Lucas Papademos: Challenges for the European economy

Speech by Mr Lucas Papademos, Vice-President of the European Central Bank, at the conference “The European Political Ideal: Cultural Origins and Future Challenges” organised by the European Cultural Centre of Delphi and the Konstantinos G Karamanlis Foundation, Delphi, 23 July 2007.

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I. Introduction

“There is nothing more difficult to carry out, nor more doubtful of success, nor more dangerous to handle than to initiate a new order of things.” These were the warning words of the Italian statesman and political philosopher Niccolo Machiavelli, back in the 15th century. It is in the light of these words that we can especially appreciate the extraordinary achievement of the Treaty of Rome, signed 50 years ago. For that Treaty did no less than “initiate a new order of things” in Europe. It changed – irreversibly – the relations among the nations of this Continent. When Konstantinos G. Karamanlis was born, 100 years ago, Europe was dominated by nation-state rivalry, mercantilist competition and eventually isolationist protectionism that led to two catastrophic fratricidal wars among the nations of Europe. At that time, it was difficult to envision that, 50 years later. The leaders of a war-torn Continent would muster the courage and imagination to create the foundations of what is today the European Union. But they did. They managed to “think outside the box” of autonomous nation-states and indivisible sovereignty and they fashioned a novel political entity, in which decisions are made together on many important issues and sovereignty is shared, and where supranational institutions assume responsibility for the performance of tasks in the common interest.

This vision of a European Community as a cooperative endeavour to bring peace and prosperity to this Continent was one that was deeply held and vigorously championed by Konstantinos G. Karamanlis. He was the driving force behind the accession in 1981 of this country to what was then the European Economic Community –an accession which consolidated Greece’s transition to a stable and vibrant democracy. It is therefore very appropriate that this conference is dedicated to commemorating both anniversaries, the 50th anniversary of the Treaty of Rome, and the 100th anniversary of the birth of Konstantinos G. Karamanlis. I am delighted to participate in this event and address this distinguished audience.

Over the past 25 years, the evolution of the European Union and the transformation of Greece have been impressive. The European Union has taken unprecedented steps towards deepening and broadening its integration. Today, the Union comprises 27 Member States and has created a zone of peace, stability and prosperity for 495 million Europeans. A truly historic milestone with far-reaching monetary, but also economic and political, implications was the establishment of monetary union in 1999 and the creation of the single currency, the euro.

Over the same period, since Greece’s accession to the Community, its economy and society have changed significantly. In the economic sphere, structural change – including financial deregulation, market liberalisation and greater openness – has contributed to increased efficiency. Macroeconomic stability has progressively improved. In 2001, Greece adopted the euro as its currency. As a consequence of the substantial economic adjustment – nominal and real – required for participation in the euro area and as a result of the benefits entailed by the adoption of the single currency, the performance of the Greek economy has improved markedly. In recent years, fiscal consolidation and structural reforms have been further enhancing the economy’s efficiency and stability. Today, Greece can take pride in a thriving and dynamic economy – with rising living standards – although a number of important challenges still lie ahead. Some of these challenges are partly linked to the adoption of the euro, which entails benefits and opportunities but also implies constraints on economic policy and the functioning of the economy. These constraints must be fully understood and taken into account to ensure sustained growth and a continued rise in living standards.

An important consequence of a country's participation in monetary union is the surrender of monetary sovereignty to the European institution responsible for the conduct of the single monetary policy. This means that monetary policy cannot be conducted at the national level any longer, but is now the responsibility of the European Central Bank, which formulates the single monetary policy for the euro area as a whole.

In my contribution to this conference on the future challenges for Europe, I will address two issues which are fundamental to the long-term performance of the European economy and the prosperity of European citizens:

- the first concerns the necessary conditions and policies that can ensure in the long run the stability and credibility of the euro as a "currency without a state";
- the second relates to certain challenges that must be met so that the euro area economy will enhance its potential for higher sustained growth and that the national economies will fully reap the benefits from their participation in a monetary union in which inevitably the single monetary policy is conducted for the euro area as a whole.

II. The institutional and policy framework for Economic and Monetary Union in Europe

Friends from outside Europe occasionally raise – understandably, I would say – rather fundamental questions concerning the construction of European monetary union. Is a single currency for 13 – soon to become 15 – otherwise sovereign countries really a viable construction? There is a European Central Bank that formulates and implements a single monetary policy for the euro area as a whole, but there is no United States of Europe – or whatever we may wish to call a European political entity that would resemble a nation-state. Can a "currency without a state" really be solid and credible in the long run?

The success of the euro during the first eight years of its existence has demonstrated that we have found some robust answers to this question: First, the very design of Economic and Monetary Union took into account the dichotomy between, on the one hand, a supranational single monetary policy and, on the other hand, economic policies – such as fiscal, structural or employment policies – which have remained the responsibility of the member countries. How have we taken this into account? By creating appropriate institutions. "Nothing is possible without humans, but nothing is lasting without institutions", Jean Monnet observed with great prescience back in the 1950s. Solid and appropriately designed institutions are indispensable. But additional ingredients are necessary for the successful and sustained performance of monetary union. The second essential condition pertains to the policy framework which should include: clear policy objectives, intelligent and enforceable rules, effective policy instruments appropriately assigned to objectives, and credible commitment to objectives and rules.

For the monetary union pillar of EMU, the independence of the ECB, which is enshrined in the Treaty and safeguarded by the public's support, and the clear unambiguous orientation of monetary policy to the preservation of price stability are the core elements of the institutional set-up and our monetary policy framework. These elements are solid and well-founded regardless of alternative views occasionally expressed. This institutional arrangement is functioning well, it is delivering price stability and favourable financing conditions and, as a result, it is making an ongoing contribution to sustainable economic growth and job creation in Europe. Not only have inflation rates been on average in line with the ECB's definition of price stability, namely an inflation rate close to, but less than, 2%, but medium and long-term inflation expectations have also remained firmly anchored to our definition of price stability. These facts show that the markets and the public have confidence in the euro and in the ability and determination of the ECB to maintain price stability.

Beyond the well-designed institutions for monetary union, the ECB's monetary policy strategy and the actual conduct of policy have played an important role in the attainment of our price stability objective and the effective functioning of monetary union. The forward-looking, medium-term orientation of this strategy and its analytical framework, employing both economic and monetary analyses and all available pertinent information, has helped provide a comprehensive assessment of the outlook for and the risks to price stability and thus a solid basis for monetary policy decision-making. Moreover, transparent communication has enhanced the understanding, effectiveness and credibility of monetary policy throughout the euro area. Ultimately, the effectiveness and credibility of the single monetary policy will depend on the consistency of objectives, words and actions and on its ability to maintain price stability, in line with its objective, over the medium and long term.

It is, therefore, with a degree of "parental pride" that we at the ECB look upon the first eight years of the single currency. While we are fully aware of the policy challenges that may lie ahead, we can be confident in the light of what has been achieved so far. The euro has been a success – and this fact has not been lost in a number of EU countries still outside the euro area, which have been attracted by the benefits of sharing the single currency. Last January, we welcomed Slovenia as the thirteenth member of monetary union, and in less than six months from now, Cyprus and Malta, too, will be adopting the euro as their currency.

The credibility of the euro is reflected in its attractiveness which extends beyond the boundaries of the European Union. The euro is being used by many economic agents outside the euro area –private individuals, corporations, investors and financial market participants, traders as well as public authorities –as a store of value, means of payment and medium of exchange. It has become the second most widely used international currency in the world. The ECB has been collecting data about the international role of the euro since 1999, and the observed developments are indeed impressive: at the end of 2006, over 30% of all international debt securities were denominated in euro, testifying to the euro's role as a financing currency; 40 countries have exchange rate regimes linked to the euro, demonstrating its role as anchor currency; and over 25% of global foreign exchange reserves are held in euro – and we have to bear in mind that not all countries disclose such figures. These are just a few statistics. The point I want to make is the following: when economic agents outside the euro area choose the euro as their preferred currency, this testifies to the trust they place in its stability and credibility. We see this trust as a sign of distinction for the euro. At the same time, we consider the global use of the euro as a market-driven process. Therefore, the ECB takes a "neutral" view on the international role of the euro: it neither hinders nor encourages its global use.

What about the economic pillar of EMU? The effective functioning of institutions and the credible implementation of national economic policies are essential. In order to support the conduct of the single monetary policy and the smooth functioning of the monetary union, in order to ensure and better coordinate the implementation of sound, sustainable and consistent national fiscal policies, and in order to foster higher output and employment growth, an economic policy framework is necessary. This consists of a set of institutions as well as of common policy orientations, rules and procedures which have been put in place. These include the Stability and Growth Pact, the Broad Economic Policy Guidelines and the Lisbon agenda. Has this framework delivered results? On this front, the past record has been somewhat mixed, but in recent years there have been positive developments and the prospects are improving. Substantial progress has been made towards a more efficient European economy and the increase in employment has been impressive since the launch of the common currency. Nevertheless, we also have to admit that productivity and economic growth over the past decade have not been as strong as we would have liked – especially in comparison with the United States.

III. The challenges for economic policies in Europe

Currently, the euro area economy enjoys a solid and broad-based recovery and growth is expected to remain robust in the coming quarters. There are two key economic policy issues concerning the long-term performance of the euro area economy that must be effectively addressed. First, how to raise the potential for higher sustained non-inflationary growth in the euro area as a whole. Second, how to achieve this in a reasonably balanced way so as to optimise the benefits of all participants in monetary union and preserve its cohesion.

For Europe’s current economic expansion to remain dynamic on a sustainable basis in the increasingly competitive globalised economy, it is essential to further strengthen the two fundamental determinants of long-term growth: labour utilisation and productivity by appropriately influencing the underlying factors that determine the ability of the European economy to achieve increased efficiency and create more employment. In recent years, the rates of growth of both labour utilisation and productivity have increased, but there is room and need for further and sustained gains. Let me briefly elaborate on the prospects and means.

The recent and ongoing upswing in economic activity has been accompanied by a significant and steady increase in employment and a decline in the unemployment rate, which has dropped to the lowest level (7%) since the introduction of the euro in 1999. What is very positive is that these developments also reflect a continued rise in the labour force participation rate and a relatively stable number of hours worked per employed person, following a decline in hours worked in previous years. As a result, the overall rate of labour utilisation has increased and is likely to continue to rise partly in response to the labour market reforms implemented in many euro area countries that have increased the incentives to work and the employment opportunities. Nevertheless, there is clearly scope and need for further improvement in the euro area labour markets. The labour force participation rate and the hours worked per employed person are still relatively low and the unemployment rate is still unacceptably high in comparison with other advanced economies and with the performance of the European labour markets twenty years ago.

The good news that we are witnessing at present a job-creating economic recovery in all euro area countries is accompanied by another encouraging development with a potentially positive impact for sustainably higher longer-term growth: the productivity performance of the euro area has also improved recently. It is, however, too early to say whether this is a temporary or permanent improvement. But we do have evidence that, in certain sectors, and in a number of euro area countries, structural reforms and corporate restructuring have been raising productivity and are contributing to higher potential output growth. Even though more information and analysis are certainly needed in order to reach a firm judgement on the extent to which recent productivity gains represent a structural improvement, I see two conclusions emerging from labour market and productivity developments for the euro area as a whole, and for its member countries: first, the experiences of a number of Member States clearly show that reforms do pay off. And, second, further reforms are undoubtedly necessary in order to foster permanently higher growth in productivity and labour utilisation and thus faster long-term economic growth.

There is growing recognition and consensus on the need for further substantial reforms to address the structural weaknesses of the European economy. Policy-makers in Europe know what their “To Do list” is in this respect. It includes:

1. reforms to strengthen competition in goods and especially in services markets;
2. reforms to increase flexibility and adaptability in labour markets;
3. reforms to improve education (including on-the-job training and lifelong learning), boost research and development, enhance innovation and facilitate the diffusion of technological advances, so as to fully exploit the potential of an increasingly knowledge-based economy;

4. policies and institutions to create a more favourable business climate;

5. reforms to foster integration, competition and innovation in European financial markets, with a special emphasis on venture capital: and

6. reforms to enhance the quality and efficiency of public expenditure and of tax and benefit systems, and of the sustainability of public finances.

To carry out these reforms, the EU governments have set targets and made commitments within a rules-based framework. What is needed now is to honour these commitments and to actually implement what has been agreed. And the current economic upswing in Europe certainly provides a propitious opportunity to press ahead with the necessary reforms, as well as with further fiscal consolidation. After all, there is no better time to reinforce the roof than when the sun is shining!

Moreover, it is also important for the economies of the Member States in the monetary union – where the single monetary policy is geared towards maintaining price stability for the euro area as a whole – to preserve and enhance their competitiveness position. Diverging inflation and competitiveness developments in individual member countries can have an undesirable impact on the performance of the national economies. Given that the single monetary policy cannot – and therefore should not – be used to alleviate the effects of such regional divergences, structural reforms and economic policies in individual countries should be employed to address any country-specific persistent adverse inflation developments or losses of competitiveness.

IV. Concluding remarks

Let me come to a conclusion: we have gathered here in Delphi, the seat of the Delphic oracle. What would the oracle predict for Europe's future? I will not try to guess. Incidentally, Jean Monnet was equally cautious in forecasting the future of the European construction, when he stated that "nobody can say today what will be exactly tomorrow's European structure, because tomorrow's changes, which will be triggered by today's changes, are unpredictable." As was often the case in the past, the Delphic oracle's response might be ambiguous and give rise to different interpretations about the future. There are, however, two certainties we can count on. First, the inherent dynamics of the European integration process, which Jean Monnet foresaw and Konstantinos Karamanlis championed, are still at work. The Intergovernmental Conference currently underway to elaborate the details of the new Reform Treaty for the European Union is a clear manifestation of this. And, second, whatever the shape of Europe's evolving "ever closer union" in the future may be, the solid foundations of Economic and Monetary Union and the euro – our common currency and symbol of our shared identity – will undoubtedly continue to be core components of our European future.

Thank you very much for your attention.