Jean-Claude Trichet: Leadership in Europe - euro, enlargement, economic reform

Speech by Mr Jean-Claude Trichet, Governor of the Bank of France, at the 7th annual conference of the German-British Forum, London, 17 October 2002.

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Mr. Chairman, Ladies and gentlemen, dear German and British friends, it is a great pleasure and an honour to be with you today, on the occasion of the 7th annual Conference of the German-British Forum. The title of this conference: "Leadership in Europe : Euro, Enlargement, Economic reform" is especially relevant this year, as 2002 will stay as a decisive milestone in the process of European integration. The beginning of this year saw the completion of the changeover to the single European currency, the last stage of a now more-than-twenty-year process of monetary integration. And we are now at the eve of another historic stage for the European Union: the forthcoming enlargement to Central, Southern and Eastern Europe countries. From a central banker's perspective, these two major events confirm, more than ever, the attractiveness of the European endeavour, but also the necessity of implementing strong, audacious economic reforms in Europe.

Before addressing in greater detail these two main challenges that the EU and the euro area will have to cope with in the next years, economic reforms and EU enlargement, I would like, first, to recall in a few words the successful launch of the euro banknotes and coins in January 2002.

This successful launch, to the benefit of 305 million Europeans, represents the crowning achievement of the euro changeover, after the launch of the euro on the financial markets, on 1 January 1999. Both operations were a technical success because they had been meticulously well-prepared by the full body of the Eurosystem, the European Central Bank, and all the euro area national central banks, including Banque de France in France. However, aside from the technical success in itself, the warmth and enthusiasm with which French citizens and other Europeans welcomed the euro, their new currency, was proof that European construction enjoys real popular support that has all too often been underestimated.

Let me now turn to the core of my subject today: first, the process for economic reform, second, the perspective of enlargement.

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1. Economic reforms

Before reviewing the priority topics which require a new impulse, I would like to make a remark on the also often underestimated link between reform and the changeover to the euro : indeed, the introduction of banknotes and coins in euro is a major structural reform in itself, as it constitutes a powerful drive towards restructuring the European economy, and a strong lever to facilitate the comparison of prices, taxes and incomes between the Member states.

In my view, three other major prerequisites are needed in order to foster robust, sustainable growth and durable job creation, namely : the continuation and strengthening of a policy designed to keep in check unit production costs, the improvement of the competitiveness of the economy, through ambitious structural reforms and lastly, the completion of a fully integrated European capital market.

Raising the potential output growth and enhancing the competitiveness of the economy:

If Europe wants to secure sustainable growth at levels that are as high as possible, the key variable is potential output growth.

The level of potential output growth can firstly be raised thanks to investment: business leaders are completely free to invest wherever they want in Europe or elsewhere in the world. It is thus important that we create economic, legal and fiscal conditions that are as favourable as possible to investment in Europe. The investment appeal of Europe is crucial in this respect : the more we invest, the fewer inflationary pressures we will have, and the stronger potential output growth will be.

Another way of raising potential output growth is to increase the quantity of available labour and to boost gains in labour productivity: the fast transformation of information systems is likely to accentuate the structural transformation of the economies. Since last year, the evolution of Stock Exchanges has shown that the euphoria associated with the concept of a totally new economic era has vanished, but what remains true is that a remarkable potential of economic changes remains for the future. It may help to boost labour productivity significantly on a recurring basis, and, in so doing, to boost production while preserving the economy's competitive edge.

That strategy should be pursued whilst increasing the overall competitiveness of Europe's economy.

If I refer to what we observed in the past, the French economic strategy, based on a moderation in the increase of unit costs of production, gave us an important advantage: the considerable improvement in the cost competitiveness of the French industrial sector from the mid-1980s has contributed extensively to the growth of our economy. The French economy grew faster than the other major euro area economies in recent years, while repeatedly recording a large current account surplus. This was largely because, from early 1987, production costs, measured by unit labour costs in the industrial sector, have risen significantly less in France than in the euro area as a whole. That improvement in our overall cost-competitive situation has progressively materialised into growth, into job creations and into solid external accounts.

This ongoing drive to keep prices and costs in check has been accomplished thanks to the economic and monetary strategy pursued over a long period. It is of the utmost importance that the entire euro area and Europe as a whole maintain and consolidate their cost competitiveness position. Since the introduction of the single currency, it is more important than ever that we closely monitor the production cost indicator, as it determines to a large extent the competitiveness of goods and services produced in our economy and, therefore, the current level of employment. It also acts as a "leading indicator" of future employment because it gives a measure of the attractiveness of an inward investment compared with investment outside the euro area or outside Europe.

Embarking in bold structural reforms:

In this context, we also need to pursue and step up bold structural reforms, aimed at increasing the flexibility of the economy as a whole and fostering the progress of science and technologies. This is crucial if we wish to enhance the potential growth of European economies and to continue to promote sustainable growth and enduring job creation.

The European Council meeting held in Luxembourg in 1997 explicitly mentioned structural policies among the items selected for reinforced co-ordination. The Lisbon and Stockholm European Councils, held in 2000 and 2001, further enhanced the medium term strategy necessary for structural reforms in the Union. This strategy aims at raising the potential growth and strengthening the competitiveness of the EU economies. Since its launch, this strategy has been strengthened on two points: the European council of Nice adopted a Social Agenda which clarifies the measures to be taken in order to achieve the objective of Lisbon, namely to increase the employment rate. The European Council of Göteborg added to this strategy an environmental dimension and confirmed the need for consistency between the various long-term policies. These strategies are aiming at making the European Union the «world's most dynamic economy of knowledge in 2010».

However, the responsibility for structural reforms in the European Union ultimately rests with the individual Member States. Consequently, a variety of institutional solutions and regulatory arrangements across countries and sectors exist. I consider that such a decentralized approach should be seen as an opportunity, even if it has also disadvantages. At least, it fosters competition whilst encouraging «cross fertilisation» of best practices through increased co-ordination of Member States' structural policies.

Work to date in the field of structural reforms remains insufficient even if progress is being made, as was assessed by the European Council of Barcelona last March. Some advances have been registered in certain sectors with regard to the implementation of the strategy defined in Lisbon : to eliminate the hindrances to the free exchange of services, to reduce the overall level of State aid and to boost the level of liberalization.

We still have a long way to go: whereas the integration of good markets is relatively advanced, shortcomings still exist with regard to the full integration of service industries. Most of the barriers to trade in services appear to be due to national regulations. Developments would be necessary for instance with regard to the further opening of the public procurement market.

As regards the labour market, the European Council of Lisbon fixed as a central objective the rise of the employment rate of our populations from 60 to 70 % in 10 years. As a comparison, the same rate stands at 75 % in the USA. Continental Europe is therefore still experiencing levels of unemployment that are too high, although it has been declining in most of its economies over the past years.

According to the IMF and the OECD and the constituency of central bankers, 75% of unemployment in the euro zone is of a structural nature, i.e. generated by an environment which handicaps job creation. It is thus necessary to put an end to the neo-Malthusian behaviour which is still anchored in our economies.

Completing a fully integrated European capital market:

In 1999, as soon as the euro was launched, one of the expected advantages was the prospect of deeper, larger and more integrated capital markets contributing to reducing the cost of capital for businesses and giving European savers a greater range of saving options. These expectations have become realities in both the money market and longer-term capital markets.

However, there are still some barriers to further integration of EU capital markets. In this regard, the Eurosystem welcomed the ambitious Financial Services Action Plan (FSAP) launched by the European Council in Lisbon in 2000. This plan is aimed at harmonising and improving the conditions under which issuers, investors and intermediaries conduct their activities in the European Union. The European Council set a tight timetable so that this plan can be implemented by 2005, and even sooner, by 2003, as regards the measures relating to the securities markets.

At present, 30 out the 42 FSAP objectives have already been brought to a successful conclusion, allowing significant breakthroughs in various crucial areas. All these objectives involve far-reaching reforms, such as, for instance, introducing a single passport for issuers, with the planned Prospectus Directive, setting up an adequate framework for the oversight of the activities of financial conglomerates or harmonising rules concerning the use of collateral in financial transactions, especially in a cross-border context.

The Eurosystem also supports the strategic conclusions of the Committee chaired by A. Lamfalussy on the integration of the European securities markets, ratified by the European Council meeting in Stockholm in 2001 and approved by the European Parliament in early 2002. We are convinced that the implementation of these broad guidelines and the new cooperation structures at the European level will help make it possible to take full advantage of the introduction of the euro. I would only like to mention, as an example of fruitful co-operation, that the Committee of European Securities Regulators (CESR), set up last year as a follow-up to the Lamfalussy report, recently embarked with the European System of Central Banks on considering standards to be applied to the European securities settlement and clearing systems.

In the field of financial regulation and supervision, the Council of Economic and Finance ministers (ECOFIN) had mandated, last May, the Economic and Financial Committee (EFC) to make proposals concerning the structures for financial regulation supervision and stability at the European level. The framework currently under consideration has the objective of extending the arrangements that are already in place for securities regulation to the other financial sectors, based on existing inter-institutional agreements. Of course, the sectoral specificities are recognized, and especially those of the banking sector, through the appropriate participation of all national central banks in the arrangements concerning the banking supervision. Indeed, one of the statutory tasks of the Eurosystem is to contribute to the smooth conduct of prudential supervision policies and the stability of the financial system. I am therefore convinced that the involvement of central banks in this issue is absolutely crucial.

Economic reform is an ongoing process in Europe, in view of the considerable efforts that still have to be made in order to promote sustainable growth and enduring job creation. At the same time, the European Union has to face another important challenge in the near future : the enlargement process.

2. The enlargement process

The coming EU enlargement to Central, Southern and Eastern Europe countries is a historic stage in European integration. Twelve countries from central, eastern and southern Europe are currently negotiating accession to the EU. According to the calendar endorsed by the European Council, new accessions will take place as from 1st of January 2004. It testifies again, if necessary, to the attractiveness of the European framework, which has contributed to both political stability and economic progress for almost half a century in Western Europe.

Accession countries in western Europe have accomplished remarkable progress in stabilizing and strengthening their economies and institutions. Recent history shows the major improvements those countries have made, in hardly 10 years, on the road towards convergence with the EU. Let's keep in mind, with some humility, the sometimes rather slow pace the current Member States took, regarding for example trade openness, price liberalisation, structural reforms and even monetary stability and fiscal soundness.

Nevertheless, there is also general agreement on the fact that the gap, in terms of average GDP per capita, between the accession countries and the euro area, although diminishing, remains still quite significant. The size of the gap, combined recently with a rather limited growth differential between the two groups of countries, suggests that the process of real convergence will be gradual and will have to continue much beyond the tentative dates for EU accession.

Although differences in income levels are not incompatible with EU, it is important for accession countries to improve real convergence before entering monetary union. Indeed, it is essential to preserve a high level of economic cohesion within EMU and appropriate economic integration between Members States, thereby helping to minimize the risk and the effects of asymmetric shocks, in the best interest of accession countries themselves.

Let me stress five points of particular relevance for the Eurosystem, and for accession countries themselves on the road towards achieving catching-up and convergence with the EU.

- **Firstly**, we should never forget that nominal convergence must be sustainable and therefore constitutes a medium-term objective, rather than a short-term priority. The strict compliance with the Maastricht criteria will be key for joining the euro area. Indeed, the EU Treaty calls, as a prerequisite for adopting the euro, for a high degree of sustainable convergence in the fields of price stability, government fiscal position, stability of the exchange rate, and long-term interest-rate levels. The sustainability of nominal convergence itself presumes that sufficient preliminary progress has been made towards real and structural convergence (and namely having set a fully-fledged market economy, catching-up in income and productivity levels, as well as economic and social infrastructures, upgrading of the legal system…). Conversely, a sustainable catching-up process requires macroeconomic stability. Therefore, nominal and real convergence should be pursued in parallel, and are not antagonistic.
- **Secondly**, I noted that many accession countries have already expressed their intention to join ERM II as soon as possible after EU entry. This intention is to be welcomed, although it should be clear that ERM II membership needs neither to happen immediately after EU accession in all cases, nor to be limited to only two years. It would be misleading to consider ERM II as a mere “waiting room” before the euro. On the very contrary, ERM II would allow countries to retain some limited exchange rate flexibility during the catching-up process. ERM II membership offers a meaningful, flexible but credible framework for increasing convergence with the euro area, for tackling the challenges faced by accession countries on the road towards the adoption of the euro, for contributing to macroeconomic and exchange rate stability and for helping determine the appropriate level for the eventual irrevocable fixation of parities; and this, again, in the best interest of candidate countries themselves.
- **Thirdly**, a sound and efficient banking and financial system is key. Significant progress has been made over the past few years in rehabilitating the banking sector and encouraging foreign ownership. The latter has also contributed to greater integration into the EU financial system. Nevertheless, the improvement of financial technicity and banking practices is a process entirely in the hands of the accession countries. The intermediation role of the banking sector remains fundamental for the efficient use of capital and sustained growth. Progress in corporate governance, the enhancement of the legal and supervisory frameworks that support the banking sector, and an efficient fight against money laundering, are also crucial. They are conducive to achieving the macroeconomic objectives of the accession countries.
- **Fourthly**, central bank independence is of the essence. It is an integral part of the *acquis communautaire*, which is laid down not only in national legislation but above all in the Maastricht Treaty. The *effective* implementation of the *acquis communautaire* is a prerequisite for accession to the EU, as stressed in the recent Commission report on

enlargement. But effective implementation is also needed because it implies the effective transformation of accession countries' economic framework, which should facilitate their integration into the EU and, later, the euro area. In this context, it should be ensured that there is no discrepancy between the central banks' formal status in the legislation and the implementation of that legislation. It is of utmost importance that all present and future Member States respect this economic and institutional ground rule of the European framework.

- Fifthly, let us not forget the present and future contribution of Central and Eastern European countries to the economic prosperity of Europe at large. It seems that this contribution might be sometimes *under*estimated, while the relative influence of the US economy, for instance, might be sometimes *over*estimated. In fact, transition economies, as a whole, are as important as the US in terms of external demand addressed to the euro area: they both enjoy the same share, i.e. 13%, of our exports. And, during the last two years, transition economies contributed for two-thirds to the overall growth of our total external demand, while the US contributed for less than 0.1%.

More generally speaking, Central and Eastern Europe countries are already major contributors to the overall growth on the European continent. In 2001, despite the international context, they remained at quite high a level of growth, around 2.8%. This contribution is bound to further increase given these countries' considerable potential for growth.

I would like to conclude on this topic with a last remark: the EU enlargement is indeed an historic challenge for European integration. It will represent the most important enlargement process the European Union has ever faced. As a result, it has to be prepared with a great deal of care, and much remains to be done. The process of convergence will be very gradual and needs to be enhanced through multilateral surveillance and co-operation between the current Members states and the accession countries. For its part, the Eurosystem is actively contributing to this task, by deepening its relationship with the accession countries central banks.

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To conclude, let me stress three words: rapidity, stability and union.

Rapidity is a key word. We have not much time to meditate, decide, implement. The structural reforms, that we are badly in need of, must be implemented as rapidly as possible if we want Europe to be up to its historical challenges. The Chinese say "It is later than you think" has never been so true. In any case, history itself does not wait for us. And when I look back, over the last twenty years, it seems to me that an unfortunately well-founded criticism could be that we have constantly under-assessed the rapidity of the stream of history: the rapidity of the deterioration of the situation in the USSR, the rapidity of the collapse itself, the rapidity of the enlargement process, the depth, the strength and the intensity of the "desire of Europe" which is spreading in the countries in transition.

Second word: stability. Economic and financial stability, in a period of excessive volatility and of wide boom-bust episode, financial and real stability appear to be a very precious asset. Over the last twenty years, we have constructed a new world: technology has permitted instantaneous communication and incredibly powerful real-time computation. Globalization has created new cultural, conceptual, commercial and financial links between all economies including previously centrally planned systems; together technology and globalization are progressively driving us to a unified planet of universal rules and regulations, code of conduct and practices, market procedures and market instruments, accounting standards, etc. In this new world, phenomena which had traditionally a local or even a national impact may be amplified and become dangerous at the global level: amplification of financial cycles, herd behaviour, global contagion.

Analysing the opportunities and the risks, and understanding the functioning of our system with a view to making it as stable as possible is a very exiting, ambitious and urgent task.

And, last but not least, union. I can not avoid mentioning the question of completing monetary union with the entry of the United Kingdom. I would like to stress the following points in this regard: let us never forget that the UK is unanimously warmly welcomed in the euro area. It depends only on the decision of the British people and of the British authorities to join in. You know that the Germans and the French on the continent, as well as all other nations on the continent are very warmly hoping for a positive decision by the UK.

I thank you for your attention.