Christian Noyer: France, Europe, the euro and the ECB

Speech by Mr Christian Noyer, Vice-President of the European Central Bank, at the University of Nantes, 22 March 2002.

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Introduction

Ladies and gentlemen,

I should like to begin by expressing my pleasure at being invited here to talk about the euro, the ECB and the single monetary policy in the first three years of Stage Three of European Economic and Monetary Union (EMU).

The primary objective of the ECB

The Treaty establishing the European Community assigned to the single monetary policy the maintenance of price stability in the euro area as its primary objective. Monetary policy can only pursue one primary objective. The participating national central banks have long held the belief, resulting from years of experience, that it is with the credible and lasting maintenance of price stability that the single monetary policy can best contribute to sustained long-run economic growth, employment creation and better standards of living. Asking monetary policy to do more, or to serve other purposes, risks creating illusions about what monetary policy can do. The events of the 1970s, in particular, demonstrated that when a central bank aims at boosting real activity by implementing an excessively expansionary monetary policy, it faces higher inflation and risks of financial instability. Due to the need for a disinflation process afterwards, the long-run disadvantages of such an expansionary policy in terms of output and employment losses turn out always to be much higher than the immediate advantages in terms of the transitory growth push.

Price stability, on the contrary, contributes to the efficient allocation of the economy's resources by enhancing the transparency of the price mechanism and by preventing both tax distortions and an individual misallocation of savings and wealth. Moreover, by neutralising the need to hedge against inflation and in particular by minimising the inflation risk premium in long-term interest rates, price stability contributes to the channelling of real resources towards production and investment. Thus it favours economic and employment growth.

For the purposes of supporting and safeguarding the pursuit of price stability, the Treaty has endowed the ECB with a high degree of institutional independence. At the same time, to ensure transparency and accountability in the ECB's policy design and implementation, the Treaty has also imposed certain reporting requirements on the ECB. The ECB has, in fact, exceeded these, thereby setting very high standards. Monetary policy decisions are regularly explained in the press conference given by the President and myself after the first meeting of the ECB Governing Council every month, in the Monthly Bulletin of the ECB, in the speeches given by members of the Governing Council and in the testimonies of the President and other Board members to the European Parliament.

Key aspects of the ECB's monetary policy strategy

To achieve its Treaty mandate, the ECB has designed a medium term-oriented monetary policy strategy.

To enhance clarity, to anchor expectations and to offer a yardstick against which the ECB can be held accountable, the Governing Council of the ECB provided a numerical definition of price stability as "a year-on-year increase in the Harmonised Index of Consumer Prices (HICP) for the euro area of below 2%". This is very close to the objectives of most participating national central banks before the start of Stage Three of Economic and Monetary Union (EMU). The Banque de France, for example, in 1998 had defined price stability as consumer price inflation "not exceeding 2%".

The Governing Council also emphasised that price stability has to be maintained over the medium term. The focus on the medium term guarantees that an appropriate orientation be imparted to monetary policy. This ensures measured policy reactions to the threats to price stability and prevents unnecessary volatility being introduced into the economy. The medium-term orientation also realistically acknowledges that short-term volatility in prices cannot be controlled by monetary policy and that monetary policy should therefore only be held accountable for price developments over a longer horizon.

The recognition that monetary policy has to cope with an ever changing and imperfectly known world has been a key consideration in the design of the ECB's monetary policy strategy. The Governing Council chose to equip itself with a broad but robust framework for analysing economic developments and shocks, which we call the two pillars of our of monetary policy strategy. Given the long-term monetary nature of inflation, the first pillar assigns a prominent role to money. This implies the use of monetary analyses and of models in which monetary aggregates play an important role in analysing risks to price stability. In parallel, the second pillar ensures that other forms of analysis and models, such as the investigation of the interplay between supply and demand as well as cost-push dynamics, are incorporated into the analysis of price developments. Together, the two pillars ensure a comprehensive assessment of the economic situation and allow a focus on the nature of the shocks hitting the euro area, thereby providing adequate guidance to the policy process.

Can one size fit all?

The ECB's definition of price stability should be seen as a quantification of the ECB's primary objective, which applies to the euro area as a whole. This implies that for the single monetary policy to be considered successful in fulfilling its primary objective only aggregate developments matter. The euro area countries need not and will not always exhibit similar price developments. In the same way as the maintenance of price stability within a single country is consistent with divergences in the rate of price change among different regions and cities, price stability in the euro area is generally in line with inflation differentials among individual member countries. Indeed, studies of price differentials between major US cities show that these differentials are at least as large and sometimes even larger than between countries of the euro area.

Whether such differentials are a cause for concern depends on their source. Inflation differentials which result from what in public debates is often quoted as "a catching-up process", as illustrated by the Balassa-Samuelson theory, should be seen as part of a normal process of adjustment consistent with a well-functioning economy. Thus they are not a cause for concern. A catching-up process may start when the level of productivity – and thus of per capita income – of a country in the monetary union is (much) lower than the other participating economies. When some of its productive sectors, notably the traded goods sectors, become exposed to international competition, this country typically goes through a transitional, catching-up period when it may experience in the same sectors productivity growth faster than that attained by more mature participating countries. This catching-up process may, in turn, lead to faster price increases if the productivity growth the country gained in tradables is not matched by a similar productivity growth in its non-tradable sectors, as wages in tradables and non-tradables tend to converge. In the euro area, the impact of pure catching-up effects on the price level is likely to be minor as a substantial process of convergence in per capita income has already taken place over the last few decades.

However, when inflation differentials arise from excessive wage increases, unsustainable expansion of profit margins or an expansionary stance in fiscal policy, the situation may become a cause for concern. Each of these factors, in fact, may well lead to losses in competitiveness and, eventually, to losses in output and employment growth. These are, however, problems that the single monetary policy is not in a position to address. It is the task of national economic policies to avoid and to counteract such situations. I will come back to these issues later.

Inflation differentials may also be induced by economic or policy shocks which affect the euro area countries and regions in different ways and at different times. Also, local economies may respond dissimilarly to a common shock because of their individual economic structures.

Especially in the run-up to Stage Three of EMU, the quantitative relevance of asymmetric shocks has attracted a lot of attention both among analysts and among economic observers. The economic framework they had in mind, known as the optimum currency area theory, predicts that the creation of a common monetary area becomes more costly the more the participating countries experience idiosyncratic shocks, in terms of size, nature and frequency, and the more varied their responses to such shocks are. While asymmetric shocks and adjustment mechanisms have to be recognised as realities, they also have to be seen in a more general framework, within which all gains from Stage

Three of EMU are taken into account. These gains are sizeable. From a political point of view, monetary unification, as part of a more general process of European integration, should be seen as bringing long-lasting peace and a higher level of co-operation between participating countries. From an economic point of view, monetary unification should be seen as bringing greater prosperity and stability. There is no doubt in fact that Stage Three of EMU has, and will have, a net positive impact on France and all other participating countries.

It is, however, worth examining its potential effects resulting from asymmetries. To what extent do these asymmetries still exist and are they a concern? One useful way of approaching this problem is to compare the euro area with the United States. The US appears to be a fairly natural benchmark. Its economy is similar in several ways to that of the euro area, not least in the size of its economy and population. One line suggested by this approach is to compare the degree of synchronisation of economic activity among euro area countries with that of US states or regions. One interesting finding that emerges from the empirical literature is that asynchronous fluctuations also take place in the US. We therefore should not be surprised to observe a similar fact in the euro area. However, the evidence resulting from several studies carried out in the past few years points unambiguously to a higher degree of co-movement in the US than in the euro area. Yet, most studies have also found a high and increasing degree of synchronisation within the euro area, not only over a longer period of time, but also in more recent years. This degree of convergence appears to be approaching the levels recorded in the US. Similar conclusions can be reached with reference to analyses which estimate the differentiated impact of asymmetric shocks and the resulting adjustment.

These findings appear to contrast with the more diversified production structure of several euro area countries compared with that of states in the US. However, this evidence is the result of the combination of two factors: the distribution of shocks and the resulting country-specific adjustment processes to the shocks. The relative impact of these two forces across countries in Europe is unclear.

In addition to this evidence, it can been argued that analysing the evolution of the euro area economies only over the years preceding monetary union in order to gain insights into likely future developments can be misleading. Indeed, their entry into a currency union may well have fostered economic integration, enhanced intra-area trade and, with the increased interdependence, raised the degree of synchronisation of the participating countries' macroeconomic fluctuations. In addition, the adoption of the same currency eliminated one source of major external instability which affected euro area economies in the past, namely exchange rate shocks of significant magnitude. Moreover, higher synchronisation will follow from closer trade links. The adoption of a common currency, in fact, promotes trade among members of the Union by eliminating exchange rate risk and diminishing transaction costs.

In theory, an increase in trade among two or more countries could also have the opposite effect, which is to increase the divergence of business cycles. This could happen, for instance, if closer integration and trade induce a higher degree of specialisation, with the consequence that production structures will become more heterogeneous across countries, making them more vulnerable to idiosyncratic shocks. The question of which effect prevails is mainly an empirical one, as both are plausible. The evidence for the euro area so far appears to suggest that the more countries are integrated and the more they trade with each other, the more correlated the respective business cycles will be.

At the present stage, it is too early to estimate the effect of Stage Three of EMU on reducing the severity of asymmetric shocks and on increasing business cycle synchronisation among participating countries. While this impact is likely to be taking place already, the period of time needed for its full effect to develop is very uncertain.

Although useful lessons can be gained from a comparison with the US, these should not be over-emphasised. As a matter of fact, some important differences between the euro area and the US can also be identified. In the US, for example, the importance of stock markets is higher, and these markets can represent a mechanism amplifying the impact of shocks in the real economy. Moreover, evidence has been found that in the US the adjustment to asymmetric shocks is faster than in the euro area, largely because of the latter's lower mobility of capital and labour. In particular, labour mobility, which is one of the most important adjustment mechanisms in the US, is often found to be much lower in the euro area. While this is partly offset by the increased mobility of capital, which has been enhanced by the creation of the Single Market in Europe, in many euro area countries labour still remains too immobile.

A currency union needs flexible markets

When labour mobility is low, the efficient response to economic shocks having asymmetrical effects on euro area countries requires prompt adjustments in prices and wages at local levels. Flexibility in price and wage setting is therefore particularly crucial for the euro area. More precisely, an increased flexibility would allow regions or national economies to adjust more rapidly and smoothly to shocks affecting particular sectors. We should always bear in mind, moreover, that our economies operate in an increasingly competitive global environment requiring ever more frequent adjustments, particularly in some sectors.

For these and many other reasons, structural reforms aimed at increasing mobility, boosting competition and reducing rigidities and distortions in goods, service and labour markets are needed in the euro area.

In product markets, some progress has been made over the past few years. These markets have become more integrated and some sectors, such as the network industries, are being liberalised. The adoption of the European Company Statute by the Council of Ministers, for example, is a step in the right direction. This Statute allows for, and regulates, the creation of firms operating on an EU-wide basis and being governed by Community law. Another ambitious reform is the liberalisation of the EU's postal sector, although its full implementation will take time. Despite these and other encouraging developments, the pace of liberalisation has been uneven across participating countries and more efforts are still needed as several sectors in various areas remain burdened by excessive regulation. These delays act as a brake on the flexibility and competition that is required to improve the long-term sustainable employment and growth prospects.

One area still requiring much attention, as I already mentioned, is the labour market. The potential benefits, in terms of higher aggregate welfare and employment growth, of reforming euro area labour markets are high. Following the reforms implemented in the 1990s, positive effects can already be felt. These include the stronger employment growth and the sharp decline in unemployment rates recorded in the euro area in recent years.

Progress with labour market structural reforms has, however, been very uneven among euro area countries. Indeed, rigidities persist. For example, although the euro area unemployment rate in 2001 stood at 8.5%, survey studies show that companies often had problems in recruiting workers. Such labour mismatches demonstrate that more reforms are needed not only to increase labour supply and demand and improve job creation, but also to increase the likelihood that vacancies be filled and the unemployed find work more quickly. In addition, an unemployment rate still above 8%, low levels of labour force participation and uneven labour market performances across euro area countries clearly indicate that further measures need to be taken. Reforms, in particular, are required to improve job intermediation, to enhance wage flexibility and increase wage differentiation, to improve education and to promote training and life-long learning in order to maintain and develop human capital. Moreover, reforms of the tax and benefit systems, the introduction of less restrictive employment protection, working time flexibility, and measures to increase labour mobility are also needed.

It is also important to keep in mind that these reforms should be carried out in a broader, more systematic and co-ordinated manner across sectors and countries than at present. If the objective is to transform the euro area into the most competitive and dynamic economy in the world, as was decided at the Lisbon European Council in 2000, more efforts are needed.

Challenges for fiscal policy

I would now like to devote my attention to fiscal policy. National fiscal policies in Europe are guided by the budgetary provisions contained in the Maastricht Treaty and in the Stability and Growth Pact. The provisions in the Maastricht Treaty, which limit the levels of government deficit and government debt, have been key to achieving sounder public finances. The Stability and Growth Pact, agreed upon in 1997, introduced the target of a budgetary position close to balance or in surplus as a medium-term objective for Member States.

With monetary policy being conducted for the euro area as a whole, fiscal policy can be an important instrument in the hands of national governments to stabilise domestic demand and output. Disciplined and sound fiscal policies support the ECB's stability-oriented policy by reducing risks to price stability.

The so-called automatic stabilisers are one mechanism which can cushion fluctuations in demand and price developments at national level. Automatic fiscal stabilisers are mechanisms built into tax codes and social legislation. They lead to a timely and symmetrical reaction of the budget policies to economic fluctuations by reducing demand pressures in an economy during periods of strong growth and by supporting the economy in downturns, without requiring further government action.

The full benefits of automatic stabilisers can however only be secured if countries preserve the sustainability of public finances through prudent fiscal positions and low debt. Otherwise, the burden of debt servicing and the risk of excessive deficits limit their ability to let the automatic stabilisers operate. The strategy of attaining and preserving a medium-term position close to balance or in surplus, as required by the Stability and Growth Pact, promotes sustainable public finances and therefore also fully supports the stabilising role of public finances.

Nevertheless, there are considerable doubts about the effectiveness of discretionary fiscal fine-tuning as a way to manage aggregate demand due to the well-know implementation lags and problems of policy reversal.

Let me finally add a few thoughts on the relationship between monetary policy and fiscal policy. The ECB closely monitors fiscal policy since this is one of the main areas where significant shocks to price stability – and also to long-term interest rates – can originate. In fact, many episodes of high inflation in the past were related to a mismanagement of public finances combined with a very accommodating monetary stance. Monetary policy is geared to maintaining price stability over the medium term and to this end it takes fiscal developments into account. The ECB's monetary policy framework however does not envisage any mechanistic reaction to fiscal policy changes.

Moreover, there is no further need to co-ordinate monetary and fiscal policy at euro-area level if all authorities act within the clear, medium-term-oriented policy framework set out in the Maastricht Treaty and the Stability and Growth Pact. As long as participating countries comply with the objectives of this European fiscal framework, their budgetary stance supports a stability-oriented common monetary policy and each of them has the fiscal instruments at its disposal to accommodate asymmetric cyclical fluctuations or temporary shocks.

Some reflections on the first three years of the single monetary policy

I will devote the rest of my speech to an overview of the ECB's experience in the first three years of the single currency.

During this period, the single monetary policy has been challenged by, among other things, fluctuations in economic activity both inside and outside the euro area, by a depreciation of the exchange rate of the euro, and by strong oil and food price rises at various stages. Despite this, forecasters and financial markets have remained confident about the ability of the ECB to achieve its primary objective over the medium term. Surveys on long-term inflation expectations and inflation expectations as embedded in long-term interest rates have invariably been in line with our objective of price stability.

The launch of the euro three years ago and the euro cash changeover this year are two other indisputable achievements of the ECB and its single monetary policy. The changeover was a challenge of unprecedented dimensions and its success went far beyond our own expectations. People in the euro area have been enthusiastic about the currency since the very beginning of the cash changeover.

The euro's arrival in 1999 brought about fundamental changes in the way governments, financial institutions and the private sector operate in the financial markets in the euro area and the rest of the world. Within the euro area, the elimination of exchange rate risks and the lower transaction costs which followed, together with the much more transparent marketplace the euro has brought with it, have been creating new opportunities for business and driven firms towards higher levels of efficiency and competitiveness. The euro has also acted as a catalyst in the process of financial integration by widening and deepening the euro area financial markets. A large, liquid and integrated money market rapidly came into being after 1 January 1999. This in turn triggered a considerable growth in interest rate instruments denominated in euro. On the unsecured money market, the EONIA reference interest rate, which is an interbank overnight rate index collected by the ECB, has established itself as one of the most important, or even the most important, reference rate. The EONIA swap market is now considered the largest overnight swap market in the world. Also in the bond market, the euro played a crucial role in fostering the deeper and more liquid euro area bond market that we see today.

At international level, the euro has become the no. 2 currency. It is the second most widely used reserve currency after the US dollar. The gap between the two currencies is wide. Experience shows, however, that there is a considerable time-lag between a currency becoming important, as reflected by the economic weight of the issuing country or region, and becoming used as an official reserve currency.

As an anchor currency, the euro plays a role in the exchange rate regimes of more than 50 countries outside the euro area. These countries have either opted for very close or even full links to the euro, in some cases unilaterally deciding to use the euro as legal tender, i.e. "euroisation", or they have chosen looser types of anchoring, such as peg arrangements and crawling fluctuation bands.

Conclusion

Let me conclude by considering the challenges that lie ahead. I am referring in particular to the enlargement of the European Union and, subsequently, of the euro area. Currently, 12 countries from central, eastern and southern Europe are negotiating to join the EU. Integrating this large group into the European Union will be an enormous undertaking for all parties involved, not least because of the considerable economic gap between most of these countries and the current Member States. Major efforts will be required. However, we firmly believe that both the current and future EU Member States will benefit significantly over the long term from political and economic integration.

I thank you.