Jean-Claude Trichet: European priorities - an ECB perspective

Speech by Mr Jean-Claude Trichet, President of the ECB, at the European Institute, Washington, 23 April 2004.

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Ladies and gentlemen,

The introduction of the single European currency has been a historical landmark. For more than 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 euro has been firmly and credibly established** as a stable currency. The euro area has witnessed a period of moderate inflation rates and low long-term interest rates. Almost all countries have seen their lowest market interest rates since the Second World War. **Where do we stand now and which are the "European priorities" we are currently facing?**

I would like to concentrate on three key priorities, which I consider particularly challenging at the current juncture: the historical **enlargement** process of Europe, the need for higher growth and employment by means of **structural reforms** and the necessity of implementing an original concept of fiscal surveillance in a single currency area.

The historic enlargement of Europe

Ten countries in Central and Eastern Europe and in the Mediterranean will join the European Union (EU) on 1st May 2004. This upcoming enlargement is profoundly rejoicing. It is an emblematic illustration of the victory of political democracies on totalitarism. It is a living demonstration of the efficiency of market economy rules. And it gives the funding fathers of the European Union the most extraordinary reward they could have dreamt of fifty years ago. Had we told Jean MONNET in the fifties that one day the six would be twenty-five, that we would not only have a single currency for 306 million people but also a single market for 450 million European producers and consumers and that the reconciliation between Germany, France, Italy and the BENELUX countries was only the prelude for a future intimate Union between a large part of the East of Europe and the full body of the West of your continent, what would have he been likely to say? Perhaps, as is reflected in his memories: It is an extraordinary historical achievement but we will be in the future even more surprised: "the historical evolution of United Europe is unpredictable because nobody can say which new bold changes will be triggered tomorrow by the effects of today's changes".

Whatever new achievements are likely in the future, today the ten new Member States together, with 75 million people, will increase the EU population by about 20%, to more than 450 million people. The economic weight of the new Member States is lower. Their total GDP represents, at market exchange rates, around 5% of that of the current EU. Looking beyond these numbers, **the largest ever expansion of the Union in terms of new countries will** bring important economic benefits. **Both new and current Member States alike will be able to enjoy the mutual benefits of a wider Union**, in particular from the expanded internal market, as the cases of past enlargements showed. Trade integration has already reached a high level in the acceding countries, where 67% of the total exports and 60% of total import stems from the EU.

Both the current and new Member States have prepared intensively for enlargement. Let me first focus on the situation in the new Member States and then in the present Union members. I will concentrate on the ultimate objective of enlargement from the monetary standpoint, namely the future adoption of the euro by the new EU Member States.

The acceding countries have made remarkable progress in recent years. They significantly advanced macroeconomic stabilisation and structural reforms. Moreover, the former centrally planned economies have been able to establish functioning market economies. Overall, the progress they have made so far is encouraging. **There remain, however, great challenges**. The key ones are to advance real convergence while safeguarding and, where necessary, enhancing macroeconomic and financial stability. Locking in inflation at low levels, preserving the soundness of the financial sector, correcting of unsustainable external imbalances in a few cases and renewing efforts towards fiscal consolidation are all of the utmost importance. Moreover, the gap in per capita income between the current and most of the new Member States remains large. And in some countries, the process of catching-up in real incomes has been slower than expected at the start of transition. For acceding countries as a whole, per capita income today is less than half of the average of the EU. Given the low starting point for most countries, increasing prosperity and living standards will be a major policy objective for quite some time. In view of that strategic objective, one has to underline that prudent macroeconomic policies are key to support and facilitate progress towards higher GDP-per-capita levels.

Accession to the EU is expected to have positive effects on the countries' prospects for convergence. The full integration into the internal market will increase growth prospects and thus foster the catching-up process, mainly through trade and investment (FDI), together with lower interest rates. New Member States will have to implement and enforce the “acquis communautaire” of the European Union, which they have adopted in the course of recent years (excluding, for the time being, those areas where transitional arrangements apply).

The EU has also been preparing intensively to make enlargement work. Within the realm of central banking, the Eurosystem has been engaged since 1999 in a constructive and ever more intensive dialogue with the central banks of the new Member States. Already since the signing of the EU Accession Treaty in 2003, the Governors of the national central banks of acceding countries have been taking part as observers in the General Council of the ECB. I would also like to recall the unanimous recommendation we submitted on the voting modalities of an enlarged Governing Council, which has been accepted by the EU Council and is about to be ratified within these days by all Member States. This will allow the ECB to maintain efficiency and timeliness of decision-making in an enlarged euro area.

Eventually, enlargement of the EU will lead to the extension of the euro area, as the new Member States are expected to adopt the single currency at some point in the future. In fact, upon EU accession, **they will be committed to striving towards the eventual adoption of the euro**. The main aim of the Eurosystem in the process towards euro adoption is to ensure that the monetary integration of each new Member States proceeds in a smooth manner and in line with Treaty provisions. In view of this challenge, at the end of last year the Governing Council of the ECB adopted a policy position paper on exchange rate issues relating to the acceding countries. The Treaty foresees that at some point following accession, new Member States will join the Exchange Rate Mechanism II (ERM II). To ensure a smooth participation in ERM II, however, it would be necessary that major policy adjustments - for example with regard to price liberalisation and fiscal policy - are undertaken prior to participation in the mechanism and that a credible fiscal consolidation path is being followed. As they differ greatly in terms of economic structure, exchange rate and monetary regimes, and in the degree of nominal and real convergence already achieved, **no single path towards the euro can be identified or recommended to all of them**. Various 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 area. Progress towards the adoption of the euro will thus need to be assessed on a case-by-case basis. At the same time, 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 not only nominally but also in a sustainable manner before they enter the euro area, as required by the Maastricht Treaty. There will be no additional criteria, neither will there be a relaxation of the criteria.

The need for structural reforms

Let me now discuss the need for structural reforms in Europe which applies to both “new” and present Member States. On March 2000 the European Council held a special meeting in Lisbon dedicated to employment, economic reform and social cohesion. At this meeting, the Council set the European Union a new strategic goal for the next decade, namely “to become by 2010 the most competitive and dynamic knowledge-based economy in the world capable of sustainable economic growth with more and better jobs and greater social cohesion”.

The ECB very much welcomes and supports the impetus given by the Lisbon European Council to the economic reform process, the so-called Lisbon agenda. We also welcome that the Presidency Conclusions of the Spring 2004 European Council delivered a message of determination and confidence reinforcing the validity and relevance of he Lisbon process. **Four years after the launch**

of the Lisbon agenda, the pace of reforms needs, however, to be significantly stepped up in order to meet the ambitious targets defined in Lisbon.

Let me explain why we need structural reforms and we ask Member States to actively pursue their implementation. Structural reforms in participating countries increase employment opportunities and real income, and thus support the sustainability of the social security system. It is widely recognised **that structural reforms in labour, products and capital markets are needed** to improve the prospects of the euro area. Structural reforms permit a higher level of sustainable long-run economic growth by increasing the supply of production factors and improving the efficiency with which they are used. They furthermore enhance the capacity of the economy to cushion macroeconomic shocks. The more flexible labour, product and financial markets are, the lower the employment and income losses in response to adverse domestic and global economic developments will be. Moreover, given that demographics in the euro area are less dynamic than in other economies, including the US, we need even more improvements in terms of higher productivity growth, rising labour force participation and declining structural unemployment. The case for decisive structural reforms is therefore pressing.

Structural reforms are generally associated with changes in the long-term equilibrium demand and supply conditions of an economy and changes in the relative prices of goods and services. The transition from the pre-reform to the new post-reform equilibrium conditions normally takes time and within this period some resistance and uncertainty may occur. For this reason the implementation of **structural reforms requires a strong leadership, a great deal of courage and a tireless explanation activity**. It is very important to make it clear to the public that, if governments, Parliaments and social partners deliver those reforms, the benefits will be significant.

In **capital markets**, structural reforms should aim at allowing a more effective allocation of savings toward the most rewarding investment opportunities. Since the introduction of the euro, the pace of capital market reform has been impressive. This includes policy-induced reform, such as the Financial Services Action Plan initiated by the European Commission in the spring of 1999 or the development of national legal frameworks governing the issuance of mortgage bonds. Reform covers also market-led initiatives, such as the development of electronic trading platforms or consolidation in the clearing and settlement infrastructure. This was possible due to a cohesive and effective interplay of free competition, coordinated action by all market participants and policy enforcement by public authorities. The **need for continuation and completion remains**.

Much progress has also been made regarding the integration and level of competition in **product markets**. Substantial barriers to free competition continue however to exist, particularly preventing the integration of services markets and effective competition in network industries. Fostering competition in these areas should also contribute to a downward effect on prices. **Further regulatory reforms** should be accompanied by a sustained reduction in state aid - particularly if it constitutes economically questionable ad hoc and sector-specific measures. This will help to smooth the restructuring process in product markets by promoting the entry of new players. In the end, such reforms will enhance innovation and an efficient allocation of resources. And **cuts in subsidies** will reduce the tax burden. These product market reforms will contribute to prosperity across the euro area and they will help to **address what is the largest current economic and social challenge in Europe, namely high unemployment and insufficient employment rates**.

Thus far, progress with the implementation of **labour market reforms** has been uneven in the euro area. In some countries, significant achievements in terms of lower unemployment are already visible. Others are lagging behind and uncertainty prevails about future steps. In many countries, it is important to enhance the **flexibility of labour contracts and wage-setting** to enhance employment growth in a lasting manner. **Over the second half of the 1990s, efforts** made by some euro area countries to improve the functioning of the labour marked **appear to have been fruitful** in fostering employment growth and promoting a more job-intensive output growth compared to the late 1980s. In particular, labour market reforms implemented in the second half of the 1990s seem to have benefited those groups facing particular challenges when trying to enter the labour market, such as women, the youngest and oldest age groups and the lowest educated. Reforms are also needed that allow wages to reflect more strongly regional and sectoral productivity differences. This will make the whole economy more flexible and better able to absorb economic shocks. These measures have to go hand in hand with product market reforms and **reforms of the pension and health care system**. Such reforms are essential to contain expenditures on pensions and health care. They will not only be needed to reduce non-wage labour costs and increase incentives for job creation but also to ensure the sustainability of the social security systems.

The surveillance of fiscal policies

We have been very bold in Europe in setting up a single currency. I remember all the remarks made by American friends during the 90's. They were easy to sum up: “You put the cart before the horse. You should have first set up a political federation, with a federal government and a federal budget. Then you could have introduced a single currency.” Two main arguments were put forward. First, without a federal budget of some significance the policy mix would have been very erratic, depending on the random behaviour of the different national fiscal policies of the member countries of the Monetary Union. And second, without such a federal budget it would be impossible to weather, with the help of the fiscal channel, asymmetric shocks hitting one particular member economy of the Monetary Union. These two economic arguments are perfectly valid and would have been sufficient to discourage the creation of the Euro had we not set up a profoundly original concept of national fiscal policy surveillance. It is this concept, the Stability and Growth Pact which guarantees the coherence and the consistency of the European Economic and Monetary Union (EMU), namely a single currency area without a political federation. On top of these fundamental economic underpinnings a number of other considerations are worth mentioning. In particular, a fiscal policy that is set according to rules, and is lived up to, adds to macroeconomic stability by providing economic agents with expectations of a predictable economic environment. This reduces uncertainty and promotes longer-term decision-making, notably investment decisions, and economic growth. In addition, sound fiscal policies can contribute to lower risk premia on long-term interest rates and thus support more favourable financing conditions for the entire economy.

The fiscal rules set up under the **Maastricht Treaty** and the **Stability and Growth Pact** provide an important **framework to ensure the necessary fiscal discipline**.

The rules are useful at the country level to preserve budgetary discipline and sustainable public finances, which is the best contribution fiscal policy can make to macroeconomic stability and growth. In a monetary union like EMU with a single monetary policy and national fiscal policies, there are two additional arguments. For small countries, there is an incentive for an expansionary fiscal bias which could threaten sustainability, because the common interest and exchange rate might adjust only marginally to their fiscal imbalances. For big countries, on the other hand, lack of fiscal discipline may have an effect on the common interest and exchange rates, creating a negative externality for the other participants.

Compliance with the fiscal framework of the Treaty and the SGP guarantees the sustainability of public finances and the operation of automatic stabilisers, while respecting as much as possible the fiscal sovereignty of Member States.

Could we rely on financial markets to impose sufficient discipline on budgetary policy? In principle, growing concerns about the sustainability of a country’s debt should be reflected in the risk premia that this country would have to pay for its borrowing. However, it would be unrealistic and therefore very risky to rely only on financial markets. Experience suggests that financial markets react only with a substantial lag to a deterioration in the fiscal situation, but the reaction can then be quite drastic, coming too late for a timely correction, making the crisis more severe and placing a large burden on all participants.

In view of this, the Governing Council has expressed its regrets that, last November, the ECOFIN Council decided not to act on the basis of the European Commission's recommendations in the excessive deficit procedure. We also respect the Commission's decision to seek legal clarity with respect to the excessive deficit procedure. It would surely be wrong to declare the Stability and Growth Pact as dead. In fact, it is very much alive. We do not believe that it is advisable to amend the text of the SGP. We think however that, without actually changing the wording of the Pact, it would be possible to improve its implementation, in particular by better analysing the structural imbalances as well as by strengthening the incentives for sound fiscal policies during periods of strong economic growth.

The introduction of such policies will also **strengthen economic confidence** and support demand in the short run. Indeed, confidence among European citizens is vital for a stronger economic recovery and sustained growth. The ECB’s Governing Council recognises that the still low level of consumer confidence is related in part to the debate about the appropriate path for fiscal policy and structural reform in many countries in the euro area. Also for this reason, progress with the implementation of the necessary structural reforms and more determined efforts to establish sound fiscal positions over the medium term are the key to stronger confidence.

Let me underline as a conclusion that the ECB, its Governing Council, and the full body of the Eurosystem are doing all what they can for Europe to cope with its present challenges. Our best contribution, in conformity with our mandate, is to ensure price stability and to be credible in so doing not only on a short to medium term basis but also on a medium to long term basis. In fulfilling efficiently this role, the ECB brings about today a major contribution to European prosperity, growth and job creation: in consolidating a low level of medium and long term market rates for the 306 million citizens of the euro area; in preserving the purchasing power of the household which is a necessary condition for consumption growth; and in augmenting the level of confidence of economic agents which is so important in the present juncture in Europe.

Ladies and gentlemen, thank you for your attention.