Gertrude Tumpel-Gugerell: What lies behind the success of the euro?

Speech by Ms Gertrude Tumpel-Gugerell, Member of the Executive Board of the European Central Bank, at the Investmentforum 2011, Salzburg, 21 March 2011.

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Ladies and Gentlemen,

I would like to thank you for inviting me to this event.

It was the Austrian economist Joseph Schumpeter who stated that "a nation's monetary system is a reflection of everything that the nation wants, suffers and is. … Nothing says what a nation is made of so clearly as what it does in terms of its monetary policy."

In the light of this, I would like to explore the ways in which our single currency and our single monetary policy have contributed significantly to the growth and stability of our economies. Over the last 12 years, the euro has been successful not only at bringing down inflation; it has also served as a defensive buffer during the crisis.

Nevertheless, I would also like to talk about the fact that further efforts are required if we are to safeguard the success of the euro. Efforts are required, particularly on the part of governments, in devising economic and fiscal frameworks, which are of the essence to the single currency. However, efforts are also necessary on the part of financial market participants and supervisors, given that the maintenance of financial market stability is a crucial prerequisite for monetary and macroeconomic stability.

When it was first launched in 1999 and then when the euro cash changeover took place in 2002, the euro was met with a certain degree of criticism and scepticism. Today, the euro is the single currency for 17 countries, with a total population of 330 million citizens. The euro has proved to be a resounding success. Given that the average rate of inflation in the euro area for the first 12 years of the currency's existence stands at just below 2% (show chart), the euro is as stable as the deutschmark or the Austrian Schilling were earlier. And this is the case despite the testing times for monetary policy experienced of late – as evidenced by the recent financial crisis and the earlier turmoil in oil and commodity prices (for example, oil prices reached a peak of USD 145 per barrel). Even by international standards, the euro fares well. Indeed, the regional differences within the euro area in terms of rates of inflation and growth are more or less comparable with regional differences observed in the United States. Furthermore, the euro has established itself as the second international reserve currency behind the US dollar, and investors trust the euro when investing in euro-denominated financial products.

I would like to take this opportunity to:

- provide you with an insight into our current of the current economic situation;
- explain how the single currency has contributed towards the management of the financial market crisis;
- offer you an overview of the financial market reforms in the European Union;
- outline what is still to be done to guarantee the stability of the euro over the long-term horizon.

Assessment of the economic situation of the euro area

Allow me to first explain the ECB's current assessment of the economic outlook from a monetary policy perspective. As regards the economic situation of the euro area, there are a number of positive signals. The economy is following an upward trajectory (show chart). Since its trough in the second quarter of 2009, the economy has made up close to half of its recession-induced production losses. The relatively low rate of growth observed until now is in line with experiences of other economies recovering from severe financial crises. A peculiarity of the current recovery in comparison with previous upturns is the relatively low contribution to growth stemming from consumer spending. However, in this area to, there are some positive signals. As regards private households, the labour market situation is stabilising, which should boost consumers' purchasing power and, by extension, domestic demand. The impact of the crisis weighed more strongly on the number of hours worked than on the number of employed. That is why the rebound in economic activity is also making itself felt more in the number of hours worked than in the rate of unemployment, although the latter has been hovering around 10%.

In the near future, all available forecasts indicate that the gradual recovery of economic activity in the euro area is likely to continue. According to the most recent projections of ECB staff (table), the real economic growth rate is expected to stand at between 1.3% and 2.1% this year and between 0.8% and 2.8% next year. At the same time, the outlook for growth in the area of exports and domestic demand is now predicted to improve. Overall, the most recent economic data confirms that the underlying momentum of economic growth in the euro area is favourable.

However, as regards economic activity and the medium-term risks to price stability, the surge in oil prices is increasing cause for concern (show chart). In the light of heightened geopolitical uncertainties, the price per barrel of the leading North Sea oil, Brent crude, has been ratcheted upwards by around 25% since the beginning of the year, peaking at close to USD 117. Rising oil prices have already had a clearly visible effect on the rate of inflation in the euro area. This stood at 2.4% in February of this year and will hover markedly above 2% in the coming months on the back of persistently elevated oil prices.

Our assessment is that the risks to medium-term price developments are tilted to the upside. In their most recent projections for the euro area, ECB staff see inflation ranging between 2% and 2.6% this year and between 1% and 2.4% next year. It must be stressed, however, that these projections do not take into account the recent oil price hikes and are based on the assumption that wage pressures will remain subdued. The question also remains unanswered as to whether indirect taxes and administered prices stemming from the necessary fiscal consolidation measures of the next few years will rise more sharply than currently anticipated.

Against this background, strong vigilance is, of course, necessary and we are monitoring the situation closely. Should there be any signs of inflationary risks over the medium term, the ECB is ready and determined to take appropriate action in good time.

In summary of our assessment of the current situation, it is safe to assume that the cyclical recovery that is under way stands on sound foundations. The oil price-indiced increase in inflation is being monitored closely. The fact that this view of the overall economic situation is actually rather favourable, ladies and gentlemen, is due not least to the stability of the euro, to a monetary policy stance oriented to stability and to the decisive action undertaken in the financial crisis to stabilise the banking sector. Let me explain this in somewhat greater detail.

The financial crisis as a test of the strength of the euro

The financial crisis has put the euro and the economy of the euro area well and truly to the test. During the financial crisis, the Governing Council of the ECB proved its capacity to take the necessary steps in a timely manner and its readiness to contribute positively to financial stability.

The speedy intervention of the ECB made it possible to prevent the liquidity and confidence crises from spiralling into a systemic crisis. The ECB responded immediately – as early as

9 August 2007 – to the tensions that suddenly emerged in the money markets. Ever since, the Eurosystem has bolstered stability in the interbank market through extensive liquidity provision. Within the space of only seven months, the ECB lowered its key interest rate by 325 basis points to just 1% (show chart). In order to provide further support to financing conditions and the provision of liquidity to the banking system, the Eurosystem has implemented a string of temporary non-standard measures over the past two and a half years.

The financial crisis soon made evident that monetary policy is only able to achieve its goals if also economic and financial policies at the national level live up to their responsibilities. A large number of governments adopted sizeable measures to strengthen the capital bases in, and guarantees for, the financial sector, as well as economic stabilisation measures to curb the real economic downturn. Together with the stabilisation packages put in place by the governments, the non-standard measures of the ECB have had a stabilising effect on both the financial sector and economic activity in the euro area. The concerted efforts have contributed to the financial stability and economic recovery in the euro area.

In recent months, the situation in the money markets of the euro area has improved further. On the whole, banks are requesting significantly less liquidity than before. Since last summer, an ongoing process of normalisation has been observed in interest rate spreads in interbank money markets (EONIA), which have more or less returned to the levels prevailing before the onset of the financial crisis in August 2007. These developments are indicative of the increased trust among banks in the euro area – a development due largely to the decisive action undertaken by the ECB. Looking at other important money markets (such as that of the United States or the United Kingdom), we see that there, too, interest rate spreads have narrowed at a similar rate. Their central banks had likewise intervened in the form of interest rate cuts and extensive non-standard measures.

The government stabilisation measures come at a price, however. In particular, the financial crisis has put public finances under pressure – not only in euro area countries but indeed in all advanced economies. This phenomenon has been most clearly manifested in surging public deficits and government debt ratios (show chart). As a result of the financial crisis, budget deficits in other industrialised countries, such as the United Kingdom, the United States and Japan, have even reached double-digit levels. According to the autumn 2010 economic forecasts of the European Commission, the public deficit for the euro area stood at 6.3% of GDP last year, while a decline to 4.6% of GDP is projected for this year. These figures far exceed the 3% ceiling laid down in the Stability and Growth Pact.

The deterioration of public finances in a number of euro area member States has impacted negatively on investors' confidence in government bonds issued by these countries, and thus to further turbulences in the financial markets. This is also reflected in the sharp increase in the cost of provisions for losses on the government bonds of a number of euro area countries. The additional distortion has not only given rise to further instability in the financial system, but has also had an impact on the ECB's monetary policy action.

Allow me to take a closer look at two of these aspects: the first is the need for a stable financial system and the second relates to the safeguarding of the stability of the euro by way of stability-oriented economic and fiscal policies.

Financial market reforms in the European Union

The financial crisis has highlighted that turbulences in the financial markets can have a massive impact on economic growth. The crisis, which originated in the markets for complex financial instruments, rapidly evolved into a crisis encompassing large parts of the financial sector. This resulted in a decline of lending to households and enterprises, as well as in a drop of 4% in euro area growth in 2009.

Although the causes of the financial crisis are multifaceted and complex, far-reaching reforms that lead to an improved regulatory framework for, and a better supervision of, the financial markets are essential in order to avoid a recurrence of such adverse developments in the future.

There is a general consensus on the necessity of improving the regulatory framework and supervision. The G20 countries were quick in striving for reforms, which have since been elaborated further by the Basel Committee on Banking Supervision and the Financial Stability Board (FSB).

All in all, some progress has already been made in the area of reforms to financial market regulation, with the most notable advance being the agreement reached in the Basel Committee, i.e. “Basel III”. The accord calls for a strong reinforcement of current capital requirements and the liquidity reserves of financial institutions. Even in relation to previously unregulated or lesser regulated financial institutions, such as investment funds and ratings agencies, tentative steps are being taken to improve transparency.

Banks operate internationally, and financial flows have become global in character. Regulatory and supervisory measures, by contrast, are largely taken and coordinated at the national level and fail to take these developments into consideration to an adequate extent. That is why the reforms in the field of financial market supervision are much to be appreciated. The Heads of State or Government have agreed on a new structure for financial supervision in the European Union (EU), with a view to better preventing future financial market disruptions. This three newly established European Supervisory Authorities for banks, insurance companies and financial markets became operational at the beginning of 2011 and are designed to enhance micro-prudential supervision.

However, the financial crisis has not only reminded us of the fact that banks operate on an international scale, but has also taught us that, given close financial interlinkages, disruptive developments within an individual credit institution may have for-reaching consequences for the financial system as a whole. Risks to the financial system as a whole can emanate from individual institutions, but also from specific components of the financial market or from financial instruments used. The identification and surveillance of these systemic implications are a matter of public interest. In Europe, it was with this in mind that the European Systemic Risk Board (ESRB) was established with the mandate to conduct macro-prudential supervision within the EU. Headquartered in Frankfurt am Main, the ESRB is expected to help ensure that we are better able to deal with systemic risks in the future, in particular by giving political decision-makers an earlier warning of systemic risks.

Much has thus been achieved with respect to reforming financial market regulation and supervision since the onset of the financial crisis. But the efforts undertaken in this respect thus far need to be continued. Let me mention just three aspects that I regard as particularly important:

First, the regulatory net needs to be cast wider and wider. The crisis has revealed the significance of systemic risks. If we are to better counter risks of a systemic nature, all systemically relevant financial institutions, markets and infrastructures must be regulated and treated in exactly the same way. This holds particularly true in the event of more stringent regulatory requirements being imposed on the traditional banking sector. Where systemically relevant financial institutions are concerned, it is also essential to continue to investigate whether additional regulatory provisions are needed and how such institutions might contribute to the costs of dealing with a crisis.

Second, greater transparency is required as regards over-the-counter trades and activities in the non-banking sector. Greater transparency would be possible if more financial products were to be traded on central trading platforms, such as stock exchanges, or settled in clearing houses. Given their growing importance, it is particularly crucial for clearing houses to have appropriate risk management schemes in place. Furthermore, the activities of nonbanks must become more transparent. This also includes improving the quality and plausibility of risk assessments by rating agencies.

And third, the banks themselves must be encouraged to undertake reforms and to accept responsibility, in particular, for reviewing their individual corporate governance models as regards risk assessment, incentive structures and compensation.

Safeguarding the future stability of the euro

Ladies and gentlemen, allow me now to turn to the second aspect that is of key importance for the stability of the euro, stability-oriented economic and fiscal policies.

In order to counter the potential systemic implications of the government debt situation in a number of euro area countries in a decisive and timely manner, the Heads of State or Government in the EU have agreed on the establishment of a permanent European Stability Mechanism (ESM) to safeguard fiscal stability in the whole euro. This mechanism will supersede the European Financial Stability Facility (EFSF), which will remain temporarily in place until June 2013. The ESM will be activated when the financial stability of the euro area as a whole is in jeopardy. Member countries in financial distress will receive financial assistance in the form of credit, subject to their fulfilment of strict conditions.

I regard this decision as an important contribution to keeping the financial system stable, and thus to safeguarding the stability of the euro. Nevertheless, the existence of this mechanism should not be seen as an inducement to postpone a correction of the stance of economic policy for too long and to trust in the help of other euro area countries.

In order to prevent this from happening, it is essential that the permanent stabilisation mechanism is underpinned by a fundamental strengthening of the regulatory framework for compliance with fiscal policy objectives and the need for competitiveness. It is thus crucial that the framework for monitoring both the public budgets and economic activity in the euro area is reformed in an effective manner. The Van Rompuy task force and the European Commission have put forward proposals on how improvements can be made in these two areas. The proposals recommend a strengthening of the Stability and Growth Pact. In particular, it is suggested that possible sanctions for member countries with excessive deficits should be imposed sooner than currently foreseen. Next year, an enhanced macroeconomic surveillance framework applicable to the euro area will also be implemented. This comprises the introduction of an early warning mechanism based on a scoreboard of predefined macroeconomic indicators. At the same time, the European Commission will assume responsibility for using these indicators in order to identify potential macroeconomic imbalances and excesses, and then reporting thereon to the political authorities.

The ECB is of the opinion that the current reform efforts in both areas are not sufficiently extensive. In fact, the Governing Council of the ECB considers that while the proposals tabled by the European Commission may indeed go some way towards improving macroeconomic and fiscal surveillance in the euro area, they fall short of the quantum leap forward that is needed in the surveillance of the euro area and in order to guarantee the smooth functioning of Economic and Monetary Union. As regards fiscal surveillance, greater automaticity of procedure and the definition of clear and binding regulations for reducing debt ratios are required. In terms of macroeconomic surveillance, clearly defined sanctions are necessary. Efforts must focus more clearly on the most vulnerable countries (those which have suffered from losses in competitiveness), in order to ensure the sustainable effectiveness of the latest framework. Moreover, the procedure requires more transparent and more effective trigger mechanisms. In the future, the stability of the euro, the stability of the financial system and sound economic and financial policies will need to be viewed as inseparable from one another. The Monetary Union was designed to be an economic and monetary union. What we need now is also the second pillar.

The ECB has done what it can by pursuing a stability-oriented monetary policy, by keeping the value of money stable and by providing for crisis-related liquidity needs. The other policy domains mentioned are now called upon to shoulder their part of the burden and safeguard the stability of both the financial system and the single currency over the long term.

A single market and a common currency also demand well-coordinated economic and fiscal policies. This calls for clear rules and mechanisms for monitoring these policies.

Allow me to now briefly discuss the three key areas which I consider to be vital to the long-term success of the euro. These elements are: a sound fiscal policy, sustainable economic growth and a stable financial system.

1. Sound fiscal policy

The soundness of public finances was to be guaranteed by the Stability and Growth Pact. Unfortunately, however, the rules of the Pact have been ignored all too often – even prior to the financial crisis. For this reason, it is imperative that, first, fiscal consolidation efforts at the European level comply with the rules of the Stability and Growth Pact. Second, the foundations of the Stability and Growth Pact are in need of reinforcement.

2. Sustainable economic growth

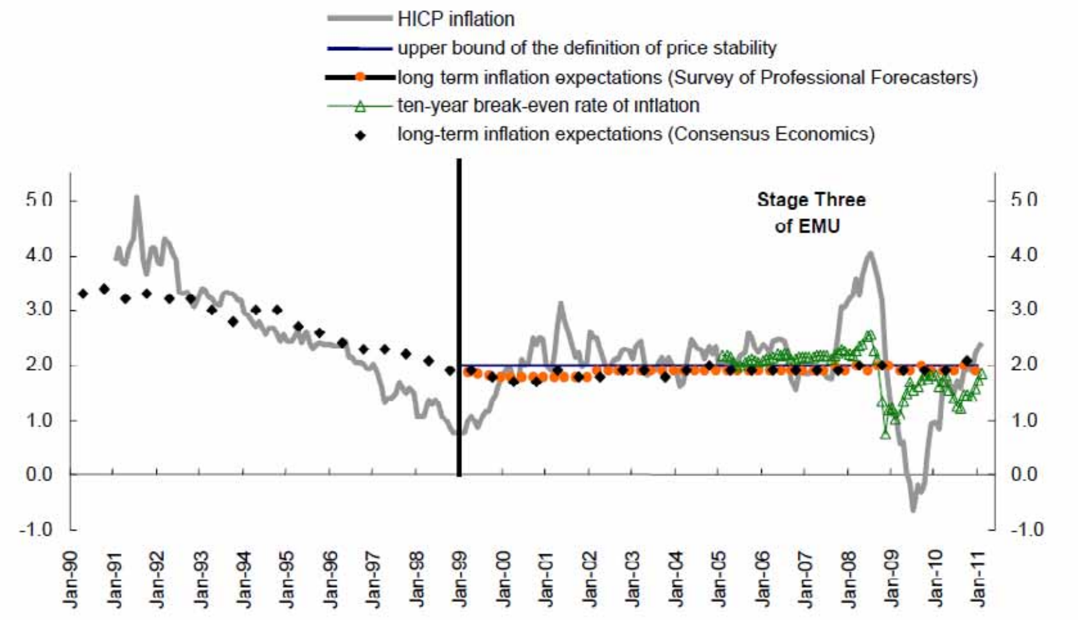
Stable prices are a precondition to sustainable growth and the generation of employment. Equally important is the competitiveness of euro area member counties. In some euro area countries, excessive increases in unit labour costs and current account imbalances have caused their competitiveness to decline significantly over the past few years. This meant that some countries were in a position where they were unable to respond to the crisis with the degree of flexibility required, which resulted in weakening economic and productivity growth and a surge in unemployment. To combat this, economic reforms that foster growth and employment on a sustainable basis are essential. Such reforms should be directed at increasing competitiveness. To this end, flexible labour and product markets are required, as well as long-term projects to enhance infrastructure and competitiveness and, above all, the promotion of innovation through investment in training and research.

3. A stable financial system

The financial crisis has illustrated the significance of systemic risks. It has made clear that the procedures in place for assessing threats – stemming from the proliferation of individual, mutually reinforcing, risks of relevance to the stability of the financial system or the real economy as a whole – were inadequate. The governments and central banks have both contributed to stabilising the financial system. Its lasting stabilisation, however, calls for institutional reforms that lead to a better regulation and supervision. In addition, it is essential that consideration be given to the question as to how the private sector itself might be able to better protect itself against the consequences of a financial crisis, in order to create stronger incentives for risk awareness and a longer-term perspective in economic activities undertaken in the financial sector.

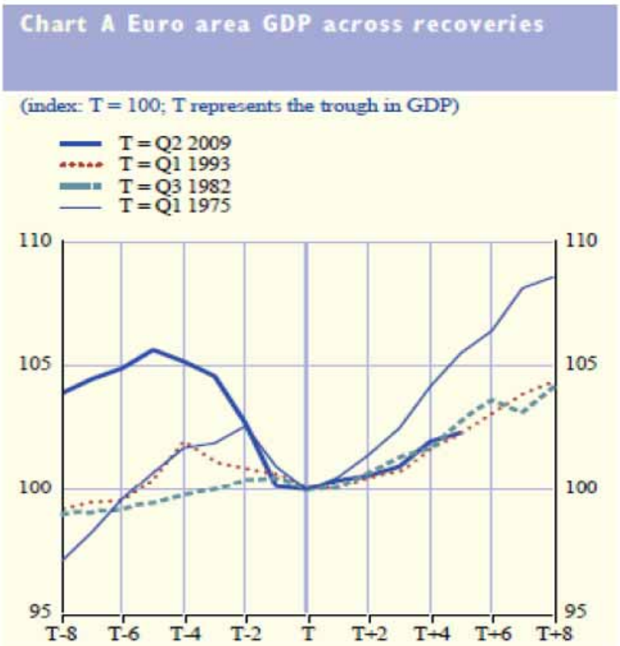
Ladies and gentlemen, over the past 12 years, the euro has contributed significantly to Europe's economic sustainability and stability. If we succeed in implementing the necessary reforms in a decisive manner, then the ECB will be able to guarantee the long-term stability of the euro. I am confident that the success story of the euro will endure, to the benefit of all EU citizens.

Inflation and inflation expectations in the euro area



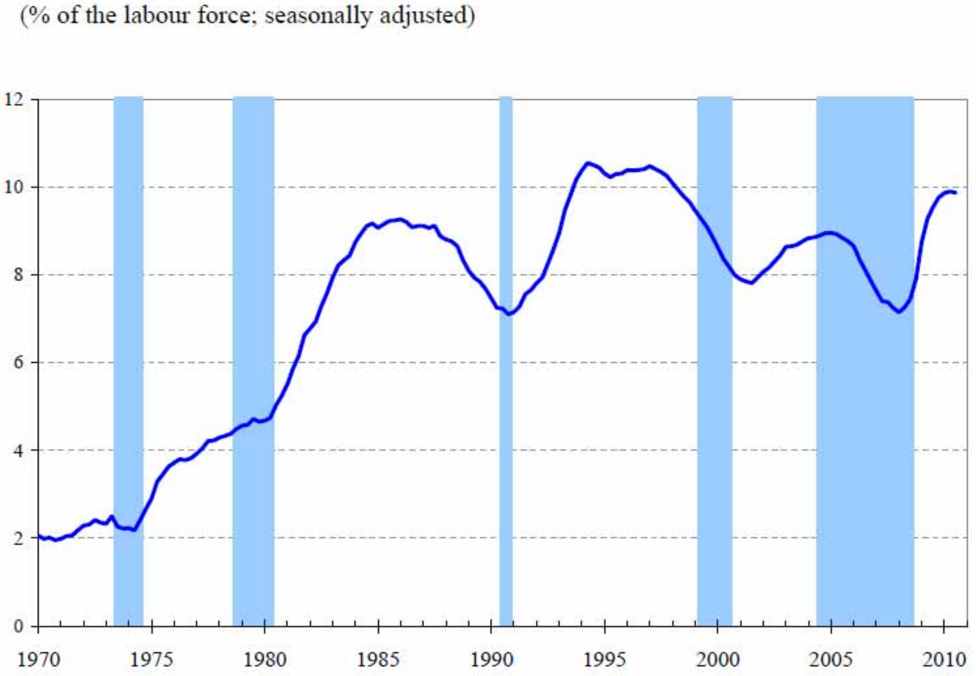
Sources: ECB, Eurostat and Consensus Economics.

Economic recovery in the euro area



Sources: Eurostat, AWM database and ECB staff calculations.

Unemployment in the euro area



Source: OECD.

Macroeconomic projections from ECB staff

Table A Macroeconomic projections for the euro area

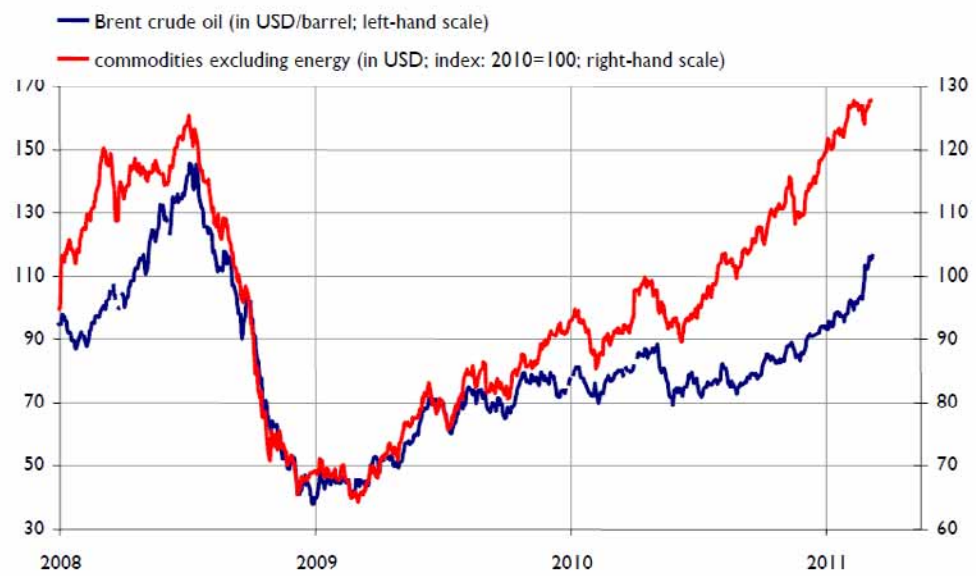
(average annual percentage changes)[1), 2)]

	2010	2011	2012
HICP	1.6	2.0 – 2.6	1.0 – 2.4
Real GDP	1.7	1.3 – 2.1	0.8 – 2.8
Private consumption	0.7	0.6 – 1.4	0.4 – 2.2
Government consumption	0.8	-0.3 – 0.5	-0.5 – 0.9
Gross fixed capital formation	-0.8	0.4 – 3.4	0.7 – 5.5
Exports (goods and services)	10.9	4.9 – 9.5	3.0 – 9.2
Imports (goods and services)	9.0	3.5 – 7.7	2.8 – 8.4

1) The projections for real GDP and its components are based on working day-adjusted data. The projections for imports and exports include intra-euro area trade.

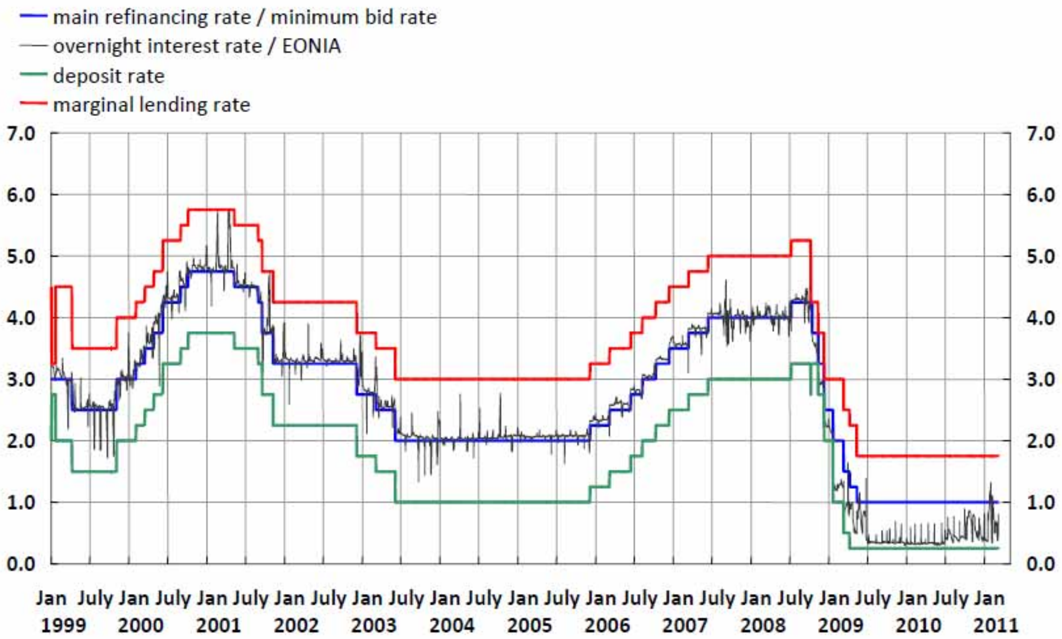
2) The data refer to the euro area including Estonia, except for the HICP data in 2010. The average annual percentage change for the HICP in 2011 is based on a euro area composition in 2010 that already includes Estonia.

Oil price developments



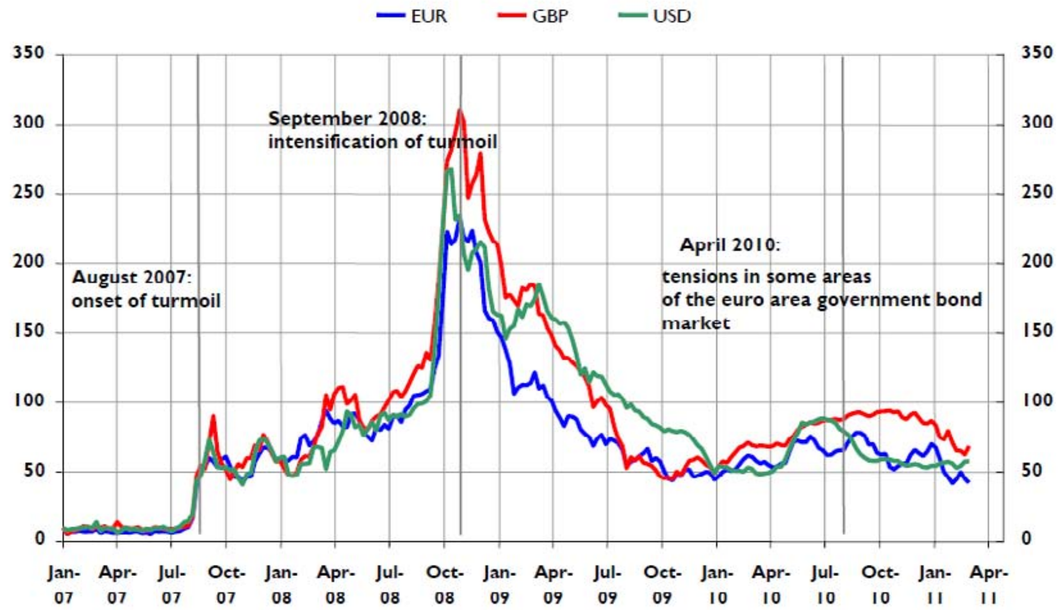
Sources: Bloomberg and HWWI.

Central bank interest rates in the euro area



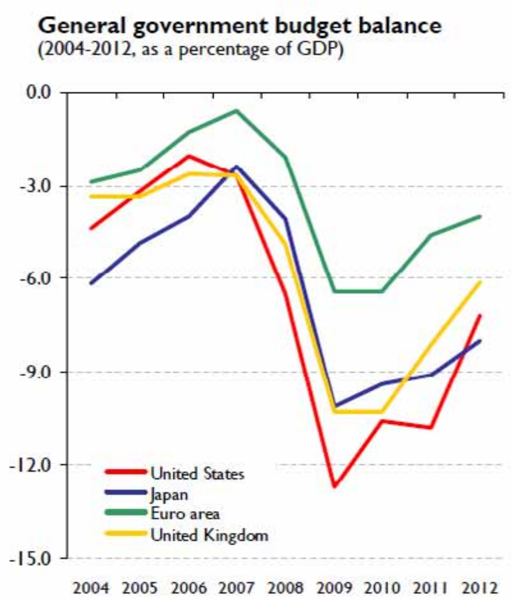
Source: ECB.

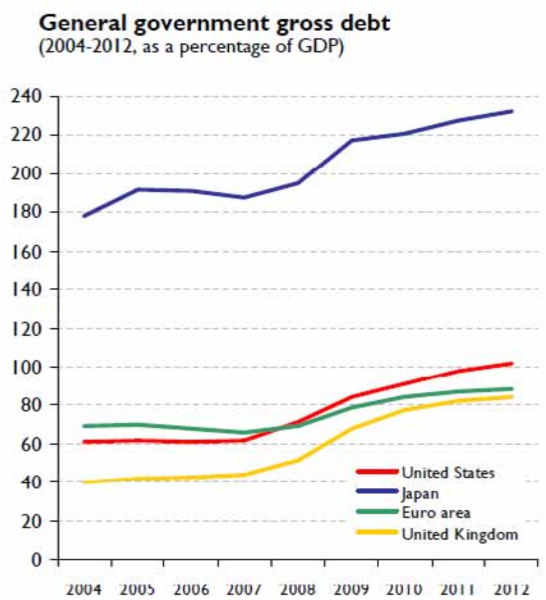
Interest rate spreads in interbank trading



Source: Bloomberg.

Public deficits and government debt ratios





Sources: IMF Fiscal Monitor, update January 2011.