Jean-Claude Trichet: How to increase the competitiveness of the European economy

Speech by Mr Jean-Claude Trichet, President of the European Central Bank, at the panel discussion, Karlspreis Europa Forum, Aachen, 30 April 2008.

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Ladies and gentlemen,

I would first like to thank the organisers for inviting me to speak here today and share my views on how to increase the competitiveness of the European economy. Competitiveness in a broader sense can be understood as the ability of economies to thrive in an increasingly integrated international economy and to embark on a sustained path of high output growth that enhances people's wealth. Competitiveness is therefore related to macroeconomic stability and the ability to maintain the real value of people's assets, as well as to structural factors that contribute to the long-term growth potential.[1]

The introduction of the euro has been recognised as a remarkable success not only in Europe, but across the entire world. Since then, Monetary Union has been effective and very successful in providing the right framework for Europe to be performing and to create jobs. However, given the modest growth performance of the European countries and of the euro area in the past, improving structural factors to raise European competitiveness remains a major policy issue. It is essential to overcome these constraints to growth in the current environment, where the European economy is facing a number of important challenges, including rapid technological change, accelerating globalisation and ageing populations.

The successes of Economic and Monetary Union (EMU)

With the introduction of the euro, a completely new monetary policy framework was introduced in Europe, with the ECB conducting a single monetary policy for the entire euro area. Despite the uncertainty that surrounded the transition to this new regime, the ECB and the euro have benefited from a very high level of credibility since the very first days of EMU. This achievement certainly rests on the constituent features of the ECB's institutional architecture, which gives a clear mandate to the ECB to safeguard price stability in the euro area, and grants it full independence in pursuing this mandate. Central bank independence is key for monetary policy to be credibly and effectively geared to price stability.

From the very beginning, the successful launch of the euro and the strong credibility of the newly created monetary authority led to an impressive convergence of market interest rates at all maturities to the lowest interest rates prevailing prior to the euro.

Of course, the credibility of the ECB in delivering price stability has to be maintained over time. And there is no better way to establish a reputation than by allowing the public to recognise this in our repeated behaviour. The ECB is a young institution, but it is widely recognised that our track record over the past ten years has been more than satisfactory. Since the introduction of the euro, there has been an average annual HICP inflation rate of slightly above 2%, despite a succession of very significant shocks (energy prices, commodity prices and food prices in particular). Prices have remained relatively stable, with average annual inflation rates significantly below those that prevailed in most of the countries

[1] In a more narrow sense, the concept of competitiveness captures countries' ability to sell their products in world markets. In this context, competitiveness is usually discussed in terms of cost and price differentials. Finally, non-price factors, such as technological innovation or the quality of products, are probably even more important, but are usually harder to quantify.

participating in the euro area in the decades preceding the start of Stage Three of EMU. In the same vein, inflation volatility has been significantly lower in the euro area than it was before EMU.

This favourable track record has been acknowledged by financial markets and the public at large, with long-term inflation expectations derived from bond yields and surveys remaining successfully anchored at levels that are in line with the ECB's definition of price stability. I would like to stress that the stability of medium term inflation expectations has been remarkable, considering the series of adverse economic disturbances which have hit the euro area since its inception.

The success of the ECB's monetary policy in delivering price stability and its determination to ensure a firm anchoring of inflation expectations has provided significant support to other European Community objectives, notably favourable financing conditions and macroeconomic stability, which support both investment and sustainable economic expansion.[2] The euro also promotes the deepening of trade and financial linkages across euro area countries. There is clear evidence that the introduction of the single currency and the associated increase in price and cost transparency have fostered both intra and extra-euro area trade in goods and services.[3] In addition, the euro is acting as a catalyst towards a single market in financial services and a gradual portfolio reallocation from holdings of domestic financial instruments to holdings of financial instruments issued elsewhere within the euro area.

Review of the past performance of the euro area

Despite these successes in macroeconomic stability and increased integration, a comparison of the economic performance of the euro area with that of other industrialised economies from a longer-term perspective, shows that Europe has scope to better develop its growth potential.[4]

One of the principal factors behind the euro area's disappointing performance in the past is the low trend growth in labour productivity. Indeed, the growth in labour productivity in the euro area has significantly slowed down over the past 30 years. During the 1980s hourly labour productivity in the euro area grew on average by 2.3%, while in the 1990s, it declined significantly to 1.8% and further decreased to 1.2% between 1999 and 2007. In contrast, hourly labour productivity growth in the US accelerated from 1.2% to 1.6% and 2.1% over the same periods.[5]

What lies behind these disappointing developments? The impressive rise in the overall employment rate in the euro area over the past decade, which partly reflects the progress made on structural reforms, wage moderation policy and immigration flows in some

2 Most euro area countries have benefited from significantly more favourable financing conditions than in the 1990s, which has supported private and public investment, as well as fiscal consolidation. For instance, in the euro area in the nine years following the introduction of the euro, real gross capital formation grew on average by 3.0% per year, compared with only 1.7% during the nine-year period preceding the introduction of the euro.

3 Exports and imports of goods and services within the euro area rose from about 31% of GDP in 1998 to around 40% of GDP in 2007. The completion of a single market for services will further facilitate trade in services. The rate of increase in extra-euro area exports and imports of goods and services even exceeded that in intra-euro area trade, rising from about 32% of GDP in 1998 to almost 44% of GDP in 2007. Extra-euro area trade has, of course, also benefited from a period of strong external demand and increasing integration at the global level.

4 Since 1999, for instance, the annual growth rate for the euro area has averaged 2.2% per year compared with 2.7% in the United States.

5 Source AMECO database. Data on hours worked per worker for the euro area for 2007 are assumed to be constant. Data on hours worked per worker for the US are estimated using the OECD data for 2006 and 2007.

European countries, has undoubtedly constituted a source of growth.[6] At the same time, specific policies aimed at increasing employment, particularly in the unskilled segment of the labour market, have certainly contributed to the observed slowdown in labour productivity growth.

However, the developments in labour supply are only part of the story. To a large extent, the slowdown in labour productivity growth can be attributed to a marked slowdown in total factor productivity growth, which is generally taken as a measure for technological progress and improvements in the organisation and overall efficiency of production. In the 1980s, total factor productivity grew on average by 1.6%, before declining to 1.1% in the 1990s and 0.7% between 1999 and 2007.[7] Those countries that have managed to exploit the efficiency gains generated, in particular, by new technology have enjoyed stronger labour productivity growth. For instance, in the last ten years, investment in information and communication technology in the United States has doubled that of the euro area.[8]

There are many factors behind the decline in total factor productivity growth. Most prominently, the structural features of the European economies undermine incentives to invest in real and human capital, and reduce the flexibility of firms to smoothly and quickly adjust to their new environment, including innovations. It appears that the structural characteristics of the best performing industrialised economies, namely a more flexible labour market, a higher degree of competition in product markets and lower barriers to entry for new firms, have been more conducive to exploiting the opportunities provided by new technologies.

The need for structural reform

Pursuing resolutely structural reforms is of the essence to improve total factor productivity and labour productivity. Well-functioning and integrated markets are required to meet the challenges posed by greater innovation, to increase the adjustment capacity of an economy and, ultimately, to make Europe more competitive and more dynamic.

In the context of rapid technological change, a flexible labour market is essential to facilitate the adjustment of human capital to labour market needs. A high level of rigidity in the labour legislation has a particularly strong negative impact on industries experiencing rapid technological change, since it may prevent the efficient matching of workers to jobs in view of new job requirements. Unfortunately, progress in increasing contractual flexibility, particularly for permanent contracts, remains slow in several euro area countries.

Flexible wage setting is also essential. In a number of economies, characterized by mediocre relative competitiveness, it is important that wage increases do not fully exhaust productivity gains and allow productivity performance to translate into improved competitive positions as measured by relative costs. In this context, it is the belief of the Governing Council that features that enforce wage rigidity and lead to non-optimal wage setting, in particular, general indexation of nominal wages to the consumer price index, should be avoided. This is particularly relevant today: second-round effects stemming from the impact of higher energy and food prices on wage and price-setting behaviour must be avoided. This is of key importance for preserving price stability in the medium term and, in turn, the purchasing

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6 Since the start of EMU, the number of employed people has increased by more than 15 million in the euro area, compared with an increase of approximately 5 million in the nine preceding years, and the euro area unemployment rate has fallen to its lowest level since the early 1980s.

7 Source European Commission.

8 ICT investment represented 4% of GDP in the United States compared with 2% in the euro area over the period 1995-2004 (source Groningen database).

power of all euro area citizens. The Governing Council is paying particularly close attention to wage negotiations in the euro area.

Increasing competition by establishing efficient and well-functioning product markets is equally fundamental. Many studies point to the potential of competition to boost productivity trends by improving production efficiency and enhancing the incentive to invest and innovate. In the European Union, significant progress has been made on strengthening competition and increasing economic integration over the past two decades. The single market has already led to sizeable benefits for the European economy. The extension and deepening of the internal market remains a priority as regards further financial market integration,[9] the pursuit of effective competition in the energy market and the implementation of the Services Directive. The growing role of services in modern economies suggests that improvements in European living standards and competitiveness will crucially depend on productivity improvements in this area. The aim of the Services Directive, for instance, is to improve the competitiveness not just of service enterprises, but of European industry as a whole.

Finally, last but not least, to fully exploit productivity potential, the labour and product market reforms I have just mentioned need to be accompanied resolutely by policies that support innovation and technological change. These include, inter alia, the unlocking of business potential, measures to support innovation through higher investment in research and development, and policies aimed at improving human capital.

Thank you very much for your attention.

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[9] The process of European financial integration is taking place gradually, and considerable progress has already been made. The degree of integration, however, varies across market segments, and integration is generally more advanced in those market segments which are closer to the single monetary policy. While the euro area banking markets for wholesale and capital market-related activities have shown clear signs of increasing integration since the introduction of the euro, the retail banking segment has remained more fragmented, leaving European firms and consumers unable to take full advantage of the benefits of EMU and the Single Market.