Nicholas C Garganas: Adjusting to the single monetary policy of the ECB

Luncheon address by Mr Nicholas C Garganas, Governor of the Bank of Greece, before the Euro 50 Group, Athens, 24 June 2005.

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Ladies and Gentlemen,

I would like to thank Prof. Richard Portes for his kind introduction. It is indeed an honour and a pleasure to address such a distinguished audience of academics and practitioners specialized in the field of European economic policies and broader issues linked to the Euro.

This meeting is an important event. It takes place at a time of tensions about the impact of the single monetary policy on the euro area and when several commentators have raised doubts about the sustainability of monetary union. Europe's single-currency undertaking is perhaps the boldest attempt ever in which a large and diverse group of sovereign states has attempted to reap the efficiency gains of using a common currency. The euro has created a new monetary reality for 307 million Europeans that few would have thought possible a generation ago. Like most bold undertakings, however, the euro has had its share of ups and downs. When the euro was launched in 1999, skeptics were doubtful whether it would be possible to make the euro a stable currency. Yet, the euro, which is probably the most visible and tangible symbol of this integration process, is now in its seventh year and has been firmly and credibly established as a stable currency.

Today, I want to address a widely-debated issue - namely, whether a single monetary policy can fit all parties in a supposedly heterogeneous currency area. This issue has been debated extensively since the start of EMU. The debate has recently intensified, reflecting concerns about the increased divergence of growth rates over the past few quarters and uncertainties deriving from French and Dutch rejections of the Constitutional Treaty. Before I discuss this issue, allow me to offer the following qualification. My perspective is that of someone from Greece, a small, open economy with a history of very high inflation and enormous fiscal deficits in the 1980s and the first half of the 1990s. Other countries' perspectives might well highlight features other than those that I will discuss.

EMU: An optimum currency area perspective

EMU brought unique challenges for monetary policy. Critical observers took the view that a single monetary policy was doomed to failure. This skepticism was supported by the arguments of the traditional theory of optimum currency areas, which recommended monetary unification only among economies with flexible markets, free mobility of labour, a centralised fiscal policy, and a limited incidence of asymmetric shocks. Clearly, these conditions did not - and do not - hold for the euro area. After all, the euro zone is characterised by significant rigidities in labour and product markets, the absence of a significant centralised fiscal transfer mechanism, and national economies with unique institutional and economic features - a set of circumstances that results in a high incidence and impact of asymmetric shocks.

In these circumstances, so the argument goes, such shocks are likely to lead to widening price differentials so that a common nominal interest rate in the monetary union results in different real interest rates among countries. For member countries with relatively-strong domestic demand and a higher-than-average inflation rate, the lower real interest rate fuels domestic demand and national inflation. Conversely, for countries with relatively-weak domestic demand and a lower-than-average inflation rate, the high real interest rates put further downward pressures on domestic demand and inflation. A one-size monetary policy, in other words, does not match the needs of all members.

The foregoing, traditional view of optimum currency areas neglects several important factors. It seeks to identify the characteristics that a country should satisfy prior to joining a monetary union - that is, ex ante. We now know, however, that participation in a monetary union may itself induce changes in economic structure and performance ex post through at least two channels. These channels operate through enhanced credibility and trade and financial integration.

How does the credibility channel work? A major benefit of participating in EMU, especially for countries such as Greece, Italy, Portugal, and Spain that have had recent histories of relatively-high inflation rates, has been the credibility gain derived from eliminating the inflation bias of discretionary monetary

policy. With low and stable inflation and inflation expectations, nominal interest-rate differentials between these countries and countries with histories of relatively-low inflation rates, such as Germany, have almost been eliminated. With lower nominal interest rates in traditionally high-inflation countries, the cost of servicing public-sector debt is reduced, facilitating fiscal adjustment, and freeing resources for other uses. Moreover, with low and stable inflation, economic horizons lengthen, encouraging a transformation of the financial sector. The lengthening of horizons and the reduction of interest rates stimulate private investment and risk taking, fostering faster growth.

For Greece, entering the euro zone has meant not only the loss of an independent monetary policy - the fruits of which were amply demonstrated in the 1980s and the early 1990s - but also the credibility gains associated with a stable, low-inflation monetary regime. In the 15 years until 1994 - the year in which Greece's efforts to qualify for euro-area entry began in earnest - inflation averaged almost 20 per cent while real growth averaged less than 1 per cent. In contrast, during the past 6 years real growth has averaged more than 4 per cent while inflation has been slightly above 3 per cent. Another way to infer the credibility gains is by looking at interest-rate spreads. In 1997, the year in which a 10-year government bond was first issued in the Greek financial market, the yield differential between that bond and the comparable German bond was 412 basis points. Today, it stands at only 24 basis points. I suggest, therefore, that giving up a nationally-tailored monetary policy has not, in fact, been a cost, but a benefit.

Now let me turn to the trade channel. Recent empirical work has shown that a common currency can promote trade and growth over and above any effect produced by separate currencies tied together with fixed exchange rates. For the euro area, the evidence suggests that the adoption of the euro has already increased trade among EMU members by between 4 and 16 per cent compared with trade among European countries that have not adopted the euro. Increased trade integration leads to more-highly-correlated business cycles because of common demand shocks and greater intra-industry trade, reducing the need for country-specific monetary policies.

There are additional reasons that a monetary union reduces the incidence of country-specific shocks. One of the principal causes of asymmetric shocks - the effects of divergent monetary policies - no longer exists. Furthermore, it is to be expected that the deepening of financial-market integration will also entail a convergence in the transmission mechanism of monetary impulses. Finally, the common currency helps to increase price transparency and, therefore, competition in goods, services and factor markets, leading to a further alignment of economic cycles.

Inflation differentials

The fact remains, however, that there are inflation differentials among the members of the euro zone. How significant are these differentials and how concerned should we be? Recent evidence provided by the ECB shows that, over the period 1990-99, the 12 countries now comprising the euro area experienced a downward trend in the degree of inflation dispersion - measured as the standard deviation of that dispersion - from about 6 percentage points in the early 1990s to a low of less than one percentage point in the second half of 1999. Since that time, inflation dispersion has changed very little - that is, it remains less than a percentage point. To provide a basis of comparison, since 1999 inflation dispersion across the euro area has fluctuated close to the level observed across the 14 metropolitan statistical areas of the United States. Remarkably, the process of nominal convergence in the euro area was not accompanied by greater dispersion of real GDP growth rates, which has remained close to its historical average of around 2 percentage points following the adoption of the euro.

There is one notable difference, however, between inflation differentials in the euro area and those in the United States. Although inflation differentials in the euro area have not widened, they have exhibited a relatively-high degree of persistence, higher than that experienced across the 14 metropolitan statistical areas of the United States. Seven of the 12 euro-area economies have recorded annual inflation rates that have remained either persistently above or persistently below the euro-area average since 1999. One of those countries is Greece, where inflation has persistently exceeded the euro-area average by about one-and-a-half percentage points since Greece became a member of the euro area in 2001.

Several factors have contributed to the persistence of inflation differentials across euro-area economies. One factor in relatively-low income countries, such as Greece, is the so called Balassa-Samuelson effect, according to which long-term differentials in regional inflation are attributable to

differences in the rate at which productivity increases in the various regions' tradable and non-tradable goods sectors. Although it is difficult to quantify this effect with precision, it provides only a partial explanation for the persistent inflation differentials that exist in the euro area. In any case, this effect is a transitory one. It is part of what I have called the adjustment mechanism - in this case, the adjustment to a higher standard of living.

Other factors contributing to the inflation differentials within the euro area, including misaligned fiscal policies, wage dynamics not linked to productivity developments and structural inefficiencies such as rigidities in product and factors markets, are not so benign. Redressing these problems, as you know, is not within the domain of monetary policy. National economic policies are the relevant instruments to enhance the ability of individual countries to respond to economic shocks and to national divergences. I believe that EMU has helped stimulate reforms in the euro area. Major reforms are undoing the rigidities accumulated over decades, preparing social institutions for the looming demographic changes and making the euro area increasingly competitive internationally. It is crucial to continue strengthening competition in labour and product markets, for example, through liberalisation and deregulation, to improve the efficiency of price signals. National fiscal policies also provide important instruments. They can react to shocks in such a way as to counteract the emergence of differentials. However, sound public finances are an essential element of price stability and are necessary if automatic stabilizers are to work fully without the risk of excessively high deficits. In this respect it is important that Governments strive to achieve balanced budgets or surpluses in periods of favourable economic activity.

What difference would such changes make? I previously referred to the relatively-low dispersion of real growth rates in the euro area, which is, in fact, of an order of magnitude near that existing among regions of the United States. The dispersion among US regions, however, is centered around a higher average growth rate. Since 1999, the US economy, which is more flexible than that of the euro zone, has grown at an average rate of about 3.1 per cent, compared with about 1.9 per cent average in the euro area.

It is important that national labour market policies enhance flexibility at the national and regional levels. Structural policies should also aim at improving the efficiency of the wage and price setting mechanism to reduce the persistence of inflation divergence. In this connection, I should note that in some countries, such as Greece, wage behaviour has not fully adapted to the new regime.

Conclusions

Let me conclude with the following thoughts. Recent events have given rise to some populist rhetoric about the wisdom of a single currency within Europe. A few commentators have posed the question: Why have a monetary union in Europe? My perspective is very different. I share the sentiment of my colleagues on the Governing Council who have dismissed as "absurd" speculation that the euro area's future has been thrown into doubt. A single-size monetary policy has worked extremely well, delivering price stability so that changes in prices convey more effective information about demand and supply conditions.

The credibility of the ECB's monetary policy has delivered interest rates that are at historically low levels to all member countries of the euro-area. Yet, price stability and low interest rates are not enough to raise growth and improve living standards. They provide the fabric upon which a more dynamic Europe can be woven. Recent events, in my view, only confirm that a currency union requires greater competition than do independent monetary areas. Market reform and strict fiscal rules are not luxuries for members of a monetary union, but necessities. In response to those who are asking, "Why have a single currency? let me cite some wise words penned by the late Irish playwright, George Bernard Shaw. "Some people," he wrote, "look at things as they are and ask, 'Why?' I look at things as they might be, and ask 'Why not?'" This, Ladies and Gentlemen, is the way I look at the future of Europe. Why not, indeed?

Ladies and Gentlemen, thank you for your attention.