Lucas D Papademos: Challenges for monetary policy in Europe

Address by Mr Lucas D Papademos, Vice-President of the European Central Bank, at the 9. Internationales Finanz- und Wirtschaftsforum, Vienna, 13 November 2003.

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Ladies and Gentlemen,

When I accepted the invitation to talk about challenges for monetary policy at this distinguished forum, I was not aware that I would be confronted with a challenge *before* even starting to talk. In this panel, we are three speakers from the Eurosystem: Governor Klaus Liebscher, Governor Matti Vanhala and myself. As members of the ECB's Governing Council, we aim to speak with one voice or to "sing from the same hymn sheet" when we communicate to the public the Eurosystem's policies that we have jointly decided. Even though "repetition is the mother of learning" ("repetitio mater studiorum est"), according to the Latin proverb, we thought it would be to the benefit of everyone - and far more interesting - if there was a certain division of labour among ourselves. I hope we have managed this and will not sing the same hymn three times over, but rather perform a "concerto in three movements".

I have selected four key challenges the ECB faces in a medium- to longer-term perspective. These monetary policy challenges relate to the achievement of objectives in the current circumstances, fiscal developments in several euro area countries, the heterogeneity of the European monetary union and the forthcoming enlargement. I would now like to share some thoughts with you regarding these challenges.

1. Price stability in the context of a gradual economic recovery

Our first and permanent challenge is, of course, the attainment of the ECB's primary objective: the maintenance of price stability in the euro area. Over the past five years, the ECB, together with the NCBs in the Eurosystem, has succeeded in delivering low inflation. Indeed, the average inflation rate in the euro area since the launch of the single currency has been precisely 2%, in line with the ECB's definition of price stability. Our new central bank has gained credibility with the markets and it has earned the trust of the public at large that it will secure price stability in the euro area as a whole over the medium term. It has also set an example of true supranational policy-making for the benefit of all European citizens. With a balance sheet like this, some may think that we can afford to lean back in contentment and settle, from now on, for "business as usual". Given the forward-looking nature of monetary policy, however, and the degree of uncertainty surrounding the functioning of the economy and our ability to forecast future developments, a central banker's job can never be considered done and it will never become "business as usual". Moreover, the ECB has further objectives to attain and tasks to perform in a rapidly changing economic and financial environment, not least because of the forthcoming enlargement of the European Union.

Last Thursday, the Governing Council decided to leave the ECB's key interest rates unchanged. Our judgement on the appropriateness of the current monetary policy stance is based on, among other things, the expectation of a gradual economic recovery in the euro area during the second half of the year, in an environment of improving activity in the world economy as a whole. This expectation is supported by new data releases, several forward-looking indicators including confidence surveys, recently published forecasts from official and private sources, as well as developments in financial markets. Even though inflation may not fall over the coming months as quickly and by as much as had been previously anticipated, the medium-term outlook for price stability remains favourable. The past appreciation of the euro should continue to dampen import prices and it is presumed that wage increases will be moderate. Finally, the strong monetary expansion, which we have been observing for quite a while, is not considered a factor adversely affecting this outlook, for the time being.

The mild recovery underway in the second half of 2003 is expected to gain momentum over the next two years. The pace of economic activity, however, is likely to increase only gradually. Consequently, average annual real GDP growth is projected to approach its potential level in 2005, while unemployment is not expected to fall next year. In the short run, the risks to growth appear to be limited and balanced. In the longer run, the balance of risks is more difficult to assess: they depend, firstly, on the sustainability of global growth, which may be undermined by external and fiscal imbalances in some parts of the world and, secondly, on the ability of the euro area economy to generate faster growth internally.

In my view, the main lever for achieving higher growth in Europe over the medium and longer run should be reforms on the supply-side of the euro area economy. Eliminating constraints and rigidities in the labour and product markets that limit mobility and competition is essential for infusing new dynamism into the European economy. Such dynamism should to help boost aggregate demand. There is not enough time for me to address the necessary structural reforms. I should say, however, that, by improving the functioning and expanding the productive capacity of the euro area economy, greater market flexibility and higher productivity growth would also enhance the scope for monetary policy's scope for supporting stronger demand without jeopardising price stability. In the United States, our central bank colleagues have been able to strengthen economic activity while maintaining low inflation because of the American economy's flexibility and high productivity growth.[1]

Overall, the medium-term outlook for price stability is favourable and the prospects for stronger and broad-based growth are encouraging. Needless to say, we will continue to monitor carefully all developments that might affect our assessment of the risks to price stability. This leads me straight to my next point.

2. Fiscal developments and the single monetary policy

At present, fiscal developments in the euro area pose a very serious challenge to economic and monetary policy in Europe. We - and I can speak for all my colleagues on the Governing Council - view this matter with deep concern. Observing the manner in which the debate has evolved, and the public discourse surrounding it in several Member States, some of us have a sense of *déjà vu* - a feeling that we have experienced it all before. The process of widening budget deficits and the transmission of their effects on long-term growth is usually gradual. The anticipated short-term positive effect of deficits on aggregate output is often supported by arguments focusing on their immediate direct impact while neglecting their indirect and long-term unfavourable consequences. Since the process is gradual, there are often, depending on the prevailing economic situation and the initial fiscal position, no visible strong indications of the ultimate adverse effects of persistently high budget deficits. As Paul Volcker once said: "Things continue in government unless you feel a crisis. In fact, we didn't have a crisis, so the deficit persisted." As we know from experience in many countries, the necessary adjustment for correcting growing and persistent fiscal imbalances can be painful. Moreover, in situations when the initial fiscal position of a country is unsatisfactory, as reflected not only in the budget deficit but also in the public debt-to-GDP ratio and the size of the unfunded future liabilities of the social security system, an expansionary fiscal policy and the concomitant widening of the deficit may not have a positive effect on economic activity, even in the short run. In such situations,

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[1] See Robert Gordon "Two Centuries of Economic Growth: Europe Chasing the American Frontier" (http://faculty-web.at.northwestern.edu/economics/gordon/355.pdf) for comparisons of productivity growth rates and living standards between the European Union and the US.

households and investors are likely to adjust their own spending in view of the perceived inevitable need for the government to reverse the fiscal stance in the future.

Sound public finances are beneficial for the economy for several reasons. In particular, because they sustain consumer and investor confidence and thus contribute to growth and employment. Furthermore, a credible and respected fiscal policy framework is all the more important in a monetary union. In the Stability and Growth Pact, the EU has given itself such a framework. If we - the Governing Council of the ECB - are now insisting that the rules should be fully abided by and implemented in every respect, this is not out of a mere concern for procedure. Of course, fiddling with procedures and timetables can harm the credibility and public acceptance of the Pact. What has not been sufficiently emphasised, however, in the public debate is the *economic* rationale behind the Pact. Let me elaborate:

In a large single currency area, unsustainable fiscal policies and excessive deficit financing in one country can become more tempting, since the “punishment” in the form of higher interest rates is spread over all member countries and might be imposed with some delay. The temptation to “free-ride” and the associated negative externalities it implies for all other member states need to be limited by a set of rules effectively discouraging excessive fiscal laxity. The current debate about a more flexible “interpretation” of the provisions of the Pact can damage the credibility of the overall economic policy framework in the euro area. Moreover, part of this debate is beside the point.

The Pact already allows for considerable flexibility in the conduct of fiscal policy and in the application of the Pact’s rules. The Pact does take into account that national budgets also need flexibility to adapt to the economic situation, especially since the single monetary policy has to focus on price stability in the euro area as a whole. Such flexibility is best provided via the so-called automatic stabilisers: revenues and spending can vary in a proportionate and smooth way throughout the economic cycle, while deficits and surpluses should broadly balance each other out in the course of time. A balanced budget over the medium term not only contributes to the sustainability of public finances but it also allows fiscal policy to play an output-stabilising role.

We sometimes hear these days siren songs about abandoning the Pact, so as to “give growth a chance”, as if policy makers were confronted with a choice between stability and growth. This is a fallacy: stability and growth are not, in general, conflicting economic objectives. Rather, they reinforce each other. A credible consolidation of public finances, especially if embedded in a comprehensive medium-term strategy of expenditure reform, will enhance confidence and contribute to growth. The Pact provides a fiscal policy framework which aims to promote both stability and growth, as suggested by its name.

In what way does the current state of public finances in the euro area pose a challenge to the conduct of monetary policy? There is no straightforward relationship in the short run between the budgetary situation and the monetary policy stance, since several other factors also determine economic and financial conditions and the outlook for price stability and, therefore, influence the decisions of the central bank. It is also not easy to identify a simple relationship between high budget deficits and the level of interest rates, not least because economic agents’ expectations, including expectations about the future course of fiscal policy, play a crucial linking role. That said, both theory and evidence teach us that over longer periods of time, and “other things being equal”, imprudent fiscal policies and a stability-oriented monetary policy will become incompatible and will eventually clash. Such a constellation of policies - given the commitment of monetary policy to price stability - will have adverse effects on growth.

3. Monetary policy in a heterogeneous economic area

The challenge posed by fiscal developments in the euro area is - hopefully - of a transitory nature. Other challenges may be of a more permanent nature. I am referring to the challenge of defining a monetary policy for a single currency area, in which regional inflation rates and growth dynamics continue to exhibit certain divergences. The forthcoming large-scale enlargement of the EU, and later on, of the euro area, is unlikely to diminish this challenge. Allow me to address these issues in turn.

Differences in inflation rates across the euro area have, after a significant decline in the first year of monetary union, increased again in 2000 and remained stable for the rest of the period until now. Even though in terms of size the inflation differentials are not noticeably different from those observed across regions of the US, they are more persistent on this side of the Atlantic.

From theory, it is clear that participation in a monetary union - where domestic monetary and exchange rate policies are no longer available to correct for country-specific imbalances - makes relative price and wage flexibility as well as factor mobility increasingly important as alternative adjustment mechanisms. Does that mean that we should accept inflation differentials as a “normal” phenomenon in a large and heterogeneous economy like the euro area? Any economist proud of his profession has the answer ready: “It depends.” And in this case, he is right. On the one hand, inflation differentials can be “benign”, for example, when they are associated with the process of a gradual catching-up of incomes and the general price level. On the other hand, inflation in a particular country that is persistently higher than the monetary union average can be a reason for concern, given its effects on competitiveness. However, in these latter cases, policy makers often have means at their disposal to address at least part of this problem: for instance, by tackling existing rigidities in wages and prices, or the lack of openness and competition in key industries; through liberalisation measures and structural reforms; through measures to increase the flexibility of labour and product markets.

As regards growth differentials, the 1990s witnessed a significant convergence of real GDP growth rates, as preparations for the euro got underway. National policies oriented towards price stability and budgetary consolidation as well as moderate wage growth led to a marked synchronisation of business cycles. More recently, however, we have also observed the apparent cyclical divergence between a group of fast-growing, smaller countries and the larger countries at the core of the Union, where growth has been sluggish. Several factors can explain these phenomena: first, the “tigers at the fringes” of the euro area economy were those that benefited particularly from the convergence of interest rates towards historically low levels. Nevertheless, the degree of dispersion of growth rates during the second half of the 1990s was still lower than that observed in the 1980s and early 1990s. Second, over the past three years the pattern of GDP growth rates has converged again. I see the cyclical downturn, triggered mainly by the “common shock” of a large fall in world trade, as a determining factor during this period. Third, interest rate convergence may have also greatly contributed to the cyclical synchronisation of domestic demand in the euro area. In fact, not only short-term interest rates have fully converged, but long-term interest rates have also been characterised by a sizeable convergence, while disparities in real interest rates have narrowed. In that sense, we have evidence that the dynamics of convergence that can be expected to be inherent in a monetary union appear to be at work. These developments have contributed to making the transmission of the effects of the single monetary policy across euro area countries more symmetric.

4. The challenge of enlargement

These conclusions should reassure all those who are concerned about the increasing heterogeneity of the EU economy as a result of the forthcoming enlargement of the Union - and, later on, of the euro area. Given that all acceding countries are committed to the eventual adoption of the euro, and a number of them are eager to do so sooner rather than later, many observers had raised questions whether this would put intolerable strain on the cohesion of the euro area and whether it would impair the proper functioning of the single monetary policy?

These are serious questions, which require thoughtful answers, not least in order to properly communicate the impact of enlargement and foster public support. Let me point - briefly and inevitably somewhat sketchily - to three main arguments in this context: first, “size matters”, in that the impact on euro area aggregates of future entrants into monetary union should not be overstated: the combined GDP of the new Member States amounts to around 6% of euro area GDP. Second, the ten acceding countries have undergone a remarkable economic transformation in the past decade, with high growth rates; inflation rates that are close to the euro area level; with relatively stable exchange rates; falling long-term interest rates and a gradual catching-up in terms of real incomes. That said, it is a fact that in some countries fiscal developments, persistent current account deficits as well as financial sector developments and the employment performance are not satisfactory and will need to be carefully monitored. Third, the Treaty requires a thorough examination of convergence - and its sustainability - to assess whether the new Member States are ready for participation in EMU. Achieving a high degree of nominal convergence and a significant degree of “institutional” convergence is essential for, first, smooth participation in the Exchange Rate Mechanism (ERMII) and, later on, successful membership in the euro area. Such an approach is beneficial both for the functioning of an enlarged euro area and for the performance of the economies of the new Member States within monetary union. The greater the degree of the new Member States’ nominal and institutional convergence prior to the adoption of the euro, the smaller the variability of inflation and output across the euro area as a whole. Put differently, adequate preparation for future expansions of the euro area will help to make the challenge of heterogeneity more manageable.

Let me conclude my “movement of the concerto” with a fitting quote from the American writer Joshua J. Marine: “Challenges are what makes life interesting; overcoming them is what makes life meaningful.” In this sense, I see both a very “interesting” and “meaningful” time ahead of us, for the ECB and economic policy makers in the European Union.

Thank you very much for your attention.