Jean-Claude Trichet: The euro - five years on

Speech by Mr Jean-Claude Trichet, President of the European Central Bank, at the Annual Dinner of the Guild of International Bankers, London, 2 February 2004.

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Ladies and gentlemen,

For five years now, we have had a single currency and a monetary policy conducted by the Eurosystem, consisting of the European Central Bank and the national central banks of the euro area. The introduction of the single European currency has been a historical landmark. The process of preparing for the adoption of the single currency had led to a degree of convergence in the 1990s that many had not thought possible.

Sceptics were unconvinced as to whether it was possible to establish the euro as a stable currency and to successfully formulate a monetary policy for a diverse currency area. In particular, some observers considered the continuing existence of autonomous national fiscal policies as incompatible with a supranational monetary policy. The "one-size-fits-all" approach implied by the single monetary policy was, on account of the diverse nature of the currency area, criticised to give rise to permanently asynchronous economic developments. Critical observers therefore took the view that a stability-oriented monetary policy was doomed to failure.

Where do we stand five years later? The euro has been firmly and credibly established as a stable currency. The euro area has witnessed a period of low rates of inflation and low levels of long term interest rates. Most countries have had their lowest market interest rates for decades. The introduction of the euro, first, in book-entry form, and, second, in the form of banknotes and coins went very smoothly. The euro has become part of people's daily lives.

The successful introduction of the euro

The birth of the euro and the cash changeover

In January 1999 the **transition** to the euro was virtually free of technical problems, although many people had predicted that such a big project would inevitably be delayed or affected by bugs. We established, almost overnight, a unified money market, which functioned smoothly from the very start.

Three years later, the exchange of the old national banknotes and coins of the 12 countries of the euro area for the new euro notes and coins was a huge organisational, logistical and technical undertaking. The **euro cash changeover** progressed well and rapidly, without any major hitches, to the benefit of more than 300 million European citizens.

The mandate of the ECB

Equally important, the ECB's monetary policy has been successful in keeping **inflation and inflation expectations** under control over the last five years, even in the face of substantial adverse shocks. To a large extent, policy had to be **conducted in a context of exceptional economic, financial and geopolitical uncertainty**. But we kept a steady hand and never overreacted, with a view to anchoring long term inflation expectations.

It is important to recall which factors have enabled us to make the euro a stable currency. I would name here, most importantly, the institutional framework of European Economic and Monetary Union. The Maastricht Treaty assigned to the Eurosystem the unambiguous **responsibility for the maintenance of price stability**. This clear focus of our mandate and the independence granted to the ECB have been indispensable in ensuring a high degree of credibility for our policy from the outset.

There is a broad consensus today that the overriding goal of monetary policy should be the maintenance of price stability. If credibly pursued, this will create confidence, thus diminishing inflation risk premia incorporated in long-term interest rates and enhancing, ultimately, growth and employment. Price stability also prevents the large distortions in relative prices which are encountered with inflation or deflation, and which lead to a misallocation of resources. It also avoids an ad hoc redistribution of wealth as a result of unexpected price developments, thereby also contributing to social cohesion. Thus, an environment of stable prices fosters the functioning of the price mechanism, favours allocation efficiency, anchors inflation expectations and reduces market uncertainty and risk premia. Maintaining price stability is therefore a necessary condition for sustainable growth and job creation and this is recognised very widely. It is in particular a strong belief that the Eurozone shares with the United Kingdom.

The institutional framework for monetary policy in the euro area has helped the ECB to keep inflation low and stable. The **credibility of the ECB** is reflected in low long-term inflation expectations. And this credibility was already high at the start of European Economic and Monetary Union. I well remember that at that time some observers argued that the quality of the euro as a new currency would converge only towards a sort of an arithmetic average of the legacy currencies, rather than to the benchmark set by the stronger ones. In fact, what happened is that long-term interest rates in all participating countries converged towards those of the most credible currencies. This is one of the euro's main achievements.

Independence and transparency

The independence of the ECB and the need for transparency go hand in hand. For us to successfully maintain price stability, we constantly have to make all the reasons underlying our decisions transparent to the public. The announcement of the monetary policy strategy in October 1998, well before the introduction of the euro, was a key element in this. It clearly stated the ECB's understanding of its objective and the framework used to guide policy decisions. In addition, the regular publication of the Governing Council's assessment of the current economic situation and the risks to price stability are an important part of our striving for transparency. Monetary policy decisions are regularly explained in the **press conference** that we give after the first meeting of the ECB Governing Council every month. Further details are given in the Monthly Bulletin of the ECB, in the speeches given by members of the Governing Council and in the testimonies of the President to the European Parliament. With its monthly press conference the ECB was the first central bank to provide such extensive and open real-time diagnosis - and other central banks are now doing likewise.

The historic enlargement of Europe

EU enlargement

The introduction of the euro as a stable common European currency was not the last challenge to be faced by the ECB and the European Union in general. The forthcoming enlargement of the EU will be the largest ever expansion of the European Union. The number of Member States will go up from 15 to 25 and the EU population will increase to more than 450 million people.

Many acceding countries have made remarkable progress in recent years, especially in terms of macroeconomic stabilisation and structural reforms. Moreover, those eight acceding countries that were formerly centrally planned economies have been able to establish functioning market economies, thus driving forward the process of transition.

There remain, however, important challenges. The task at hand is to advance **real convergence** while safeguarding and, where necessary, enhancing macroeconomic and financial stability. In particular, locking in inflation at low levels, preserving the soundness of the financial sector and making determined efforts towards fiscal consolidation are all of the utmost importance.

At present the **gap in per capita income** between the current and most new Member States is large. For acceding countries as a whole, per capita income today is less than half of the average of the euro area. In general, the process of catching-up in respect of real incomes has been slower than many expected at the start of transition, while the progress achieved has differed from country to country. Given the low starting point for most countries, increasing prosperity and living standards will remain their main policy objective for quite some time.

Of course, accession to the EU has a positive effect on the countries' growth prospects. Full integration in the internal market and inclusion into EU regional policies will foster the catching-up process.

Moving towards the euro

The Eurosystem has been engaged since 1999 in a constructive dialogue with the central banks of the acceding countries. The governors of these central banks already attend the meetings of the General Council of the ECB as observers and will as from 1 May 2004 be full members of that Council.

Enlargement of the EU will also lead to an **expansion of the euro area** at some time in the future. The main aim of the Eurosystem in this process is to ensure that the monetary integration of the new Member States proceeds in a smooth manner and in line with the Treaty provisions. The principle of equal treatment will continue to apply throughout the entire process of monetary integration. Adopting the euro is an irrevocable decision and it is of the utmost importance that countries fulfil the convergence criteria in a sustainable manner, as required by the Maastricht Treaty. There will be no additional criteria but neither will there be a relaxation of the criteria.

The Governing Council of the ECB published a policy position paper on exchange rate issues relating to the acceding countries on 18 December 2003. This document consolidates into a single comprehensive policy text the previous positions of the Eurosystem on the matter. It lays out the key principles for financial markets and for the public at large in a European Union of 25 Member States.

As the acceding countries differ greatly in terms of economic structure, exchange rate and monetary regimes, and in the degree of nominal and real convergence already achieved, they will need to be assessed on a case-by-case basis throughout the **process leading to their adoption of the euro**. In this respect, no single path towards ERM II and the adoption of the euro can be identified or recommended. Many strategies may be feasible, provided they are based on sound economic reasoning, conform to the existing institutional framework and contribute to the high level of sustainable convergence which is essential when joining the euro.

The need for structural reforms

While Economic and Monetary Union has been highly successful in furthering macroeconomic stability in Europe, policymakers still have to undertake important efforts to fully realise the advantages of a stable common currency. Structural economic impediments in participating countries reduce employment opportunities and real income, and they undermine the sustainability of the social security system. It is therefore widely recognised that **structural reforms in capital, labour and product markets** are needed to improve the prospects of the euro area. In this respect, the ECB very much welcomes and supports the impetus given by the Lisbon European Council to the economic reform process. Structural reforms that are designed to increase the flexibility of markets permit a higher level of sustainable long-run growth and employment. They furthermore enhance the capacity of the participating countries to cushion macroeconomic shocks. The more rigid labour, product and financial markets are, the higher will be employment and income losses experienced in response to changing domestic and global economic conditions. This is due to the fact that prices and wages cannot adjust suitably and in a timely manner. Conversely, the speedier adjustments of wages and prices can take place in response to adverse changes in macroeconomic conditions, the lower will be the costs in terms of employment and output losses.

As the central bank responsible for the euro area, we place great value on seeing a major necessary condition for growth, job creation and prosperity for current and future generations being fulfilled: ensuring price stability, confidence in the euro and its purchasing power is our own decisive contribution to sustainable growth. And this contribution is less difficult to deliver in an environment where governments and social partners - based on sound policies - contribute to confidence and potential output growth.

There is no denying the fact that the implementation of structural reforms requires courage and leadership. Especially, as they may temporarily have negative repercussions for some groups, namely those that profited from protective regulations or subsidies. For example, while regulatory reforms will ultimately result in broader choices and lower prices for consumers, they may imply some adverse short-run effects for formerly protected firms. This may, amongst other factors, be due to the inefficient use of resources in incumbent firms before the sector was opened up to competition. However, after some time, employment in the liberalised sector can be expected to increase, as new services are being introduced. Most importantly, all other sectors which before had to finance the subsidies will immediately enjoy the benefits from the reform. These gains are often overlooked in the public debate. In fact, there is a **formidable challenge to gain the support of parliaments and the public for**

implementing structural reforms. It is therefore imperative to make it clear to the public that, if governments and social partners deliver those reforms, the net benefits will be significant.

The impetus from **determined structural reforms in capital, labour and product markets would set in train a virtuous circle of increasing confidence**: the more credible the reforms are, the more confidence they will create, and the more confidence is created, the sooner positive results will be visible.

Among the necessary measures, structural reforms in capital markets should aim to allow a more effective allocation of savings toward the most rewarding investment opportunities. Since the introduction of the euro, the pace of reform has been impressive. Through a cohesive and effective interplay of free competition, co-ordinated action by all market participants and policy enforcement by public authorities, micro-economic reform in capital markets has been proceeding. However, the need for continuation and completion remains. First, the Financial Services Action Plan (FSAP) initiated by the European Commission in 1999 should be implemented and enforced, giving rise to a genuine common financial legislation and regulation. And second, a further consolidation and integration of market infrastructure and harmonisation of the standards and conventions routinely used by market participants, is required, extending also to accounting standards.

Also regarding the integration and level of competition in **goods markets** much progress has been achieved. But substantial barriers to trade and free competition continue to exist, particularly limiting the integration of services markets. The Internal Market Directives have not yet been fully implemented, and a number of infringement cases, too, indicate that delays and inefficiencies remain. A strengthening of competition, through further deregulation, should be accompanied by a sustained reduction of state aid - particularly to the extent that it constitutes economically questionable ad-hoc and sector-specific measures. This will help to smooth the restructuring process in goods markets, by promoting the entry of new players. It will enhance innovation and an efficient allocation of resources. It will have a downward effect on prices. And cuts in industry- or sector-specific subsidies will reduce the tax burden. All this will contribute to boost welfare across the euro area.

Progress with the implementation of structural reforms in **labour markets** has been uneven in the euro area. Output growth has become somewhat more job intensive at the end of the 1990s, and we also have some tentative evidence that the structural level of unemployment has tended to decline. However, it is urgent to reduce non-wage labour costs and labour mismatch and to improve the flexibility of labour contracts and wage-setting to enhance employment growth in a lasting manner. This will help to increase the employment opportunities for those who face particular difficulties in the labour market, such as women, the youngest, the oldest age and the lowest educated groups. These measures have to go hand in hand with a reform of the pension and health care system. They are indispensable to contain expenditures on pensions and health care and thus to reduce non-wage labour costs.

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In conclusion, Ladies and Gentlemen, let me make three remarks.

First, as regards the Euro, I would only mention here that the Eurozone today represents already four fifth of the number of countries members of the present European Union, four fifth of the population and four fifth of the GDP of the fifteen. Let me add that UK entry is very warmly welcomed by all of us. That of course depends on the decision of the authorities and people of the United Kingdom.

Second, as regards enlargement, I would like to stress again the major historic achievement that it represents. It is not only an impressive illustration of the success of the concept of European Union. It is also a formidable chance and opportunity for Europe, not the least in the economic field. Let us seize this chance and this opportunity in a highly responsible and professional manner in the Western part of Europe as well as in the Central and Eastern part of it. We have all reasons to be optimistic as regards the impact of this historic endeavour on overall European growth.

Third, the ECB is conscious of its particular responsibilities in a time of meditation and hesitation as regards the institutional framework of present and future Europe. We do all what we can to preserve and enhance confidence as a fully unified executive institution in our domain of responsibility. Let me also tell you that I remain personally very confident that Europe will overcome its present difficulties. I draw this personal intimate conviction in particular from the reading of Jean Monnet's memoirs written in 1976 : "When one sees the persistence of European sentiment within this permanently changing environment, one cannot doubt that there is at stake a very powerful trend of historic nature (...) '*Il faut compter avec le temps*', One has to take account of time".

“Those who decide not to start any enterprise because they are not assured that things will move in strict conformity with their plans are condemning themselves to absolute immobility. Nobody can say today what will be the shape of tomorrow’s Europe, because future changes that will be born from present changes are unpredictable”. This was written in 1976 by the founder of the European Community concept. It is truer than ever today.

Ladies and gentlemen, thank you for your attention.