# Jean-Claude Trichet: EMU after seven years - successes and challenges

Speech by Mr Jean-Claude Trichet, President of the European Central Bank, at the Frankfurt Chamber of Industry and Commerce, Frankfurt am Main, 5 May 2006.

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Ladies and gentlemen,

Es ist eine große Freude für mich, heute auf Ihrer Konferenz über meine Ansichten und Erfahrungen zur Europäischen Wirtschafts- und Währungsunion und zum Euro sprechen zu dürfen. Selbstverständlich ist mir bewusst, dass der Deutsche Industrie- und Handelskammertag (DIHK) immer ein starker Befürworter der Währungsunion und allgemein des europäischen Integrationsprozesses war. Lassen Sie mich den weiteren Vortrag nun in Englisch halten.*[It is a great pleasure for me to speak today at this conference about my views on and experience of Economic and Monetary Union in Europe and the euro. I am fully aware that the Deutscher Industrie und Handelskammertag (DIHK) has always been a strong supporter of the EMU and, more generally, of the European unification process. Before continuing, please let me switch into English.]*

In the first part of my talk today I shall elaborate on the reasons why I think that the single currency and the single monetary policy introduced more than seven years ago have worked very well. Nevertheless, past success is not an excuse to overlook the challenges that lie ahead of us all, policymakers and social partners. In the second part of my speech I shall thus try to make clear how, in my view, these future challenges imply an urgent need for action and reform going forward. And finally, I will discuss how such reforms support the ECB's monetary policy and the adjustment mechanism in the euro area.

But let me start with the first years of EMU.

### A credible and transparent new monetary policy framework

At the time of the introduction of the euro, a completely new monetary policy framework was introduced in Europe, with the European Central Bank (ECB) conducting a single monetary policy for the entire euro area, consisting of eleven and soon twelve countries and more than 300 million citizens. The most remarkable aspect of this new endeavour is that since the very beginning the ECB and the euro managed to inherit the high level of credibility already achieved by the most stable national currencies, which had been earned during many years of successful, stability-oriented monetary policy. It should not be underestimated that at the time of the introduction of the euro, all along the yield curve, market interest rates on instruments denominated in euro became aligned with the lowest – and not with the average – rates prevailing prior to the euro; the historically low level of short, medium and long-term market interest rates was unthinkable in some countries which had experienced much higher interest rates in the past. At the same time, the creation of a single currency put an end to the high volatility and realignments of exchange rates among euro area countries which used to significantly distort their relative competitiveness.

The successful implementation of the single monetary policy in the euro area is rooted in the institutional framework enshrined in the Treaty establishing the European Community as well as in the effectiveness of the ECB's monetary policy strategy.

With regard to the key institutional provisions, the ECB has been given a clear mandate, namely to pursue the primary objective of maintaining price stability, and its independence is fully guaranteed by the Treaty. Furthermore, principles for pursuing sound fiscal policies are enshrined in the Treaty; the Stability and Growth Pact implements these principles via regulations.

Turning to the monetary policy strategy, it is based on the definition of price stability and on a comprehensive two-pillar approach involving both an economic and a monetary analysis. The precise definition of price stability for the euro area showed full continuity with the national central banks' previous definitions of price stability and thus ensured that inflation expectations for the new currency would be the same as for the most credible national currencies immediately before the setting up of the euro. Our commitment to monitoring monetary developments and cross-checking the results of this analysis with the results of the economic analysis helps to frame the ECB's daily assessment and monetary policy conduct in a medium-term perspective that provides strong support to the anchoring of long-term inflation expectations. Over time we have deepened our monetary and economic analysis and we publicly explained in considerable detail the principles which govern our monetary policy. This includes issues such as the relationship between asset prices, fiscal policy or cross-country diversity, on the one hand, and monetary policy, on the other.

It is my conviction that the public and in particular financial markets have over time understood very well how the ECB conducts its monetary policy. This has helped us to achieve a high level of predictability of policy, which signals a high degree of transparency. This is particularly rewarding, considering that part of our job is devoted to explaining and discussing our actions and our concept to the public. Transparency is not only a precondition for accountability, but also a crucial aspect of a successful monetary policy, as it makes policy more effective. In this regard, allow me to stress that the ECB was the first major central bank to introduce on a monthly basis a press conference displaying in detail the diagnosis and the monetary policy decisions of the Governing Council to the public only a few hours after the end of the relevant meeting.

All of these factors have contributed to the high degree of credibility enjoyed by the ECB's monetary policy and thus to price stability and the successful anchoring of inflation expectations. But credibility is never gained once and for all. It has to be permanently preserved and enhanced. That is why the ECB pays the utmost attention to monitoring inflation expectations.

**Price stability contributes to low macroeconomic volatility in the euro area**

In our short history, we have had to face substantial challenges and economic shocks. Just think of the economic consequences of the terrorist attacks in September 2001, the sharp decline of equity prices at the beginning of this decade and the substantial increases in oil prices.

Against this background, our track record since 1999 in terms of price developments and inflation expectations bears testimony to the ECB's ability to deliver a monetary policy that is in continuity with the best practices inherited from the national central banks of the euro area. As you know, the ECB aims to maintain price stability by keeping inflation rates below, but close to 2% over the medium term. Since the launch of the euro back in 1999, the inflation rate in the euro area has been on average slightly above 2%. We are of course not satisfied with inflation above 2%. In this context it is important that, since 1999, average long-term inflation expectations – as measured, for example, by Consensus Economics forecasts or the Survey of Professional Forecasters – have been at a level consistent with price stability, i.e. below, but close to, 2%. The steadiness of inflation expectations over such a long period of time, during which, as mentioned, many unforeseen events impacted on the euro area inflation rate, demonstrates that markets and private agents perceive the ECB as being fully committed to maintaining price stability in the euro area.

The process towards Monetary Union and the stability-oriented monetary policy of the ECB have improved the welfare of euro area citizens, both directly by maintaining price stability and indirectly by contributing to lower volatility and uncertainty of macroeconomic developments. First, in concomitance with the intra-euro area convergence process in the 1990s, inflation volatility almost halved. The volatility of quarterly changes of HICP inflation in the euro area (measured as the standard deviation) fell from around 0.6 percentage point during the 1980s to around 0.3 percentage point in the 1990s. Over the last seven years, inflation volatility has only been 0.2 percentage point, in spite of major inflationary shocks during this period. And the average volatility of long-term consensus inflation expectations has also declined substantially, by four-fifths, from almost 0.5 percentage point in the 1990s to less than 0.1 percentage point in recent years.

Lower volatility of actual and expected inflation reduces consumer and investor uncertainty and thereby benefits all citizens. Stable inflation expectations and a high degree of confidence on the part of financial market participants in monetary policy should, over time, also lead to a reduction in the volatility of longer-term interest rates, and thus also to lower risk premia. Indeed, we have seen a substantial decline in the volatility of long-term interest rates. In the 1990s, for example, the standard deviation of long-term interest rates (on the basis of monthly data) was around 2 percentage points; in the past seven years, this measure has fallen to around 0.7 percentage point.

Anchoring inflation expectations is not only important for maintaining low medium and long-term market interest rates, it is also crucial for reducing macroeconomic fluctuations in response to economic shocks. It is welcome if wage and price-setters in the euro area incorporate an inflation rate which is in line with our definition of price stability. Indeed, less indexation of wages and prices to current and past inflation would tend to contribute to lower volatility of employment and output in response to macroeconomic shocks. Under current circumstances, this implies that higher inflation due to oil price shocks and higher indirect taxes should not be included in wage contracts. Otherwise unemployment and inflationary pressures would increase.

It is sometimes argued that a policy aimed at price stability could lead to higher unemployment and increased macroeconomic volatility. It will not surprise you that I do not agree with this view. To the contrary, not only reforms that enhance the flexibility of markets, but also credible monetary policy and well-anchored inflation expectations, over time, contribute to job creation and to dampening macroeconomic fluctuations. And indeed, the achievements in the area of monetary stability have not come at the cost of higher unemployment. Despite remaining at still unacceptably high levels, especially in some euro area countries, the unemployment rate in the whole euro area has averaged around 8½% over the past seven years, which is more than one percentage point lower, on average, than in the 1990s. Furthermore, annual employment growth (in terms of persons employed) has doubled from an average of around 0.5% in the 1980s and 1990s to around 1.2% since the start of the single monetary policy. Moreover, in recent years the volatility of some real variables has also declined relative to the averages observed during the 1980s and 1990s. For example, the volatility (in terms of standard deviation) of quarter-on-quarter percentage changes of real GDP growth has fallen from around 0.5 percentage point in the 1990s to around 0.4 percentage point in the last seven years. The volatility of employment growth has also fallen from over 0.3 percentage point in the 1990s to 0.2 percentage point since 1999.

### The challenges ahead: reforming the structure of the euro area economy

A fair assessment of the last seven-and-a-half years of economic developments in Europe cannot avoid taking into account the fact that despite the success of EMU, output growth has been disappointing. A major reason has been that labour productivity growth has been weak since the mid-1990s. In my view, this is, together with too high unemployment and the implications of population ageing, the main economic problem that policy-makers are currently facing in the euro area. I will now illustrate this issue in more detail and thereafter argue that the solution requires a stepping-up of structural reforms aimed at increasing the as yet insufficient flexibility and dynamism of some euro area economies.

Since the launch of the Lisbon strategy in 2000, the average annual real GDP growth rate for the euro area has averaged 1.8%, thus remaining below its main competitors. In the last fifteen years per capita income growth in the euro area has been relatively subdued and systematically lower than in other developed economies like the US. Furthermore, the employment rate in 2005, at 64%, remains considerably lower than the employment rate in the US, where it stood at 71% in 2005.

The main factor behind these developments is the disappointingly low trend in hourly labour productivity growth in the euro area, which declined to an average 1.2% over the period 2000-2004, down from 1.8% during the 1990s and 2.4% during the 1980s. By contrast, in the US hourly labour productivity growth accelerated to an average of 2.8% over the period 2000-2004, which is more than double as high as in the euro area.

The lack of sufficient flexibility in labour and product markets in Europe is, in my view, a major determinant of the sluggish economic growth and of the still high unemployment in the euro area.

I will therefore now turn to structural reforms that have the potential to increase both euro area labour productivity growth and labour utilisation, and therefore also the long-run growth potential of the economy.

Without aiming to be exhaustive, I should like to highlight some of the key priorities for reform in three main areas, namely getting people into work by enhancing the functioning and the flexibility of the labour market, increasing competition in product markets and unlocking business potential by creating an entrepreneurial-friendly economic environment.

Finally, I shall address the main fiscal policy challenges and in particular the implications of population ageing in the euro area for the sustainability of pension and healthcare systems.

First of all, well-functioning labour markets set the right incentives for households which take decisions concerning their participation in the production process by entering the labour market and actively searching for a job. Some observers have argued that European households prefer to work less in comparison with, for example, US households, thus attributing the relatively low participation in the labour market to some deep behavioural motivation or preferences. In my view, this argument is not satisfactory. The low labour participation rates in the euro area are significantly influenced by structural distortions like the legal and regulatory environment, the tax systems and social institutions. For example, marginal tax rates that are too high discourage labour market entry and have a downward effect on average hours worked. Moreover, restrictions on the maximum number of hours worked, imposed either by social partners' agreements or by law, are also often not in line with preferences of a number of individual employees. Furthermore, benefit systems that are too generous discourage job search and early retirement schemes encourage early withdrawal from the labour market. Rigidities caused by regulations, in particular wage rigidity and a high degree of job protection for older workers, reduce the incentives for firms to hire people in this age group. Indeed, in 2005 the employment rate for workers aged 55-64 in the euro area was just two-thirds of the corresponding figure in the US. In addition, female labour force participation rates in the euro area could also be supported by specific measures, like the adequate provision of childcare facilities, aiming at reconciling motherhood with professional life. Finally, a more extensive use of flexible forms of work such as part-time and temporary work may also provide further working incentives for those categories of workers that would not find it feasible to become full-time employed.[1]

I do not deny that much has been done in the last ten years in those European countries that have joined the euro area. In many countries labour market institutions, for example, have become less rigid. This has helped to maintain wage moderation across the euro area and has helped monetary policy to maintain price stability. Furthermore, the liberalisation and the increase in competition in some sectors have already brought significant benefits in terms of lower prices for some goods and services.

However, it is my firm opinion that much remains to be done in order to address the structural difficulty of the euro area economies to achieve a satisfactory level of productivity.

Beyond the reform of tax system and labour market regulations, it is crucial to improve the labour force's level of education and expertise. This will allow for an efficient allocation of workers between sectors and firms as well as facilitate product innovation and the adoption of new technologies.[2] The last decades have seen an enormous increase in the level of educational attainment of new generations in the euro area. Nevertheless, meeting the challenges of technological progress and preserving the labour force's employability and flexibility require that human capital continuously adjusts to labour market needs through improved education and training as well as lifelong learning. We need to think of market-oriented measures which enhance the incentives of firms, employees and unemployed people to invest in education and knowledge.

Structural measures aiming at increasing labour supply, however, would not solve the serious unemployment problem in the euro area, which requires the fostering of labour demand through higher wage flexibility and adjustments to the level of employment protection legislation, in particular where this legislation impedes the hiring of younger and older workers.

Second, increasing competition in an effort to establish efficient and well-functioning product and service markets is another prerequisite for higher medium to long-term growth. A lack of competition harms productivity trends by limiting production efficiency and by reducing the incentive to innovate. Restrictions on competition also hinder job creation. In the EU, it is crucial to build on the experience of several network industries that are now fully or largely open to competition. For example, the extensive liberalisation of the telecommunication sector in the course of the 1990s led hourly labour productivity in that sector to grow on average by 8.5% in the euro area over the period 1996-2003 compared with 6.9% in the US.[3] If liberalisation and higher competition are pursued in other services sectors, it is very likely that such excellent productivity growth performances can be repeated. And to the extent that nominal wage moderation is ensured conditions for job creation are enhanced.

In this respect, it is crucial that policies aimed at increasing the level of competition and at liberalising the product markets include the extension and deepening of the EU internal market. The internal market policies have already contributed to an increase in employment and real income in the EU. However, there is much more potential that could be exploited, especially in the services-related

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[1] See, for example, V. Genre, R. Gomez-Salvador and A. Lamo (2005), "European women: Why do(n't) they work?", ECB Working Paper Series, No 454, March.

[2] See G. Schwerdt and J. Turunen (2006), "Growth in euro area labour quality", ECB Working Paper Series, No 575, January.

[3] Groningen Growth and Development Centre (GGDC) database of Groningen University.

activities, which represent around 70% of nominal value added and employment in the euro area and where labour productivity is particularly disappointing in comparison with the US. The directive aimed at a free market for services in the European Union which is currently being prepared is thus very important.[4] However, it would be desirable that Member States improve their record of existing internal market legislation and proactively ensure that the number of internal market infringements is kept to a minimum.

The third prerequisite for higher growth in the euro area is the unlocking of business potential by creating an entrepreneur-friendly economic environment. This includes lowering costs and constraints imposed by public sector administrations on existing firms and business start-ups. According to the World Bank, in 2004 the average cost of starting a business with up to 50 employees in the euro area (excluding Luxembourg) is estimated to have been around ten times higher than in the US. Furthermore, today it takes on average 27 days to set up a new business in the euro area[5] compared with 5 days in the US.[6] In this respect, it is important that European governments and EU institutions follow up on the recent call of the European Council for the establishment of "one-stop" arrangements in each Member State which would allow the setting-up of a company in one week by end-2007.

Furthermore, to fully exploit productivity potential, the labour and product market reforms just mentioned need to be accompanied by policies that help to diffuse innovation and technological change. This includes, inter alia, measures to support innovation through higher investment in research and development in order to reach the target of 3% of GDP by 2010 that Europe has set itself.

Turning to the challenges pertaining to fiscal aspects of EMU, I would start by stressing why maintaining sound fiscal positions is important. The sustainability of fiscal policies reduces the uncertainty surrounding long-term economic decisions, thus reducing risk premia on borrowing and lending rates, and fostering higher investment and consumption. Hence, it is of the utmost importance that national governments continue to proceed along the virtuous fiscal policy path that they took in the 1990s, when the convergence process led the average deficit ratio in the euro area to decline to 2.6% in 1997 from about 5% in 1990. More recently, the euro area average deficit ratio has remained below the values recorded in the 1980s and 1990s. As a consequence, the long-run increasing trend in the debt ratio, which more than doubled from 34.2% in 1980 to 74.7% in 1997, has been halted.

Overall, the fiscal policy framework was successful in reducing average fiscal deficits in the euro area and halting the trend increase in the debt ratio. This framework, as laid down in the Maastricht Treaty and the Stability and Growth Pact, ensures that fiscal discipline is maintained in EMU. In this respect, it must be admitted that a number of governments still need to correct large fiscal imbalances and improve the structure of public finances. Moreover, national institutions for fiscal policy-making should support the fiscal commitments under the EU framework. Finally, governments must prepare now for the fiscal burden arising from demographic ageing that in the long run will put a substantial burden on public finances. In a recent report by the Economic Policy Committee, it has been projected that if the implications of ageing are not addressed by structural changes, public expenditure could increase by up to 10% of GDP in the euro area by 2050.

This will occur directly through the impact on public pension and healthcare expenditure as well as via the growth-dampening effects of a gradually shrinking share of the labour force in the population. Hence, governments need to take pre-emptive action today before expenditure pressures start to increase rapidly after 2010. In many countries, this requires reducing current debt ratios and reforming public pension and healthcare systems. This, in conjunction with reforms that aim at increasing labour market participation and lowering unemployment, will allow the euro area to cope with population ageing and to maintain a sustainable fiscal position whereby the tax burden is reasonable and does not impede sustained growth.

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[4] See also ECB (2006), "Competition, productivity and prices in the euro area services sector", ECB Occasional Paper Series, No 44.

[5] Unweighted average. Figures range respectively from lows of 8 and 11 days in France and the Netherlands to highs of 47 and 54 days in Spain and Portugal.

[6] Data collected from the Doing Business database maintained by World Bank (www.doingbusiness.org).

**Structural reforms support the ECB's monetary policy and also enhance the intra-euro area adjustment mechanism**

As a welcome side-effect, the structural reforms that I just discussed also have a positive impact on the conduct of monetary policy in the euro area.

From the euro area point of view, structural changes which enhance flexibility, job creation and potential growth tend to facilitate monetary policy and increase its effectiveness. A more flexible economic environment helps the labour and product markets to better adjust to economic shocks and to respond to policy actions more quickly. For example, more flexible labour markets may imply that negative supply shocks are absorbed with a less pronounced increase in inflationary pressures. This, in turn, allows monetary policy to react less strongly. Furthermore, in the case of a cyclical downturn caused by a temporary lack of demand, flexible markets and, in particular, wages normally allow monetary policy to lower policy rates more or faster as inflationary pressures decline more quickly in an economic downturn.

Furthermore, enhancing the single market as well as the structural flexibility of the euro area national economies will also facilitate the ECB's single monetary policy by improving the functioning of the intra-euro area adjustment mechanism.

If there are situations of excess demand, or overheating, in one region of the euro area and, at the same time, there is a lack of demand, or under-utilisation of capacity, in another region of the euro area, a well functioning adjustment mechanism ensures that such divergences do not become too persistent and do not lead to an unwelcome dispersion of countries' business cycle positions.

To be sure, the available empirical evidence on output growth and inflation differentials within the euro area shows that the magnitude of inflation and output growth differentials across the euro area countries is not exceptional and is comparable to that in the United States.

In addition, it appears that cyclical synchronisation in the euro area is relatively high.

However, contrary to the experience of the US regions, output growth and inflation differentials in the euro area have been rather persistent and seem to be largely driven by persistent positive or negative deviations from the euro area averages. Over the last ten years, the performance of euro area national economies in terms of real GDP growth rates has been polarised, with a group of countries growing persistently at lower rates than the euro area average and another group growing persistently at higher rates. These trend deviations reflect in particular differences in the potential growth. In turn, these differences can be very much related to the different degree of market flexibility in each single country and to the structural reforms that have been implemented in the past.

Hence, structural reforms are needed that help to reduce output growth differentials in two ways: first, by increasing potential growth, especially in those euro area countries that have shown a persistently low growth performance; and second, by enhancing the functioning of the key channels or mechanisms of adjustment within the euro area, namely the trade channel and the risk sharing channel.

I have discussed the impact of reforms on productivity and potential output growth one minute ago. Let me now elaborate on the second issue by giving you some examples of how structural reforms could improve the adjustment mechanism within the euro area.

First and foremost, it is important to increase price and wage flexibility within the euro area in order to allow firms to quickly adjust their cost and price structure to the changing demand conditions for their products. For example, following a negative demand shock in one country, a lack of competition and the related rigidities of wages and prices – including stickiness of nominal wages and excessive protection – would hinder the market adjustment that entails lower prices and costs for domestically produced services and goods. In this case, the real exchange rate (or the trade) channel cannot work effectively and higher unemployment and other regional disparities could be persistent. However, increasing the flexibility of the national economies, while necessary, may not be fully sufficient to ensure that the adjustment to asymmetric shocks does not generate unwelcome inflation and output growth differentials. To reduce the persistence of low capacity utilisation and higher unemployment in the regions hit by a negative shock, it is important to foster competition and trade across national borders. Firms and workers in the slow-growing regions with under-utilised capacity would then find it easier to supply their goods and services in fast-growing, overheating regions. Enhancing cross-border trade and competition would thus contribute over time to a smoother and quicker "reallocation of excess demand" across the euro area countries and in this way allow the euro area to adjust to asymmetric shocks and different national policies with less pronounced and less persistent swings in relative wages and in relative unemployment.

Another important area for reform relates to the progress in creating conditions which allow a market and competition-based process of enhanced integration and efficiency of financial markets across the euro area. To be sure, the money market is already very well integrated. This is crucial for a swift implementation of the single monetary policy, since only an integrated interbank market can ensure that central bank liquidity is evenly distributed and the level of short-term interest rates across the euro area is homogeneous. Furthermore, the level of integration of the euro area government bond markets is also very high, mainly due to the disappearance of intra-euro area exchange rate risk and the convergence of inflation expectations across countries by the time the euro was introduced. Finally, the corporate bond market in the euro area is fairly well integrated in the sense that the country of issuance is only of marginal importance in explaining yield differentials.

Leaving aside stock markets where the integration across the euro area, measured by the reaction of individual markets to euro area-wide factors and news, is an ongoing process, one major area where further integration is warranted is the retail banking industry. The Eurosystem, together with the European Commission, supports the initiative by the European Payments Council to create a Single Euro Payments Area (SEPA), in which European citizens should be able to make payments throughout the euro area from a single bank account using a single set of payment instruments as easily and safely as in the national context today.

Enhanced financial integration and portfolio diversification should tend to make financial structures more similar and reduce firms' and households' exposure to regional shocks. In particular, it would help to mitigate the adverse consequences of a downturn in the economic activity of a particular country or region within the euro area. In this way, enhancing conditions for cross-border investment and financial integration and the related increased portfolio diversification would imply that original asymmetric shocks and trends have more homogeneous effects on real income across the euro area. This would limit one possible source of unwelcome inflation and income differentials.

**Conclusion**

Let me now conclude. I have explained today that EMU and a credible monetary policy benefit euro area citizens and create great opportunities for job creation. A good monetary policy is a prerequisite for sustainable growth and job creation but cannot, alone, guarantee full success. Other conditions have to be met. It cannot be stressed enough that a high degree of flexibility in all markets, as well as further progress in terms of financial and economic integration, are also preconditions for job creation, prosperity and growth.

Regulations or laws that hinder competition between existing firms and the entry of new competitors tend to support excess prices, incomes and profits in those sectors that are protected. Of course, the costs of such protection have to be borne by consumers in the form of overly high prices, by the unemployed in the form of fewer opportunities for new jobs and by most workers as reduced productivity growth undermines prospects for real wage increases.

Indeed, the more successful the structural measures aiming at increasing productivity growth are, the more jobs will be created at current wage levels.

I am fully aware that it is often not easy to implement structural reforms and consolidate government budgets because public opinion is sometimes not fully convinced or aware that everybody would benefit from these reforms. The ECB considers itself part of the necessary process of awareness rising, of tireless explanation. For this reason I have spent some time today discussing this issue.

I thank you for your attention.