifically on the financial sectors. Financial integration is indeed of key importance for the ECB, given the relevance for the conduct of the single monetary policy. The process of European financial integration is gradually taking place and considerable progress has been made for instance in capital markets and wholesale banking. However, the retail banking sector appears to have not yet reached its potential, and competition seems insufficient in this area leaving European consumers unable to take full advantage of the benefits of the EMU and the Single Market.[14] This seems also to have constrained, to some extent, the economic performance and development of these sectors in the euro area.

More generally speaking, the evidence suggests that the reallocation of capital from declining industries to industries with high investment opportunities and high productivity is faster in countries with developed financial markets. These findings suggest that countries with more liquid capital markets and a developed banking system are growing faster on average.[15]

Increasing product market competition – at the EU and national levels – would enable more efficient production structures. The benefits of opening network industries to competition can be seen in the telecommunications sector. The hourly labour productivity in this particular sector saw a significant acceleration from 4.5% to 7.3% from the periods 1980-1995 to 1995-

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[11] 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.

[12] European Commission, "The single market: review of achievements", November 2007.

[13] Today, the services sector accounts for 70% of GDP, 68% of employment and 96% of the new jobs created, but only 20% of intra-EU trade. This discrepancy reflects not only the fact that services often have an intrinsically local character, but also the many barriers and obstacles still hindering the free movement of services within the European Union.

[14] See P. Hartmann, F. Heider, E. Papaioannou and M. Lo Duca (2007), "The role of financial markets and innovation in productivity and growth in Europe", ECB Occasional Paper Series, September, as well as ECB (2007) "Financial integration in Europe", Frankfurt a.M: ECB.

[15] Some authors have calculated that if the average size of capital markets in the European Union was bigger - in the United States for instance, it is around 450% of GDP instead of 220% as in the European Union (based on an overall indicator measuring total financing in the economy by aggregating bank credit to the private sector, stock market capitalisation and the outstanding amount of domestic debt securities issued by the private sector) - then annual GDP per capita growth in the European Union could be positively influenced (see G. Favara (2006), "An empirical reassessment of the relationship between finance and growth", mimeo).

2005, and telephone prices charged by the former monopolies for national and international calls for instance, fell by more than 40% on average in Europe between 2000 and 2006. This supported the purchasing power of consumers, who have now more of their income available to spend on goods and services.

Supporting an innovative environment

To fully exploit productivity potential, the product market reforms I have just mentioned need to be accompanied by policies that support innovation and technological changes. These include, inter alia, the unlocking of business potential by creating an entrepreneurial-friendly economic environment, measures to support innovation through higher investment in research and development (R&D) and policies aimed at improving human capital.

First of all, 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. An entrepreneurial-friendly economic environment would imply less red tape for small and medium-sized enterprises to help them develop at home and across borders, as well as positive action to ease access to the finance they need. Europe is significantly lagging behind in this field. For instance, venture capital financing in Europe remains only a fraction of what it is in the United States relative to the size of each economy.

Second, promoting R&D investment is also a major issue. While many Member States expect to increase their R&D spending, Europe will fall short of the 2010 overall EU target of achieving 3% of GDP. In 2005, R&D investment relative to GDP was 1.9% in the euro area compared to 2.7% in the US. The efforts of European countries to increase R&D investment are still insufficient.[16]

Finally, to make these measures most effective, they need to be accompanied by efforts to improve the labour force's level of education and expertise. Meeting the challenges of innovation and its dissemination as well as 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. Europe is still badly in need in Europe to enhance the quality and efficiency of our schools and universities as well as to increase incentives for all relevant parties, including firms and workers to invest in human capital.

Before concluding, let me insist on the importance of sound fiscal management in line with the Stability and Growth Pact. Sound public finances are a prerequisite to support long-lasting growth of output and employment, as the Spanish experience over the last decade has clearly shown. A complacent attitude related to current buoyant tax revenue that might result in higher expenditure could lead to negative surprises, should the macroeconomic environment turn less favourable.

Beyond that, the "quality" of public finances also matters for growth. It is essential to increase public spending efficiency in order to facilitate the reorientation of public expenditure towards productivity-enhancing physical and human capital accumulation.

And finally, let me remind you that within our currency union, regional monetary and exchange rate policies are no longer viable options. Flexible and integrated labour and product markets are prerequisites of the utmost importance for the smooth functioning of the

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[16] In the spring 2006 European Council, Member States announced country-specific targets for R&D expenditure amounting to 2.7% of EU25 GDP by 2010, up from 1.9% in 2006. The European Commission estimated that if Member States achieve their targets, R&D activities will rise by 50% in 2025, generating an increase of between 2.6% and 4.4% in GDP on the basis of conservative assumptions (see report from European Commission "Implementing the renewed Lisbon strategy for growth and jobs: A year of delivery" (2007)).

euro area, and are crucial to maintaining and ensuring the competitiveness of the individual European companies over the medium to long run. We should keep in mind that in a context of monetary union, not only fiscal policies, but also price competitiveness and unit labour cost developments across countries should be continuously and closely monitored.

III. Conclusions

Ladies and gentlemen, I would like to conclude by stressing a few points.

Europe is in the process of reforming its economy so as to adapt to the challenges of globalisation, technological change and an ageing population. Significant progress has already been made as reflected by the notable rise in employment growth over the last decade.

Monetary Union has been effective – and hugely successful – in supporting growth through a credible monetary policy that delivers price stability in the medium run, hence contributing to lower financing costs in the euro area through a reduction of risk premia. It has also given a further impetus to resolute European integration, particularly in financial markets.

The challenges ahead are a reminder that European integration is a dynamic process and that it will bring about deeper structural transformations. The historical process of European integration is moving forward steadily and will require all our efforts and commitment for years to come. I am personally convinced that Europe can meet the challenges I mentioned and I am therefore thoroughly optimistic for the future of Europe.

Thank you very much for your attention.