# Nout Wellink: Economic and Monetary Union at eight – achievements and challenges

Speech by Dr Nout Wellink, President of the Netherlands Bank and Chairman of the Basel Committee on Banking Supervision, at the Nieuwegein Business Center, Studievereniging ECU '92, Nieuwegein, 31 May 2007.

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## Introduction

Eight years after its establishment, it is sometimes forgotten what a monumental achievement Economic and Monetary Union actually is. In the early nineties, many people believed it would never happen. Others speculated that if it were to happen, it would soon fall apart. These doomsayers were wrong. Monetary Union happened and it happened smoothly, bringing huge benefits to the people who share the euro. With this in mind, I will today resist the temptation to predict the future of Monetary Union. Instead, I will touch upon the benefits of having the Monetary Union and the key challenges it still faces. By taking up these challenges, I am positive its future can be shaped into a more prosperous one.

## The achievements of EMU

Let me first go into the economic benefits of the Monetary Union. The euro has brought about substantial improvements in the macroeconomic policy framework. Most notable is that the ECB has managed to deliver low and stable inflation. Although countries like Germany and the Netherlands also enjoyed low inflation before the adoption of the euro, the ECB has been able to “export” that benefit to other countries, such as Italy and Spain. This has been greatly facilitated by the ECB´s independence and its mandate to safeguard price stability. As a result, annual consumer price increases in the euro area have been kept around 2 percent over the past 7 years. The ECB has also succeeded in anchoring stable and low inflation expectations, as indicated by consumer surveys and inflation-indexed bonds. This is a major achievement for a young central bank, in particular considering the shocks the euro area faced such as sharp rises in oil prices. Along with lower inflation, interest rates have fallen dramatically. Globalisation has definitely played a role, but the credibility of the ECB has also contributed to lower interest rate levels.

It takes two to tango: macroeconomic stability in a monetary union cannot be guaranteed without sound fiscal policies. The Stability and Growth Pact aims to ensure prudent fiscal policy over the economic cycle. In the medium and long run, the Pact also promotes sustainability of public finances. If we look at the cyclical-adjusted fiscal balance over time, we see an impressive improvement in the run up to the euro. Between 1995 and 1999, the average public sector deficit fell from 4.5 to 1.5 percent of GDP. In the following years this deficit worsened again, to a low-point of 2.8 percent of GDP in 2002. The good news is that this bottom lies at a much better level than the troughs in the 1980s and 1990s. As a consequence, the increasing trend in the debt-to-GDP ratio, which rose to almost 75 percent of GDP in 1997, has been reversed and declined to 69 percent of GDP in 2006. While this performance is not impressive against the backdrop of lower interest rates, it does suggest that with the arrival of the euro the worsening in public finances has come to a halt.

Besides supporting macroeconomic stability, Monetary Union has been a catalyst for integration. The euro has eliminated exchange rate risks within the euro area and has increased price transparency across borders. These factors have led to significant positive effects on trade within the euro area. A popular empirical model to analyse trade flows is the so-called gravity model. It is a straightforward application of the Newtonian model of gravity from physics. Translated to economics, bilateral trade tends to increase with the size of the countries concerned and to decrease with their mutual distance. Figuratively speaking, distances have become smaller between member states by the elimination of exchange rate risk and the reduction of transactions costs. Studies using this method estimate a positive growth effect on trade of 5 to 10 percent[1]. Another indication of increased trade within the Monetary

[1] R. Baldwin (2006), The euro’s trade effects, European Central Bank Working Paper No. 594, March 2006.

Union is the substantial decline in the differences of traded-good prices across member states. These have dropped to a level akin to regional price differences in the US[2].

But Monetary Union has left it greatest mark on European financial markets. Traditionally, the efficiency of these markets has been hampered by costs associated with the use of multiple currencies. Given the large volumes traded in financial markets, even small transaction costs can produce substantial distortions. The euro has reduced those transaction costs and has improved the efficiency of European financial markets. For example, euro area cross-border holdings of bonds have increased strongly – from about 10 percent at the end of the 1990s to 60 percent in 2006[3]. This suggests that investors are increasingly diversifying their portfolios across the euro area. Together with financial innovation, the euro has increased market liquidity and the opportunity for risk sharing. The bond market's depth has recently increased to 11 trillion dollar, outnumbering the size of euro area's GDP. Admittedly, the corporate bond market in the euro area is still substantially smaller than in the US, as European firms traditionally rely more on bank financing. However, firms on this side of the Atlantic increasingly make use of debt securities. Between 1998 and 2006, the value of outstanding bonds in terms of GDP has doubled, while it increased "merely" 60 percent in the US[4]. More efficient and deeper financial markets benefit companies through lower borrowing costs.

## The challenges for EMU

As we speak, the euro area is undergoing an upturn. Economic figures have been better than expected. In 2006, GDP grew by 2.9 percent, outstripping the United States for the first time in 5 years. Unemployment has fallen to 7.5 percent in 2006, the lowest level in 15 years. While the recovery reflects a cyclical upswing, these figures also suggest that structural reforms in the past are starting to pay off. However, as Henry Kissinger once said: "each success only buys an admission ticket to a more difficult problem". Monetary Union's problem is twofold: weak public finances and subdued per-capita-income growth. Things have improved, but I am convinced we can do much better. Without aiming to be exhaustive, I will mention a few steps that enable countries to tackle these issues and to further capitalise on the advantages of the single currency.

## Creating sustainable fiscal positions

A first challenge will be to bring public finances on a sustainable footing. In periods of buoyant revenue growth, there is often a tendency to overestimate the strength of the underlying budgetary position. That is partially because economists can only tell you tomorrow why things predicted yesterday didn't happen today. If spending is allowed to increase on a structural basis, but higher revenues turn out to be transitory, the budgetary position starts to deteriorate as soon as economic conditions turn nasty. This was exactly the mistake made by some countries in the beginning of this decade. Let's not repeat that mistake. Countries with sizeable deficits and public debts should use the current windfall in tax revenues to consolidate. Sound public finances are also crucial for dealing with the costs due to population ageing. While living longer is good news, public expenditures in the euro area are projected to increase by up to 10 percent of GDP by 2050 if the implications of ageing are not addressed[5]. Action is therefore needed. By lowering public debt more financial room is created for less favourable democratic times. But governments should also reduce the burden of ageing itself by, for example, reforming public pay-as-you-go pension schemes. Germany and the UK have recently announced a gradual rise in the statutory retirement age to 67 and 68. As this measure appears quite effective to absorb an increasing life expectancy[6], other European countries should follow this example.

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[2] J.H. Rogers (2007), Monetary Union, Price Level Convergence, and Inflation: How Close is Europe to the United States?, Journal of Monetary Economics, 54 (2007) 785-796, and Faber and Stokman (2005), Europese convergentie in vogelvlucht, Economische Statistische Berichten, 128-130.

[3] ECB (2007), Financial Integration in Europe, March 2007.

[4] BIS (2007), BIS Quarterly Review, March 2007.

[5] Economic Policy Committee (2006), The impact of ageing populations on public spending, November 2006.

[6] CPB (2006), Ageing and the sustainability of Dutch public finances, March 2006.

### Improving labour markets

Fiscal consolidation is more likely to succeed if it is accompanied by structural reforms that lift the potential growth path. One obvious candidate is the labour market. The average participation rate in the euro area still relatively low. This is most striking for workers aged between 55 and 64, where the rate is just two-third of the figure in the US. It is often argued that this is because Europeans are keen on leisure. But financial incentives play a large role in people's decision to either work or not. For example, empirical studies show that labour supply is responsive to the tax rate on labour. This suggests that if we want to increase economic wellbeing, improving financial incentives could be of help. Labour force participation could be stimulated by further lowering marginal taxes on labour. According to the OECD, the average marginal tax rate on labour in the euro area is high and it hovers around 15 percent points above the rate in the US[7]. Female participation could be supported by providing adequate childcare facilities. Euro area's labour markets could also use some extra flexibility. The OECD indicated that rigid employment protection and generous unemployment benefits have barely changed over the last years. In 2005, the average replacement rate of unemployment benefits[8] in the euro area was more than 20 percent higher than the OECD average[9]. Improving labour market dynamics involves making employment protection less stringent and reducing the length of unemployment benefits. Through this, employees will get a stronger incentive to seek a job, while firms will find it more attractive to hire people.

### Fostering service market competition and a friendly business environment

Increasing competition in service markets is another condition for higher economic growth. A lack of competition harms productivity growth by limiting efficient production and reducing the incentive to innovate. "Necessity is the mother of innovation", Veblen once said. I think he is right. When there is pressure from contenders, one tends to perform better than without competition. Much headway has been made in raising competition in product markets. Also in some service sectors there has been progress. Noteworthy in this regard is the opening up of the telecommunication sector in the late 1990s. However, differences in permits, regulations and national monopolies continue to hinder cross-border competition in a number of service sectors, such as mail and electricity. This is particularly regrettable, given that services represent 70 percent of GDP and employment in the euro area. That also illustrates the importance of the European Service Directive. While this Directive has been watered-down compared to the Commission's original proposal, it still has benefits. It has been calculated that consumption in the EU can rise by 0.3-0.7 percent permanently due to the Directive[10]. I agree, this does not sound spectacular, but it only entails the static effect of increasing trade opportunities. If the dynamic effects from increased competition are taken into account, the number is expected to be higher. Air travel offers an example of what can happen. Due to liberalisation and competition, air travel within the EU has come within reach of tens of millions of people, often at lower fares than 20 years ago. In view of these benefits, it is important that countries bring their legislation in line with the Directive over the next years.

Enhancing cross-border competition one thing, creating an entrepreneur-friendly environment is another. This includes lowering the costs and constraints imposed by the public sector on existing and start-up firms. According to the World Bank, in 2005 the average cost of starting a business with up to 50 employees in the euro area is estimated to be 10 times higher than in the US. That is, if entrepreneurs have not given up starting a business in the meantime, as it takes on average 27 days to set up a new business in the euro area, compared to just 5 in the US[11]. I always had respect for entrepreneurs, but it's getting larger in view of the red tape they have to cut through. In this respect, I fully underscore the

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[7] Marginal tax on labour consists of income tax, employee and employer social contributions as a percentage of total labour costs of average worker.

[8] The average replacement rate is measured by the average unemployment benefits relative to the average income for three different family situations (single, dependent spouse and working spouse)

[9] A. Bassanini and R. Duval (2006), Employment patterns in OECD countries: reassessing the role of policies and institutions, OECD Working Paper No. 486, June 2006.

[10] CPB (2006), The trade-induced effect of the Service Directive and the country of origin principle, CPB document 108, February 2006.

[11] World Bank (2006), World Development Indicators, Business Environment database.

current EU Commission initiative for measuring the cost of existing legislation and reducing the administrative burden on companies with 25 percent by 2012.

### Stimulating further financial market integration

Economic growth can get an additional boost by more financial market integration. Clearly more needs to be done in the equity market. While slowly increasing, only a quarter of the equity portfolio of euro area residents consists of equity issued in another euro area country. Home-bias might be one reason for lagging integration; high costs for cross-border transactions are another. This partly reflects the lack of integration in market infrastructure for equities. Settlement of equities in Europe is divided over 19 different systems compared to only two in the US[12].Since the introduction of the euro, consolidation in this sector has failed to take place and barriers continue to hold back cross-border trade. This hampers competition, keeps transaction costs high and weakens the opportunity for risk sharing. If the market fails to produce satisfying results, than it is up to the public sector to act. Against this background, the ECB has recently launched its proposal for a single securities settlement platform. The huge economies of scale it aims to produce should create scope for lower transaction costs and a more efficient allocation of savings and investment.

Another area where further integration is warranted is the retail banking sector. The cost of opening a bank account and the cost of transferring money from it widely differs between euro area countries. National discrepancies in legislation, technical standards and procedures are obviously major impediments to further integration. Fortunately, the right initiatives are underway. It already started in 2001, with the Regulation on cross border payments in euro. Better known as the Bolkestein Regulation. This Regulation paved the way for the Single Euro Payments Area. An ambitious initiative, where European citizens should by 2010 be able to make payments throughout the euro area from their bank account as easily and safely as in their own country today. By creating a pan-European infrastructure and identical payment tools, all payments in the euro area essentially become domestic payments. 15 years ago this goal was beyond imagination. Now it appears within reach.

### Concluding remarks

To conclude, the euro has seen a number of successes: the introduction of a new currency for more than 310 million people, price stability, low interest rates and progress in the integration of the goods and financial markets. These achievements are remarkable, as they have been realised in a short period of time and in a unique political context. Indeed, Europe is the world's laboratory: we created the first supranational entity based on a sense of solidarity rather than coercion. Of course it is not all plain sailing. In the fields of public finances and the internal market work remains to be done to reap the full benefits of the euro. It is therefore important to remain ambitious in the near future. Not ambitious to be, but ambitious to do. How Monetary Union will evolve in the future is hard to predict. But if the past 8 years offer a compass for the future, I am optimistic we find the right answers to our current challenges.

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[12] G. Tumpel-Gugerell (2007), The competitiveness of European financial markets: an economic framework for effective policy making, speech at Washington Economic Policy Conference, 12 March 2007.